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Pre-seen

Sun Asia Leisure: Edge of Blossoming Epoch

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Sun Asia Leisure CEO resigns

Succession plan is in place, says the company

Richard Bayliss, the CEO of Sun Asia Leisure PLC (SAL), has announced his resignation from the company with effect from 31 December 2017 and the company has made an announcement in the Colombo Stock Exchange to that effect.

SAL completed the construction of its two landmark hotels in Pasikuda and Unawatuna and commenced their operations. Richard was instrumental in planning these projects and developing the marketing plans for the hotels.

Some sources say that a dispute between the founder/managing director Athula Amarasuriya and Richard was the reason for the latter's exit. However a company spokesman refuted the rumors and said that Richard's contract period will be ended. The spokesman further stated that the company has a well-articulated succession plan and the handing over will happen smoothly.

The company withheld any information about a new CEO and said that Athula will function as the MD/CEO until further notice.

Background

Sun Asia Leisure PLC (SAL) is a public listed company. It operates two hotels both called Sun Asia Hotels in Pasikuda and Unawatuna. SAL also runs a holiday resort in Kandy, obtained on a 15-year lease. A few other properties owned by SAL are still under development or awaiting development. At the annual general meeting (AGM) held in August 2016 Ashoka Ranaweera did not offer himself for re-election to the board of SAL. Upon his resignation Kamal Ranwatta was appointed as the chairman of the audit committee. 11 months after this AGM, the chief financial officer (CFO) Herman Mendis was appointed as a director to the board. However, following this appointment, the general manager Sudath Silva resigned from the company stating his frustration. The vacant general manager position then became a struggle between two managers; marketing manager Harsha Perera and accountant Roshan Bandara. Both Harsha and Roshan were hard workers, and had showed their loyalty in the past with every effort for the company's success. As a result, Herman was appointed as the acting general manager for a short period.

At the 2017 AGM, shareholders raised a few concerns. Delayed construction of hotels that were committed to at previous AGMs, poor performance of the hotels, collapsed market price, and a high level of financial leverage were amongst these concerns. Subsequent to the AGM, the board expressed its concern about the performance of Richard Bayliss, (the CEO), as he was responsible for the current financial situation of the company. Richard, who did not accept the allegations, had counter allegations aimed at Athula, and the rest of the board for not carrying out some of his proposals and acting outside the initial plans, which he claimed were the reasons for the present crisis situation. After a series of arguments Richard decided to resign from his position and leave the company.

Considering the restructuring proposals put forward by Herman, the board decided to curtail costs and increase volumes. As a result, the following measures were implemented with immediate effect.

1. Partnering with leading credit card companies and offering considerable discounts to local travelers.
2. Reducing staff by discontinuing all the casual staff working at the hotels.
3. Scaling down the buffet menus to reduce the food costs of the hotels.
4. Reducing the maintenance budgets of the hotels.
5. Curtailing the travelling and food allowances of senior staff members.
6. Suspending increments and incentives for staff, including head office staff.

Winning the market

Athula and his wife Mihiri were instrumental in co-founding SAL in 2010. Athula was a popular tennis player from his school days, and he later continued tennis at sports clubs and won many tournaments in Sri Lanka. He even represented Sri Lanka at the Asian Games, and was successful in bringing honor to the country. Currently, Athula holds distinguished honorary positions in committees related to governance of sports. Being a member of a financially well-off family, Athula inherited a significant amount of wealth. He followed the footsteps of some schoolmates and also became an active investor in the stock market by the late 1980s. In the mid-1990s, Athula teamed up with Derric, an experienced stockbroker cum investment advisor, to buy a licensed private brokering company, WinMar Brokers. Athula provided the capital required, and Derric took charge of WinMar with a team of skilled analysts and advisors. Within a short period, WinMar became one of the leading stockbrokers in the country. Derric made a significant contribution to the success of these achievements.

