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Chartered Accountant SINGAPORE

Singapore CA Qualification Examination

9 December 2019

Business Value, Governance & Risk

INSTRUCTIONS TO CANDIDATES:

1. The time allowed for this examination paper is **3 hours 15 minutes**.
2. This examination paper has **FOUR (4)** questions and comprises **FIFTEEN (15)** pages (including this instruction sheet). Each question may have **MULTIPLE** parts and **ALL** questions are examinable.
3. This is an open book examination. During the examination, you are allowed to use your laptop and any calculators that comply with the SAC's regulations. Please note that watches, mobile phones, tablets, and all other electronic devices **MUST NOT** be used during the examination.
4. This examination paper is the property of the Singapore Accountancy Commission.

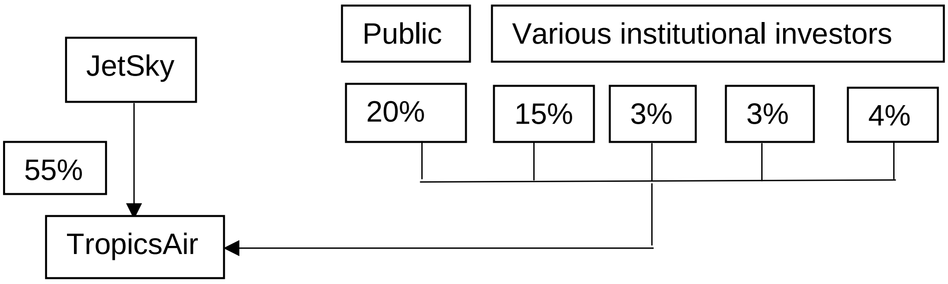
MODULE-SPECIFIC INSTRUCTIONS:

5. This case is hypothetical and has been written exclusively for the purpose of this examination. Names, characters, places and incidents used are imaginary or fictional. Any resemblance to actual events or locales or persons, living or dead, is entirely coincidental. This case is not to be cited without the permission of the Singapore Accountancy Commission.

Background Information on JetSky and TropicsAir

JetSky Ltd (JetSky) and TropicsAir Ltd (TropicsAir) are both in the airline industry and are listed on the Singapore Exchange (SGX). JetSky currently owns 55% of TropicsAir and is its single largest shareholder. There are several other key investors each owning only a few percent of the shares. The rest of the shareholdings are held by individual retail shareholders.

The shareholding structure of TropicsAir is shown as follows:



JetSky is an established global airline player that has won many prestigious global awards consistently over the years. It operates long-haul and short-haul flights and serves both full-service and low-cost segments. Beyond the air passenger business, JetSky is also significantly involved in the air cargo business. It wholly owns an engineering subsidiary that provides maintenance, repair and overhaul services for many international carriers, manufacturers and airports. JetSky and its related entities actively pursue strategic alliances with multiple players across the world.

TropicsAir is an airline which serves short-haul flights in the low-cost segment. It is focused on air passenger services. TropicsAir is much smaller in its operations as compared with JetSky. Some size indicators of JetSky and TropicsAir are as follows:

	JetSky	**TropicsAir**
Fleet (planes)	191	30
Destinations (cities)	93	38
Passengers (thousands)	29,738	6,848

A peer comparison with some benchmark airline competitors for **JetSky** is:

	F-A	**F-C**	**F-Q**
Fleet (planes)	304	212	213
Destinations (cities)	94	109	160
Passengers (thousands)	54,400	35,468	34,213

A peer comparison with some benchmark airline competitors for **TropicsAir** is:

	B-A	**SingWings**
Fleet (planes)	121	71
Destinations (cities)	63	63
Passengers (thousands)	20,738	20,280

TropicsAir occupies a market segment combination that JetSky presently does not operate in. Even though JetSky owns 55% of TropicsAir, TropicsAir is not fully aligned with JetSky's strategic directions and network development. This is because TropicsAir has an independent Board that oversees its strategic and governance matters and takes into account the interests of all stakeholders, including its minority shareholders.

Therefore, there are strong business reasons for JetSky to conduct a takeover offer of TropicsAir by acquiring the remaining 45%. This allows JetSky to make strategic decisions to enhance its overall portfolio of businesses and to optimise routes to increase profitability through the integrated flight connections from major cities to smaller towns and coastal resorts. JetSky may also want to acquire TropicsAir for operational efficiency reasons through economies of scale, to enter new markets, or increase market share.

In considering the takeover decision, JetSky has to particularly note some critical considerations. First, airport licenses need to be applied for by airlines in order to have landing rights to an airport. Airports issuing licences will have to ensure the fair and efficient market conduct by all airport licensees. In fact, there are strict airport competition laws to regulate and promote competition and contestable markets in the airline industry. Second, there are strict labour regulations on the working hours of pilots. For example, a pilot should not exceed 60 duty hours in any 7 consecutive days and a minimum rest period of 10 hours is required.

