Case Study: ABC Hotel, St Lucia

Key learning outcomes

- Understand the elements and structure of project finance.
- Identify the factors of pre-completion risk, operating risk and market risk.
- Devise and complete a credit risk appraisal.

Background

The bank has been asked to provide a secured construction loan of $30,000,000 in order to construct and operate a five star luxury hotel, at a beach area within 50 minutes travelling time south from Castries. The developers are a special purpose company, established for the project. The developer has appointed a local company, Consultancy (PVT) Limited, to undertake the construction and management of the project. We understand that they have considerable expertise in the construction of deluxe hotels and the hotel company has been closely involved with the design and planning of the hotel. The bank will appoint an independent firm of quantity surveyors to monitor the construction on behalf of the bank, and the monthly reports will be monitored by a leading firm of accountants.

The project

The project comprises a 253 bed, five star hotel located on the coast. The site is located some fifty minutes drive from the capital and covers an area of 8 hectares, bordered by beachfront on the western side and also contains a freshwater lagoon to the south. We understand there are no problems regarding the site, including flooding or any serious underground conditions.

The developer has been granted a lease to the land by the Government for a twenty-year period, with a further four 10 year periods of renewal. The initial rent is $8,560 in the first year, rising to $15,360 in the twentieth year. The lessor has the right to cancel the interest should the land be required for public purpose, but two years notice must be given, together with compensation. Tourism is a major source of foreign exchange earnings and a key generator of employment.

The developers have identified a strong demand for a luxury class resort-based hotel. The demand for hotel rooms is dominated by European travellers (62% of all travellers).

Future hotel supply and demand

In addition to this hotel, there are a number of other hotels in the pipeline, but these are three star properties and the bank's hotel division has identified a projected supply of 1,980 rooms in first class hotel accommodation over the next five years, as follows:

Projects under construction (of which this project comprises 253)	1,809
Approved projects (ie with planning)	904
	2,713
Proposed or "rumoured" projects, but not approved	990
	990
Total	3,703

The demand for hotel accommodation has been identified by the bank's hotel division because maximum occupiers have typically achieved levels well over 90%. Furthermore, there is a growing demand worldwide for luxury resort holidays, particularly in those hotels operated by the leading hotel chains.

Construction

Detailed plans and drawings have yet to be provided, but initial cost appraisals have been examined and the project will cost approximately $41,000,000 or approximately $160,000 per room. The resort will be in the traditional style comprising clusters of rooms with private terraces, together with a full range of facilities.

Operating levels

The bank's hotel division has undertaken thorough on-site research and has taken a conservative view of occupancy and the room rate which reflects the increased competition as a result of the increases in hotel supply. These figures have formed the basis of the valuation figures.

The bank's hotel division have proposed a conservative level of occupancy for the first six years. These figures are:

	1	2	3	4	5	6
Occupancy Average Room	55%	61%	58%	62%	68%	68%
Rate ($)	195	225	245	270	284	298

Valuations

This appraisal considers the intrinsic land value attributable to the site as well as the net completed value of the project on completion. Three sets of valuations have been prepared by independent chartered surveyors.

1 **Land Value**

The consideration paid for the site was $678,645. Two of the valuers provided evidence of recent land transactions, and their opinion of land value ranged between $1,470,000 and $1,860,000. In our view, the value of the land at today's prices is $m1,470,000.

2 **Completed Value of Hotel Resort**

The valuations of the completed project have been based upon the occupancy levels projected by the developer's advisors which are less conservative than the banks. The valuations have been based on a range of capitalisation rates valuation.

3 **Comparison of Valuations**

Based on the Hotel opening on time:

Estate Agent (Castries Office)	$60,000,000
Surveyor (based in location)	$48,070,000
Surveyor (based in Castries)	$45,000,000