Later, WinMar extended its business into investment and venture capital with key capital market and private investment deals. A new private company, WinMar Ventures (Pvt) Ltd, was formed for this purpose. Kamal Ranwatta, who had worked in WinMar from its inception and was a close confidante of Athula for over 10 years, was appointed as the CEO of this new company. Kamal was also entrusted to look after all the matters of WinMar when Athula was not in the country, and was in fact made one of the signatories to operate bank accounts.

Derric brought in a number of direct investments from foreign institutions as well. A few high-net-worth foreign individuals invested through WinMar Ventures resulting in noteworthy capital market transactions. A Norwegian, Frank Lloyd, purchased Gamma Resorts, a small resort chain, through WinMar Ventures. Frank appointed Athula as the the CEO of Gamma Resorts for a few years. Athula was happy to be the CEO of Gamma as he had always dreamt of leading a diversified business portfolio, and this provided him the opportunity to be a business leader with diverse experience. Derric assisted him in this role, and a team including a hotel manager was hired for the resort. Gamma became a successful business through its management even though Frank was unhappy with the profit share he received.

Mihiri was the daughter of Gregory Wijesinghe, a pioneer in the healthcare industry. He was the chairman of a few well-known companies in the industry, and held extensive experience in hospitals and pharmaceutical organisations in both manufacturing and distribution. Gregory possessed strong connections with global pharmaceutical manufacturers as well.

Mihiri, having completed her secondary education at a leading international school, went to the UK to complete her bachelor's and master's degrees in Economics and Business. She returned to Sri Lanka in 1996 and started a joint venture with a South Korean investor in 1997. This business was established as a company under the Board of Investment (BOI) regulations. The company prospered with the aid of Korean technology and became a sought-after supplier of high quality electronic components for the semiconductor industry. It also exported products to Japan, Singapore, Malaysia, Thailand and South Korea.

SAL incorporation

In late 2008, with the signs of an end to the civil war, Athula and Derric envisioned the opportunity present for the tourism industry in Sri Lanka. As such, Athula planned to identify and acquire properties suitable for tourism in the country. His aim was to secure the most attractive land in order to build a chain of hotels, and he earmarked a few large blocks of land suitable to be developed as hotel properties. Athula was confident that he was well-equipped to establish a lucrative hotel chain in Sri Lanka with more than 20 years of finance and capital market investment experience with WinMar, experience within the hospitality industry, and the business connections of his father-in-law.

A team of newly recruited graduates under WinMar Ventures helped Athula with the business analysis and strategic planning. Mihiri's business connections in countries to which her products were exported were considered as an added advantage in promoting the hotels to those markets. Athula also had close connections with the political fraternity and government agencies such as the BOI. Blessings of the government were an added advantage to Athula even though he had to bear a significant cost regularly for maintaining such political connections. The business analysis carried out identified that a boom was expected in the tourism industry and that the best opportunities were in the north-east and down-south beach areas.

After the end of the civil war in Sri Lanka, SAL was incorporated in July 2010, with Athula and Mihiri as founding directors. Athula then approached the owners of the properties that were earmarked. Since investors were still skeptical about the government's policies and plans towards tourism, the demand for coastal land was still not high. Therefore, Athula was able to secure some of the good land in prime beachfront locations at bargain prices. He bought six blocks in prime locations including beachfronts in Unawatuna and Pasikuda. These were financed through related companies, and personal equity of Mihiri. The particulars of land purchased are given in **Table 1**.

