Important note to candidates:
The sample solution for the Capstone Examination is provided for illustrative purpose only. It is meant to help candidates in their revision and learning and to illustrate the expected structure of the answers and the coverage and depth of knowledge relating to the particular requirements. The sample solution may be longer than what the candidates are expected to produce in the examination. As the Capstone Examination simulates real-life situations based on an integrated case study, the sample solution may not and is not intended to cover all the valid points that can address the requirements of the examination questions. In the examination, candidates were awarded points for valid answers that may not be covered in the sample solution.

SECTION A – CASE QUESTIONS (Total: 75 marks)

Answer 1(a)

The primary objective of the Company to go for a listing is to raise more funds without losing much management controls, and to establish an international image and reputation. The secondary objective of listing is to attract more young designers from other countries to join the Company. With reference to the objectives, the following listed out both the advantages and disadvantages for the Company to be listed in either Shanghai, Hong Kong, or an overseas city.

Listing the Company in Shanghai will bring the advantages of better business connections and more effective arrangements for the IPO process. Furthermore, comparing the stock market performance in China with other places, a higher valuation may be obtained from the Shanghai stock market. This will allow the Company to raise more funds without the need to issue more than the required public float. On the other hand, the Shanghai listing option may be the least preferrable in view of establishing an international image, as customers and investors overseas may not be aware of the listing of the Company in Shanghai, or they may not recognise its status as heavy as they would if it were listed in other places. Young and talented designers in overseas may also not know well about the Company if it is listed in Shanghai. Thus, the Shanghai option is not effective in achieving the objectives of enhancing reputation and attracting overseas talents.

Listing the Company overseas may pose higher risks to the Company due to higher uncertainty and lower recognition of a Chinese company without a presence in their places. Secondly, it is critical on the actual IPO process and the promotion tactics/ strategies when the shares are firstly offered in the overseas stock exchange. This could significantly impact the success/ failure of the listing on the Company, needless to say whether an international brand name and reputation can be established through this IPO process. Moreover, there are also other considerations such as high compliance costs, language barriers, cultural differences, and international conflicts. Thus, unless the Company can find a team of excellent professional parties, it may be risky to go for a listing in an overseas country at this moment.

Therefore, at this moment it may be a better choice to go for a listing in Hong Kong. As there are many experiences of Mainland corporations going for listing in Hong Kong, Yang and Zhang can easily get a team of experienced professional parties and obtain advices from friends and investment advisors. They can more easily understand the IPO process in Hong Kong and better control the processes. The Company may also be able to seek for a higher IPO price in Hong Kong compared to overseas countries, as investors in Hong Kong are generally comfortable to invest in newly issued shares of Chinese corporations. Going for IPO in Hong Kong can also support for establishing an international reputation as well as attracting more talented young designers to join the corporation. Therefore, when the objectives are taken into consideration as a whole, it is recommended that the Company to choose Hong Kong as a starting point.

Answer 1(b)

It is required to consider the issue from different perspectives, including the legal and regulatory perspective, business and social perspective, and professional perspective, in order to determine if it is unethical. If an activity or behaviour is identified as an unethical behaviour by law and regulations, a person may have committed a criminal offence and be subject to legal penalties. However, in this case it is quite clear that a premium salary or compensation package offered to international staff does not violate any national law and regulation in China. Thus, if Yang and Zhang wish to go ahead with a premium salary package for international designers without disclosing to the local designers, they will not commit any unethical behaviour from a legal perspective.

It is also considered that this intention should not constitute any unethical behaviour from a professional perspective, as the behaviour should not have likely violated any Code of Ethics as specified by HKICPA, CICPA, or other design or professional bodies.

However, it is arguable whether the behaviour constitutes an unethical behaviour from a business and social perspective. If Yang and Zhang keep the premium package information confidential, once the package information comes to the attention of the local designers, say by accident, they, especially the senior designers, may feel betrayed, or deserted, by Yang and Zhang. This could cause serious personnel problemsamong the designers' team that may further lead to serious consequences on the Xompany's operations and financial performance. Yang and Zhang must consider this carefully since the Company's success is largely attributed by the contribution of the designers' team. Yang and Zhang also need to bear in mind that it is not an easy task or process to persuade local designers to accept the premium salary packages for international designers without any negative feeling.

(Bonus Points: To solve the ethical dilemma on this issue, Yang and Zhang need to carefully consider how to proceed with this policy with some possible strategies such as announcing a performance-based salary package (PBSP) scale system as a perception management skill so that most designers accept the PBSP as a reasonable and acceptable system in the first place, thus it will become more difficult for designers to compare salary package even for same grade in the future.)

Answer 1(c)

To identify and attract young talents to come from overseas, the corporation needs to take care of several issues and factors in the first place.

Firstly, Yang and Zhang must prepare to pay a compensation package that is sufficient for a young person (who may not have any connection in China) to meet the basic economic needs in Beijing, Shanghai or other offices of the Company so that they can work comfortably according to their own career aspirations (without asking for economic subsidies from family members overseas). This is the minimum or survival factor to attract overseas talents. This information of economic sufficiency must be clearly conveyed to the potential designers in the first place. However, Yang and Zhang may need to take care of the possible existence of salary discrimination between local and overseas designers.
Secondly, targeted young designers should be given appropriate information for their training and development to make them feel comfortable joining the Company. As good designers themselves, Yang and Zhang should know that designers may not just look at the salary in selecting a job. Designers would normally look for developmental opportunities as well as freedom of innovation and creation, i.e., freedom of quality design.