	Months													
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**Total**
Land	678													678
Construction	1,824	1,000	1,000	1,800	1,803									7,428
Equipment	200	600	800	800	800	800	800							4,800
Interior Work	150	750	1,000	1,250	1,250	600	600	500	466					6,566
Plumbing/ Treatment Plant	300	1,500	1,000	1,250	1,250	400	400	400	286					6,786
Swimming pool/Lagoon		200	500	500	500	300	300	178						2,478
Landscaping	100		100	300	300	300	300	110						1,510
Marketing & Opening Fees		434			74	388		272		155	974			2,300
Professional Fees	1,667	100	750	1,000	1,000	150	150	150	150	83				5,200
Contingency		230	230	230	230	230	230	230	230	230	230			2,300
Cost Monitoring Fees		24	15	15	15	15	15	15	15	15	24			168
Legals/ Bank Fees		830												830
Feasibility Study	80	64												144
Total Cost excluding Interest	5,000	5,732	5,395	7,145	7,222	3,183	2,795	1,855	1,147	483	1,228			41,189
Equity	5,000	5,732	2,431											13,164
Amount Financed			2,963	7,145	7,222	3,183	2,795	1,855	1,147	483	1,228			28,025
Interest				27	92	159	190	217	236	249	256	270	272	1,974
Loan Balance			2,963	10,136	17,451	20,795	23,781	25,854	27,238	27,971	29,457	29,727	29,999	29,999
Total Project Cost	5,000	10,732	16,127	23,300	30,615	33,959	36,945	39,018	40,402	41,135	42,621	42,891	43,163	43,163

Interest 11% Fixed
Figures in $000

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7
Operating Revenues							
Rooms	9,904	12,674	13,122	15,458	17,802	18,743	19,627
Food	6,348	7,393	7,381	8,284	9,540	10,045	10,518
Beverage							
Food & Bev Other							
Telephone	558	650	649	729	839	883	925
Other Oper Depts	558	650	649	729	839	883	925
Commercial Rentals							
Health and Leisure							
Other income	198	253	262	309	356	374	392
Total Revenue	17,568	21,622	22,065	25,510	29,378	30,931	32,389
Operating Expenses							
Rooms	2,178	2,408	2,362	2,782	3,204	3,373	3,532
Food & Beverage	5,078	5,692	5,535	6,213	7,155	7,534	7,889
Telephone	530	598	584	656	755	795	833
Other Oper Depts	419	487	487	510	587	618	647
Commercial Rentals							
Health & Leisure							
Other Income							
Total Operating Expenses	8,207	9,187	8,969	10,162	11,703	12,322	12,903
Dept Operating Income							
Rooms	7,725	10,266	10,760	12,676	14,597	15,369	16,094
Food & Beverage	1,269	1,700	1,845	2,071	2,385	2,511	2,629
Telephone	27	52	64	72	83	88	92
Other Operating Depts	139	162	162	218	251	265	277
Commercial ReìÙals							
Health & Leisure							
Other Income	198	253	262	309	356	374	392
Gross Operating Income	9,360	12,434	13,095	15,348	17,674	18,609	19,486

Currency: $
Room Count: 253
Inflation: 5.0%

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7
Deducts from Income							
Admin & Gen	1,493	1,794	1,765	2,040	2,350	2,474	2,591
Marketing	878	864	772	892	1,028	1,082	1,133
Property Ops	439	713	882	1,020	1,175	1,237	1,295
Energy	966	1,124	1,103	1,275	1,468	1,546	1,619
Other							
Total Deds from Inc	3,777	4,497	4,523	5,229	6,022	6,341	6,639
Income before Fixed Charges (GDP)	5,583	7,937	8,571	10,118	11,652	12,268	12,846
Fixed Charges							
Management Fee	527	648	661	765	881	927	971
Incentive Mgmt Fee	505	728	791	935	1,077	1,134	1,187
Franchise Fee							
FF&E Reserve	175	432	661	765	881	927	971
Leasehold Rent	9	9	10	10	11	11	12
Insurance							
Rates/Prop Tax	87	108	110	127	146	154	161
Other							
Total Fixed Charges	1,305	1,927	2,235	2,603	2,997	3,156	3,304
Net Oper Inc to D/S	4,278	6,010	6,336	7,514	8,654	9,112	9,541