On TropicsAir's side, as in many other airlines, it faces various important financial considerations in operating its business. A key decision to be made is the leasing versus purchase of aircrafts to expand its fleet – there are both critical capital and maintenance issues to be factored in for the choices made. In addition, the use of debts will increase TropicsAir's financial leverage position which will affect ability to further borrow funds. As a small budget carrier, the hedging of fuel prices is also necessary due to the volatilities.

There have been recent news articles in the past months citing cases of disgruntled airline pilots from TropicsAir over remuneration packages that are not on par with competitor airlines. These articles highlighted the fallout of the first round of negotiations of salaries and benefits between the union and TropicsAir, which led to the resignation of a group of senior pilots. These events had resulted in a squeeze in the schedules of the remaining crew, causing them to work more shifts and operate more flights. As negotiations between management and pilots dragged on, the latest news article even carried a rumour on an impending strike which might cause major flight disruptions to destinations served by TropicsAir.

Board Matters of TropicsAir

TropicsAir's Board is independent of JetSky other than the two nominees from JetSky. The Board of TropicsAir currently has nine members as follows:

Name	Board Role	Brief Background
Mr Tai Ker Er	Chairman and Independent Director	He is a well-known industry captain and has vast experience in various business sectors and has chaired several boards.
Mr Seah Ai Aik	Executive Director and Chief Executive Officer	He joined TropicsAir two years ago. Immediately prior to that, he headed a major business division of JetSky for 15 years and

		he currently still holds 35,000 of JetSky's shares.
Mr Ang Boo Chong	Non-Executive Director (Non-Independent)	He is one of the two nominees of JetSky which can have two seats on TropicsAir's Board since it is the major shareholder.
Ms Bai Cai	Independent Director	She is an accountant with strong audit experience from a well-known big accounting firm.
Mr Chang Un Dae	Non-Executive Director (Non-Independent)	He is a computer expert. He runs a media company in South Korea which provides technology services to TropicsAir.
Ms Doris Tan	Non-Executive Director (Non-Independent)	She is the other nominee of JetSky to TropicsAir's Board.
Mr Edward De Souza	Non-Executive Director (Non-Independent)	He is a significant shareholder of TropicsAir amounting to 8% of shareholdings.
Mr Farid Kumar	Independent Director	He is a prominent top executive in a consumer goods company as well as a respected community leader. He is a lawyer by training and also owns 1% of TropicsAir shareholdings.
Ms Gillian Smith	Non-Executive Director (Non-Independent)	She is the former Vice President of operations at TropicsAir and stepped down last year.

In October 2017, JetSky has expressed its interest to acquire all the remaining shares of TropicsAir in the TropicsAir's Board Meeting. The Directors of TropicsAir held an emergency board meeting to discuss the Board's response should a formal offer for the shares of TropicsAir be made.

Examplify Question Number	Question 1 – (a), (b), (c) and (d):
1	**(a)** Upon receiving the offer from JetSky, TropicsAir decided to form a Board task force comprising Mr Seah Ai Aik, Ms Bai Cai, Mr Farid Kumar and Ms Gillian Smith to evaluate the offer and to work out a proposal to accept or reject the offer. **(i)** Comment on the members' composition of the task force. **(4 marks)** **(ii)** Recommend TWO areas of essential due diligence which the task force should complete. **(4 marks)**
2	**(b)** After the due diligence in part **(a)** above has been completed by the task force, state **key** subsequent compliance proceedings that the Board is expected to take. **(4 marks)**

Examplify Question Number	
	As a listed company, TropicsAir operates in an environment of intense scrutiny and public visibility. Therefore, the recent negative media exposure on its labour-management tension between TropicsAir and its pilots meant that it now finds itself in the public spotlight for the wrong reasons. As the Audit Committee of TropicsAir meets for their quarterly meeting, the news was one of their key agenda items.
3	**(c)** For good corporate governance, discuss which are the stakeholder groups whose influence or interest should be considered by the Audit Committee to ensure good governance and ethical practice in its annual report. **(8 marks)**
	Assume that TropicsAir has not yet been fully acquired by JetSky. The internal audit function of TropicsAir is currently being carried out internally by internal auditors employed by TropicsAir, and reports directly to the Audit Committee of TropicsAir. In this quarterly meeting of the Audit Committee of TropicsAir, another agenda item is to evaluate the proposal by management to outsource this internal audit function to a few tenderers, including the internal audit team of JetSky. Management of TropicsAir has strongly recommended for JetSky to take over the internal audit function of TropicsAir.
4	**(d)** Discuss the factors that should be considered by the Audit Committee in ensuring that the recommendation by TropicsAir's management meets good corporate governance. **(6 marks)** **(Total: 26 marks)**