	Pasikuda	Unawatuna	Waikkal	Tissa	H'tota	Weligama
Cost LKR million	100	120	80	90	110	50
Ownership	Mihiri	Gregory	Mihiri	Athula	Athula	Athula
Area (acres)	5	2	4	1	1	0.5
Purchased in	Feb '10	Jan '10	Feb'10	Mar '10	Oct '10	Mar '10

Table 1: Particulars of land

Athula's plan was to develop the two properties in Unawatuna and Pasikuda, as he felt that the tourism industry was expected to pick up in those two areas very soon. This was indicated in the business plan too. He explained to his friends that his mission for the next five years was to build a network of luxury resort hotels at an international level for the up-market tourists. He also mentioned that he made a series of lucrative deals in securing the land he bought at bargain prices. It was thought to have an initial equity base of LKR 2.5 billion for building the network of luxury resort hotels. With this target, the land were transferred to SAL at LKR 1.4 billion in December 2011, and the consideration was settled by issuing 140 million ordinary shares of SAL.

As the company had many plans, Gregory Wijesinghe was appointed as the chairman of the company, and Richard Bayliss was appointed as the CEO. Richard, an Englishman, was an established and committed hotel veteran with global hospitality experience in operations throughout Asia. He was responsible for the day-to-day management of the company and focused on the design and operations of the hotel constructions. He was the principal architect of SAL hotel planning, conceptualisation, design, product development, operating standards and service delivery. Besides overseeing the planning and preparation of hotel openings and operations, Richard was also expected to work closely with the new marketing manager Harsha Perera for overall product and brand development. Harsha was a marketing graduate and this was his first employment.

Revaluation of land

As insisted by the accountant Roshan, SAL obtained a property valuation from a chartered valuer, Mr. Boralugoda, a long standing business partner of Gregory. He used three alternative valuation methods in his report, and concluded that the properties were worth more than the value accounted (refer **Table 2**). Accordingly, financial statements for the year ended 31 March 2012 were adjusted to reflect a value of LKR 2.7 billion for land creating a revaluation surplus of LKR 1.3 billion. This valuation was based on the directors' best estimation.

Valuation method	Value LKR	Notes
Highest and best use	3.2 billion	Two alternative uses were considered: hotels and luxury/semi luxury housing. It was argued that the land of SAL had unique features that other land did not have. As a result, once the hotels are built, more high-end up-market tourists could be attracted and premium rates could be charged. Thus, these land had a premium value.
Sales comparisons	2.1 billion	The Pasikuda land was compared with an adjacent 2-acre bare land sold by the government to a BOI company in February 2012. The BOI company has plans to open a boat yard and construct a marine city. The Unawatuna land was compared with prices advertised for many similar land in the area.
Discounted present value	1.8 billion	Net operating income was estimated for hotel projects based on knowledge of market supply and demand and income and expenditure. SAL's prevailing WACC of 12% was used.

Table 2: Land valuation

Private placement of shares and the commencement of hotel construction

SAL forwarded an offer document for 100 million ordinary shares at LKR 12 each through WinMar. The offer document explained that the proceeds of the share issue would be utilised to construct the hotels in Unawatuna and Pasikuda. SAL was successful in convincing a considerable number of investors, who contributed LKR 1.2 billion towards equity in exchange for 100 million ordinary shares. The share issue was successfully completed during the third quarter of 2012, and construction of the hotels in Unawatuna and Pasikuda commenced in October 2012.

The estimated construction costs of the two hotels were a little over LKR 1 billion according to architectural plans and the BOQ prepared by Richard with the help of civil engineers. However, the selection of building contractors did not go through a formal procedure due to the limited time available. Athula and Gregory recommended two parties to whom the construction work of the two hotels was ultimately awarded. Richard had certain reservations about the capacity of the contractors to handle these types of large hotel construction projects, but he did not raise these reservations as serious concerns as the contractors were recommended by Athula and Gregory.

Meanwhile, the company experienced working capital difficulties, and the banks were willing to extend their facilities. Accordingly, a bank overdraft of LKR 600 million was obtained from Bank of Ceylon based on a proposal by Roshan in order to meet the working capital requirements. Based on Roshan's advice the share issue funds were reserved only to meet construction costs, while the borrowings were used to meet working capital requirements.