Currency: $

Hotel: Sensitivity Analysis

Loan (000)	30,000						
Year commencing Jan 1:							
Interest @ 11.0%	3,330	3,300	3,271	3,238	3,128	2,941	2,721
Capital Repayment	0	260	300	1,000	1,700	2,000	2,240
Cash Flow Req'd @ 1:1	3,300	3,560	3,571	4,238	4,828	4,941	4,961
Add Fixed Charges: *							
Management Fee	527	649	662	765	881	928	972
Inc. Mgmt Fee (not included)	506	729	791	935	1,077	1,134	1,188
Franchise Fee	0	0	0	0	0	0	0
Leasehold/Rent	9	9	10	11	11	12	12
FF&E Reserve	176	432	662	765	881	928	972
Insurance	0	0	0	0	0	0	0
Rates/Prop Tax	88	108	110	128	147	155	162
Other	0	0	0	0	0	0	0
GDP Required	4,100	4,758	5,016	5,907	6,749	6,964	7,079
GDP as:							
% Revenue	31.8%	36.7%	38.8%	39.7%	39.7%	39.7%	39.7%
Total Revenue	12,899	12,962	12,911	14,893	17,016	17,557	17,848
Room Revenue **60.6%	7,817	7,854	7,823	9,025	10,311	10,639	10,815
Projected Occupancy %	55.0%	61.0%	58.0%	62.0%	68.0%	68.0%	68.0%
Projected ARR	195.00	225.00	245.00	270.00	283.50	297.60	312.56
Break Even ARR	153.90	139.44	146..07	157.63	164.20	168.96	172.23
Break Even Occupancy %	43.4%	37.8%	34.6%	36.2%	39.4%	38.6%	37.5%

* As per expected results
** Based on stabilised year (ie year 4)

Hotel

Debt Section

Loan (000)	30,000	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
Interest Rate %								
Year Amort Commences	0	1	2	3	4	5	6	7
Begin Loan Bal (000)		30,000	30,000	29,740	29,440	28,440	26,740	24,740
Interest Expenses		3,300	3,300	3,271	3,238	3,128	2,941	2,721
Principal Payment		0	260	300	1,000	1,700	2,000	2,240
Debt Service		3,300	3,560	3,571	4,238	4,828	4,941	4,961
Interest Cash Flow		3,300	3,300	3,271	3,238	3,128	2,941	2,721
Loan Balance (000)		30,000	29,740	29,440	28,440	26,740	24,740	22,500
Total Interest Cash Fl		3,300	3,300	3,271	3,238	3,128	2,941	2,721
Total Debt Service		3,300	3,560	3,571	4,238	4,828	4,941	4,961
Effective Interest		11.0%	11.9%	11.9%	14.1%	16.1%	16.5%	16.5%
Pre-Tax Cash Flow								
Net Inc before Debt		4,278	6,010	6,337	7,514	8,655	9,112	9,542
Less: Debt Service		3,300	3,560	3,571	4,238	4,828	4,941	4,961
Net Cash Flow		978	2,450	2,765	3,276	3,826	4,171	4,580
Cumulative Cash Flow		978	3,429	6,194	9,470	13,296	17,467	22,047
D/S Coverage Ratio		1.30	1.69	1.77	1.77	1.79	1.84	1.92

Hotel: Repayment Schedule to assess Repayment Period

Currency: $000s

	Cashflows	Interest	Principal	Net Cashflow	O/S Debt
Yr 1	4278	3300	0	978	30000
Yr 2	6010	3257	260	2493	29740
Yr 3	6336	3119	300	2917	29440
Yr 4	7514	2957	1000	3557	28440
Yr 5	8654	2691	1700	4263	26740
Yr 6	9112	2316	2000	4796	24740
Yr 7	9541	1885	2240	5416	22500
Yr 8	10018	2475	7543	0	14956
Yr 9	10519	1645	8874	0	6081
Yr 10	11045	669	6081	4295	0
Yr 11	11598			11598	0
Yr 12	12178				
Yr 13	12786				
Yr 14	14097				

Note: First 7 years repayment schedule as per proposed loan schedule, repaying 25% principal interest at 11%.

Business Start Up Case Study

Banking at your branch is a firm of chartered accountants which from time to time introduces new business to you. One of the partners calls at the branch. He tells you the firm has been asked to help draw up a business plan for a new venture to extract, bottle and market mineral water. He asks you if your bank would be interested in providing finance for the venture.

The following information and figures show the main elements of the business plan:

Spring (aged 42) is a farmer who owns land in the Blue Mountains area, near Ocho Rios, Jamaica. He has planning permission for the development of a bottling plant, and licences from the National Rivers Authority for the extraction of water from his land.

In return for his shares in Pure Water limited, Spring will transfer the extraction licences to the company. The farm and land will be sold to Pure Water Limited for $360,000. A new building will be erected by the company on the land transferred by Spring.