Examplify Question Number	**Question 2 – (a), (b), (c) and (d):**
5	**(a)** From TropicsAir's perspective, *<u>based on the case facts</u>*, identify and discuss the risks of TropicsAir, before it is fully acquired by JetSky, in these four categories - strategic, operational, financial and compliance. **(6 marks)**
6	**(b)** From TropicsAir's perspective, explain how the risks identified in part **(a)** above will change after it becomes a fully owned subsidiary of JetSky. **(6 marks)**
7	**(c)** From the acquirer's perspective, JetSky will assume different risks as compared to TropicsAir's perspective if it were to acquire TropicsAir. Discuss and evaluate the risks of JetSky from the acquirer's perspective in these four categories - strategic, operational, financial and compliance. **(6 marks)**
8	**(d)** For EACH risk identified in part **(c)** above, provide ONE suggestion on how JetSky can mitigate and manage the risks of managing a larger group after incorporating TropicsAir. **(6 marks)** **(Total: 24 marks)**

On **2 December 2019**, JetSky has announced its interest to acquire another smaller listed airline, SingWings, which is a competitor of TropicsAir. This enables JetSky to strengthen its portfolio strategy through the expansion of its market share in the region and enhance its ability to tap into all key segments.

As an initial step, the Directors of SingWings have decided that SingWings' Chief Financial Officer should determine a preliminary valuation of SingWings based on assumptions made by the Board of Directors which can be used to compare with the current quoted market value and any hostile offer received from a competitor. The Directors of SingWings are keen to equip the Board with sufficient information before any formal offer for the company's shares is made or announced.

Information on SingWings

SingWings is currently listed on the SGX with 5,000 million shares trading at S$3.10 per share at the last close of business. Recent result for SingWings is as follows:

Statement of Profit or Loss
For the year ended 30 November 2019

	S$ million
Revenue	**7,427.1**
Expenditure	
Staff costs	(1,358.2)
Fuel costs	(2,087.2)
Depreciation of property, plant and equipment	(604.2)
Aircraft maintenance and overhauls costs	(409.1)
Commission and incentives	(215.0)
Landing, parking and handling charges	(1,000.5)
Inflight meals	(250.4)
Advertising and sales costs	(151.0)
Property and utilities	(42.5)
Other operating expenses	(486.0)
Total expenditure	**(6,604.1)**
Operating Profit	**823.0**
Finance charges	(52.8)
Profit before taxation	**770.2**
Taxation	(74.4)
Profit after taxation	**695.8**

Valuation assumptions made by the Board of Directors of SingWings

In order to assist with the valuation, the Directors of SingWings have provided the following information and assumptions.

1) Annual growth for the years from 2020 to 2023 is expected as follows:

	Annual Growth (% per annum)
Revenue	3.0%
Expenditure	
Staff costs	2.0%
Fuel costs	3.5%
Aircraft maintenance and overhauls costs	3.0%
Commission and incentives	2.5%
Landing, parking and overhead flying charges	5.0%
Inflight meals	2.0%
Advertising and sales costs	5.0%
Property and utilities	2.0%
Other operating expenses	2.5%
Finance charges	0.0%

2) For year 2024, assume growth in profit after tax is 2% per annum from year 2023 levels, and assume growth continues at 2% per annum for all years thereafter.

3) Annual capital expenditure on new aircraft is expected to be as follows:

2020	**2021**	**2022**	**2023**
S$250m	S$200m	S$150m	S$100m

4) For the years from 2020 to 2023, capital allowances on aircraft are expected to be available at 10% per annum on a reducing balance basis. The tax written down value on SingWings current fleet of aircraft at 1 December 2019 is S$9,000 million. For the purposes for this valuation, assume no other capital allowances are available.

5) For year 2024 and each year thereafter, assume annual capital cash outflow on new aircraft is equal to tax saved on capital allowances cash inflow in that year.

6) Annual corporation tax is expected to remain at 17%.

7) For the years 2020 to 2023, additional working capital, equivalent to 10% of the increase in revenue for that year, will be required. For simplicity, assume that working capital cash flows occur at the end of the year in which the increase in revenue arises.

8) For year 2024, assume the increased working capital requirement is S$25 million per annum which will continue to grow by 2% annually thereafter.

9) Assume the average airline industry price to earnings ratio is currently 19.2 and SingWings' weighted average cost of capital (WACC) is 8.5%.

10) The valuation must be for 100% of SingWings shares.

On 5 December 2019, the Board of Directors of SingWings received a formal offer for all the shares of the company from JetSky in the form of a share for share exchange.

JetSky has formally notified the SGX of the offer for shares and issued a press release to the market.

As a result of the merger, JetSky expects to create synergy of at least S$5,000 million which will increase the equity value of the newly created group.