Investments and borrowings

SAL invested in stocks expecting a bull market as forecasted by WinMar. The portfolio mostly included the speculative stocks which were bought with the hope of getting a short-term profit. Expecting a growth in the stock market, Athula advised the CEO to increase the stock portfolio. The CEO was of the opinion to liquidate the portfolio rather than undertake further investments, but LKR 15 million was invested in one of Athula's related companies, a private company with a plan for an IPO.

In the third quarter of 2013, construction of a hotel in Anuradhapura and the Lagoon Hotel in Waikkal also began. Athula had purchased the property in Anuradhapura for LKR 250 million in January 2013 with the idea of adding a hotel with cultural heritage to his chain.

In February 2014, Athula transferred a holiday bungalow in Kandy to SAL. Mihiri owned the bungalow, and SAL believed it would be a good source of revenue that could be further improved by using the company's tourism network. The bungalow was transferred on a long-term lease for 15 years at a rental of LKR 1 million per month. The total lease rentals were paid up front. The bungalow was expected to generate immediate revenue so that the financials of SAL would be somewhat attractive.

When the constructions progressed SAL became short of funds and made borrowings from banks from time to time. The total borrowings by 31 March 2014 exceeded LKR 1 billion. For borrowing purposes, the properties had to be mortgaged to the banks, and this meant that they were revalued by the banks. The valuation by the banks was LKR 650 million less than the prior valuation. Upon insistence by the auditors, the accountant agreed that the property values should be brought down through an adjustment to the revaluation surplus as at 31 March 2014.

Initial public offering

Richard planned to take SAL public through an IPO of LKR 2 biillion. SAL Pasikuda was due to be opened by July 2014 and the third quarter of 2014/15 was therefore considered the opportune time for an IPO. With the IPO plan, two new members were introduced to the board, Kamal Ranwatta and Ashoka Ranaweera, as independent non-executive directors. Kamal was the CEO of WinMar. Ashoka, a senior professional accountant, was a key customer of WinMar Brokers. At 75 years of age, he was a high-net-worth individual, and an active player in the stock market. Three board committees viz. audit committee, nominations committee and remuneration committee were set up at the beginning of the second quarter of 2014/15. Mihiri, Kamal and Ashoka were the members of all the three committees. Ashoka chaired the audit committee while Kamal chaired the other two committees.

A senior management team was put in place for the July 2014 opening of SAL Pasikuda. Herman Mendis, a senior professional accountant was recruited as the CFO on a four-year contract. The rest of the staff were also recruited by the end of first quarter of 2014/15. All the recruitment decisions including those on remuneration packages were made by Athula and Gregory as they were considered to have good industry knowledge.

Unfortunately, the contractor could not complete SAL Pasikuda within the agreed timeline. It was only opened at the end of 2014 and the hotel missed the opportunity to secure a number of lucrative bookings for the Christmas season. Consequently the IPO was also postponed to the last quarter of 2014/15. SAL also deferred construction of the Unawatuna hotel and the other two hotels in Anuradhapura and Waikkal. The IPO was launched in the last quarter of 2014/15 and LKR 600 million was fully subscribed by issuing 50 million new shares to the public at LKR 12 per share. The principal selling point at the IPO was the projected optimistic success of SAL Pasikuda and SAL Unawatuna.

Part of the money raised from the IPO was used to settle some of the overdue loan payables and temporary overdrafts taken, while the balance was used for the construction of the Unawatuna hotel. Athula gave priority to the completion of the Unawatuna hotel as he was hoping that it would generate revenue soon, and this revenue could be used to fund the construction of the other two hotels. Accordingly, the construction of the hotels in Anuradhapura and Waikkal were put on hold and all efforts were put towards Unawatuna.

Athula and Gregory worked hard to complete and open SAL Unawatuna in July 2015 (a delay of eight months compared with the original plan). However due to cost escalations and excessive borrowing costs, further borrowings had to be made in order to ensure the work of the Unawatuna hotel would not be further stalled.