In return for his shares, Bottle will:

(i) transfer the plant and equipment from the Kingston bottling plant to Pure Water limited;

(ii) cover the cost of moving the plant and equipment and installing it in the new building.

Market research shows the Carib market for mineral water is expected to be worth around $250 million in 20X3. 50% of the market is controlled by one large group, but there are over 30 other companies with a significant stake. The overall market grew by more than 25% last year.

Sampling of the water on the farm has been carried out on a regular basis. It has been of a good and consistent quality.

Agreement in principle has been reached with a large supermarket chain to take an unspecified amount of the water.

The production manager of the bottling plant has agreed to join Pure Water Limited.

The bottling plant has the capacity to deliver the sales volumes in the financial projections.

The financial projections assume that the new bottling hall will be completed in March 20X3, with the first sales taking place in April. Sales would then increase steadily over the two-year period of the forecasts. It is assumed that no profits will be earned until August 20X3, but that they will then increase in line with sales.

There is the usual disclaimer from the accountants that: 'This report has been based on information presented to us by the directors of Pure Water Limited. We have not performed an audit or carried out any checks, tests or verification work'

Required: Prepare an analysis of the business plan and indicate the answer you will make to the accountants.

Pure Water Limited

Balance Sheets

	Start Projection 31 October20X2 $000		*Projection* 31 October20X3 $000		*Projection* 31 October20X4 $000	
Fixed assets						
Freehold property	360		360		360	
Bottling hall	-		200		200	
Extraction licences	631		631		631	
Plant and equipment	493	1,484	371	1,562	249	1,440
Current Assets						
Debtors	-		920		1,000	
Prepayments	37		50		50	
VAT receivable	-		37		1	
Cash at bank	-	37	-	1,007	2,259	3,310
Current Liabilities						
Creditors	-		68		83	
Bank overdraft	330	(330)	843	(911)	-	(83)
Net assets		1,191		1,658		4,667
Financed by:						
Share capital		30		30		30
Surplus brought forward		1,161		1,191		1,658
Current year profit				437		2,979
		1,191		1,658		4,667

Pure Water Limited		
Profit and Loss Summary		
	Year 1(to 31/12/X3)	Year2 (to 31/12/X4)
	$000	$000
Sales	2,618	6,588
Gross profit	1,575	4,104
Net profit (before tax)	437	2,979

Project Accounting Ratios and Assumptions			
	31 October20X2	31 December20X3	31December20X4
Net gearing %	59	82	-
Current ratio	0.11:1	1.11:1	39.88:1
Acid test	0.11:1	1.11:1	39.88:1
Credit given (days) - (cash flow	-	53	53
forecast assumption)			
Gross margin %	-	60	62
Net margin %	-	16.1	45.2

Cash Flow Forecast Summary (Closing Monthly Balance)								
($000)								
20X2	Dec	330	DR					
20X3	Jan	450	DR		20X4	Jan	683	DR
	Feb	781	DR			Feb	435	DR
	Mar	874	DR			Mar	291	DR
	Apr	989	DR			Apr	46	CR
	May	941	DR			May	262	CR
	Jun	887	DR			Jun	457	CR
	Jul	872	DR			Jul	622	CR
	Aug	939	DR			Aug	970	CR
	Sep	1,003	DR			Sep	1,326	CR
	Oct	1,192	DR			Oct	1,642	CR
	Nov	967	DR			Nov	1,931	CR
	Dec	843	DR			Dec	2,259	CR

PROFIT AND LOSS SUMMARY

	12 Months to 28 February 20X4 $	6 Months to 31 August20X4 (Draft) $
Sales	763,406	1,129,178
Gross profit	164,792	256,424
Purchases	598,614	872,754
Directors' remuneration	25,800	17,000
Interest paid	7,375	8,266
Profit before tax	20,010	50,058

ACCOUNTING RATIOS

	28 February 20X4	31 August 20X4
Net gearing % (Directors' loans treated as capital)	-	313
Current ratio	1.01:1	1.07:1
Acid test	0.73:1	0.73:1
Credit given (days)	107	71
Credit taken (days)	198	130
Stock turnover (days)	65	42
Gross margin %	21.6	22.7
Net margin%	2.6	4.4
Interest cover (times)	3.7	7.1