Terms of JetSky's share for share exchange offer

JetSky is offering **three** JetSky shares for every **two** existing SingWings shares.

Information on JetSky

JetSky is currently listed on the SGX with 20,000 million shares which are trading at S$2.15 per share at the last close of business. JetSky's current quoted equity beta is 1.76. SingWings is listed on the SGX with 5,000 million shares trading at S$3.10 per share at the last close of business.

If JetSky's share swap offer is accepted by the shareholders of SingWings, then the market expects the asset beta for the new group to be the same as JetSky's current asset beta, as JetSky is the acquiring company and is considerably larger than SingWings.

JetSky currently has S$10,000 million of outstanding debt in issue in the form of corporate bonds. SingWings currently has S$2,000 million of long-term debt. The average maturity of JetSky and SingWings corporate bonds is 18 years. The new group is expected to refinance the new group debt immediately to benefit from JetSky's 'AA' credit rating which is higher than SingWings' 'BBB' credit rating.

Market information

Quoted credit spread for corporates in the airline sector are as follows:

Rating	1 year	2 years	3 years	5 years	7 years	10 years	30 years
AAA	18	24	28	33	43	57	79
AA	28	37	43	55	63	75	103
A	53	71	77	91	96	103	137
BBB	67	113	133	153	161	169	207
BB	243	278	290	313	320	337	384
B	462	479	510	537	562	579	637
CCC+	588	624	646	685	715	736	758

Note: The table above is quoted in basis points where 1% = 100 basis points

Additionally, the current yield on Singapore government bonds is 2.75% for all bond maturities.

The current market return on the Singapore equity market portfolio is 5.85% and the Singapore corporate tax rate is expected to be 17% for the foreseeable future.

Examplify Question Number	Question 3 – (a), (b), (c) and (d):
	For all calculations, present all workings and answers in **million Singapore dollars** to the nearest **ONE** decimal point.
9	**(a)** Determine an estimated value of SingWings' shares calculated using the Free Cash Flow to the Firm valuation method. Your valuation should be for 100% of SingWings shares as a single entity so <u>ignore</u> any potential synergy in your calculation. **(17 marks)**
	Assume all other variables remain unchanged.
10	**(b)** Determine the change in the valuation calculated in part **(a)** resulting from: **(i)** an increase in annual revenue growth in the years 2020 to 2023 by another 3% per annum; and **(ii)** an increase in the weighted average cost of capital by 3%. Calculate the change in part **(i)** and **(ii)** separately and provide an explanation for the sensitivity observed in each case. **(8 marks)**
11	**(c)** Calculate the value of all ordinary shares of SingWings using the Market Based P/E Valuation method. **(1 mark)**
12	**(d)** Explain why the valuations calculated in parts **(a)** and **(c)** are different to the current market value of SingWings quoted on the Singapore Stock Exchange. **(2 marks)** **(Total: 28 marks)**

Examplify Question Number	Question 4 – (a) to (f):
	For requirements **(a)** to **(f)**, **assume a value of <u>$3.10</u> per SingWings share in all relevant calculations**.
13	**(a)** JetSky is offering **three** JetSky shares for every **two** existing SingWings shares. Under this share exchange offer proposed by JetSky, calculate the number of new JetSky shares awarded to shareholders in exchange for existing SingWings shares and determine the percentage holding in the newly merged group for JetSky and SingWings shareholders, respectively. **(2 marks)**
14	**(b)** Calculate the expected share price for the newly merged group. Include the synergy created by the merger in your calculation. **(2 marks)**
15	**(c)** Compare the value of JetSky's and SingWings' shareholdings before and after the merger to determine if JetSky's and SingWings' shareholders are likely to benefit financially if the share for share exchange offer is accepted. **(2 marks)**
16	**(d)** On the share for share exchange offer proposed by Jetsky's directors, comment on why the shareholders of Jetsky agreed with the proposal, and whether the shareholders of SingWings will accept the proposal. **(3 marks)**
17	**(e)** Calculate gearing and the weighted average cost of capital of the newly merged group. **(8 marks)**

To avoid breaching competition rules, the Directors of JetSky understand the Competition Commission of Singapore may require the newly merged group to divest a currently profitable business unit of JetSky which operates a popular low-cost airline segment on the same routes as what SingWings currently operates.

This sale is expected to raise a minimum of S$5 million which will be used to repay S$5 million of the newly combined group's debt. The repayment of debt is expected to improve the group's credit rating to 'AAA' in the corporate debt market and reduce the average debt maturity level to 10 years.

Examplify Question Number		
18	**(f)**	Evaluate the impact on gearing and the weighted average cost of capital if the new group uses proceeds from the sale of the subsidiary to reduce its combined debt level and comment on the result. For this requirement, assume there is no change to the share price calculated in part **(b)**.

(5 marks)

(Total: 22 marks)

END OF PAPER