Performance of SAL

The two hotels in Pasikuda and Unawatuna did not pick up as expected. Subject to seasonal fluctuations, the average occupancy rates were as follows.

	2014/15	2015/16	2016/17
Pasikuda	46%	40%	34%
Unawatuna	-	43%	38%

Table 3: Average occupancy

From January 2017 SAL Pasikuda and SAL Unawatuna, which had been on Booking.com and TripAdvisor, were removed from those sites.

Accountants at the hotels have also reported that they had lost discounts and credit period extensions from suppliers with the loss of key suppliers who were reluctant to supply. Meanwhile the hotel managers were advised by the board of directors to discontinue credit purchases. Thus, managers had to depend on daily cash collection, and cashiers were instructed by the hotel managers to obtain daily cash collections from the guests. Some of the guests complained about the quality of services and food, as well as the hotel facilities. Further, most of the staff were planning to leave the company and were already on the lookout for new jobs.

Rights issue

The company managed to raise LKR 700 million in a rights issue of LKR 7 per share during the last quarter of 2015/16. In spite of the issue price of LKR 7 being at a considerable discount to the IPO price, most of the smaller shareholders did not subscribe to the issue and the major shareholders subscribed to those shares by way of additional shares.

Investment property

The company also reclassified the land where no development had commenced as investment property in the accounts for 2016/17. Upon reclassification the land were revalued as at 31 March 2017 and a revaluation surplus was recognised.

Aftermath of annual general meeting (AGM) 2017

After the AGM held in August 2017, Athula realised that in order to continue the company, a significant restructuring plan together with a significant amount of equity infusion would be required. He made up his mind even to relinquish the controlling interest as he realised that an investor would not invest such a large amount of equity without having the controlling power.

Athula used all his connections and finally found Chelsey Investment Corporation (CIC) which was interested in investing in a controlling stake in the company. The basic proposition of the investor was that the investment would be made into the company and the company would issue new shares to the investor so that the investor would have 50% – 55% of the voting shares of the company. The number of shares to be issued and the value would be finalised after a due diligence and valuation exercise.

Herman Mendis has prepared summarised statements of comprehensive income and financial position since 1 April 2012, with forecast financials as at 31 March 2018 on 'as is' basis which are given in Annexures 1 and 2. These financials were made available to CIC.

Pressure from banks

With the borrowings becoming long overdue, the banks were pressurising the company. Herman and Athula visited the banks several times to negotiate restructuring of the facilities with a concessionary package. The banks have informed the company that they would consider a restructuring package with some concessions, provided the company makes a significant up-front settlement.

During the discussions with the bank officials Herman came across that he had not accounted for certain interests and penalties charged by the bank. The following statement has been prepared by him to reconcile the total liabilities as per forecast statement of financial position as at 31 March 2018 and bank records.

Forecast bank liabilities as at 31 March 2018 (LKR million)			
	Per SOFP	**Reconciling items**	**Per bank records**
Non-current portion of borrowings	1,000	-	1,000
Current portion of borrowings			
Principal outstanding	650	-	650
Accrued interest (in other CL)	100	-	100
Unaccounted interest	-	50	50
Unaccounted penal charges	-	40	40
Bank overdraft (in other CL)	400	-	400
Dishonoured customer cheques	-	10	10
Total	**2,150**	**100**	**2,250**

Market research

CIC carried out a market research to examine the reasons for low occupancy in the hotels and the potential the company has for future growth. The research revealed that the company is constrained with just two hotels, which prevents it from offering a wide range of experience to the travelers. Some extracts of the research report have been given below.

<u>SAL: Extracts of the market research report</u>

Our market research has revealed that SAL will have a significant competitive advantage of positioning the hotels to local as well as foreign travelers, if the two hotels in Anuradhapura and Waikkal can be built up. Tour packages involving the four hotels (Pasikuda, Unawatuna, Anuradhapura and Waikkal) can be effectively marketed to attract a wide range of travelers with different appetites.

We have identified that promotion and communication is the key to increase occupancy, which in turn leads to profitability. With the statistical analysis of research data we have developed the following relationship for the chain of four hotels referred to above.

$$Y = -x^2 / 200 + 0.4x - 7.2$$

Y is the annual occupancy rate for the four hotels as a whole and x is the annual cost incurred on promotion and communication activities in LKR million. "x can take values which result in values of Y where $0\% \leq Y \leq 100\%$".

In the aforesaid circumstances, considering the varying room rates depending on the hotels and relative seasonal effects, the following relationship has also been established.

$$R = (3{,}125Y^2 + 320/Y)(1+g)^{n-1}$$

R is the total annual revenue in LKR million for the n^{th} year in which all four hotels are in operation. Y is the annual occupancy rate for the four hotels as a whole whereas g is the annual growth rate applicable to revenue.

During the first five years the revenue would grow at 10% per annum (i.e. g = 10%). At the end of five years the business is expected to reach the maturity stage after which significant growth in profits cannot be expected.

Annexure 1

Sun Asia Leisure

Statements of comprehensive income

	(LKR million)					
For the years ended 31 March	**2013**	**2014**	**2015**	**2016**	**2017**	**2018(F)**
Revenue	-	3	78	220	345	370
Cost of sales	-	(2)	(36)	(60)	(68)	(70)
Gross profit	**-**	**1**	**42**	**160**	**277**	**300**
Other income	24	12	-	-	-	-
Administrative expenses	(140)	(110)	(250)	(400)	(360)	(340)
Business promotion expenses	(4)	(3)	(20)	(10)	(13)	(10)
Net finance (cost)/income	20	(50)	(120)	(200)	(144)	(100)
FV gain/(loss) from short-term investments	-	-	48	-	-	-
Profit/(loss) for the year	**(100)**	**(150)**	**(300)**	**(450)**	**(240)**	**(150)**
Gain/(deficit) on revaluation	-	(650)	-	-	70	-
Total comprehensive income for the year	**(100)**	**(800)**	**(300)**	**(450)**	**(170)**	**(150)**

Annexure 2

Sun Asia Leisure
Statements of financial position

	(LKR million)					
As at 31 March	**2013**	**2014**	**2015**	**2016**	**2017**	**2018 (F)**
ASSETS						
Non-current assets						
Property, plant and equipment	3,200	4,440	4,978	5,010	4,212	4,154
Investment property	-	-	-	-	950	950
Leasehold property	-	179	167	155	143	131
Available-for-sale (AFS) financial assets	-	41	15	15	15	15
Total non-current assets	**3,200**	**4,660**	**5,160**	**5,180**	**5,320**	**5,250**
Current assets						
Amounts due from related parties	300	260	220	170	100	100
Other current assets	400	80	120	100	80	100
Total current assets	**700**	**340**	**340**	**270**	**180**	**200**
Total assets	**3,900**	**5,000**	**5,500**	**5,450**	**5,500**	**5,450**
EQUITY AND LIABILITIES						
Capital and reserves						
Stated capital	2,600	2,600	3,200	3,900	3,900	3,900
Revaluation reserve	1,300	650	650	650	720	720
Retained earnings (debit)	(150)	(300)	(600)	(1,050)	(1,290)	(1,440)
Total equity	**3,750**	**2,950**	**3,250**	**3,500**	**3,330**	**3,180**
Non-current liabilities						
Borrowings (non-current portion)	-	1,000	1,350	1,200	1,150	1,000
Total non-current liabilities	**-**	**1,000**	**1,350**	**1,200**	**1,150**	**1,000**
Current liabilities						
Borrowings (current portion)	-	190	300	400	500	650
Other current liabilities	150	860	600	350	520	620
Total current liabilities	**150**	**1,050**	**900**	**750**	**1,020**	**1,270**
Total equity and liabilities	**3,900**	**5,000**	**5,500**	**5,450**	**5,500**	**5,450**