On the other hand, Yang and Zhang should plan the recruitment process well beforehand, for instance, whether the applicants need to produce some design artifact for review, attend interview, or obtain reference from their own design professors/practitioners. The selection process and procedures should be communicated to potential candidates for them to understand the fair selection process. Yang and Zhang can also decide in the first place who will be the interviewers/ assessors for the candidates in product design or interview process.

Encountering talented designers may sometimes be an opportunistic process, Yang and Zhang may frequently visit design schools, attend fashion shows for design students and junior designers overseas, or directly seek for nominations and recommendations from others where appropriate. All these steps may provide fantastic results from time to time.

Answer 2

Date:	XXX
To:	Melaine Wong, Finance Director
From:	Lin Chan, Finance Manager
Subject:	High-level 5 Years Cashflow Projection and Evaluation of 2 options on Sources of Funds

(a) 5 Years Cashflow Projection

The Company is considering investment on 3 different projects, 1) JV with Evergo Group, 2) starting a new line of product "Simply black", and 3) opening more direct management stores. As a result, funding requirement is pressing. To plan ahead for the overall funding requirements, please see an estimation of cashflow projection for the Company as follows for your consideration:

RMB' million	Year 1	Year 2	Year 3	Year 4	Year 5	Total
JV with Evergo	(30)	(20)	-	-	-	(50)
Simply Black	(30)	-	5	10	15	-
Direct Mgt Stores	(15)	(10)	(5)	-	-	(30)
Total Investment	(75)	(30)	-	10	15	(80)
Cumulative Net Cashflow	*(75)*	*(105)*	*(105)*	*(95)*	*(80)*	-
Projected Profit Reserved* for the year (30% / 50%)	**33 / 55**	**36 / 61**	**40 / 67**	**44 / 72**	**48 / 80**	**201 / 336**

Points to note:

- Peak funding requirement for new investment are noted in year 2 and year 3, amounted to RMB105 million.
- The proposed profit reserve, if materialised, may help reduce the cash pressure, but may not be able to cover the full requirement, or with uncertainty about the projection.
- Cash outflow pattern of those new investments is front end loaded, i.e., the requirement is not evenly spread but more demanding at the beginning, that means to support those new investments, additional funding need to be arranged soon once the project is confirmed.
- It may take more than 5 years to pay back the investments.
- Suggest running some sensitivity analysis to simulate the potential variation of the funding requirement.

(b) Evaluation of 2 Options on Sources of Fund

To support the potential expansion of the Company, which give rise to a pressing demand for additional funding, we are actively exploring for alternative sources of fund. Response from the market is very positive. The Company has recently received various offers, and the management is interested to further understand the following two options:

1. Issuance of convertible loan of RMB100 million, with a term of 5 years, interest at 4.5% per annum, payable annually in arrears to the investor. The loan will only be convertible if the Company goes listing on any stock exchange within five years, otherwise the Company is required to repay the amount by the end of the period. The Company has the right to repay the loan early at every anniversary date of issuance.

2. Investor to directly invest RMB100 million in exchange for 20% shareholding in the Company.

The advantages and disadvantages of two options are summarised as below:

<u>Convertible Loan</u>

Pros:

(i) The 5-year term loan is suitable for the Company's medium term development financing. After 5 years, the Company's self-generated cashflow from existing business will likely be sufficient to cover the funding need, and to repay the loan, if needed.

(ii) The convertible feature provides more flexibility for the Company to consider whether to repay the loan or not within the five-year prescribed period. If the existing business perform as projected, the Company may be able to repay the loan even before end of 5 years.

(iii) Deferral of valuation provides more time for the Company's further growth and in turn reducing the amount of equity given up at a lower valuation, which is determined based on current valuation only. Especially the Company is considering an IPO in next few years, which should reasonably have a higher valuation by then as compared to the current valuation.

(iv) More control remains with the existing shareholders as the investor can only seek for minimal rights as a lender (e.g. information rights).

(v) Loan interest is a deductible expense for the Company, and therefore the arrangement is tax-effective.

(vi) Convertible loan lenders receive only a fixed, limited income before conversion. This is an advantage to the existing shareholders of the Company as the majority of net income remains with the shareholders.

(vii) The Company can issue convertible loans at a lower coupon rate as compared to standard loans.

(viii) A policy of selling differentiated securities (including convertible loans) to take advantage of market conditions can normally lower a company's overall cost of capital compared to that ofhaving only one class of debt and share.

(ix) It helps the Company secure equity financing in a delayed manner, and effectively delay any dilution in shareholdings of existing shareholders.

Cons:

(i) If the listing exercise is not completed within the period, repayment will be required for the convertible loan. There is uncertainty about the future performance of the Company, and if cashflow at the end of year 5 is not sufficient to repay the loan, new financing needs to be arranged, which pose re-financing risk for the Company.

(ii) The use of fixed-interest securities magnifies losses to the existing shareholders whenever sales and earnings decline; this is the unfavourable aspect of financial leverage, the additional interest expenses will put pressure on the Company's performance

(iii) Certain clauses such as the valuation cap and the conversion discount can complicate future equity raising by anchoring price expectations.

New equity

Pros:

(i) Long term secure funding, no repayment is needed and the Company's capital base will be enlarged for any further development.

(ii) As some famous investors have approached the Company, it may be a good opportunity to strengthen the shareholders profile and equity base, which will enhance the Company's position in future IPO, a positive factor for the future valuation.

(iii) No interest payment and profitability will likely be improved with broader investment/business profile.

Cons:

(i) Raising capital through issuance of new shares will unavoidably lead to dilution of shares and so reduce earnings per share, unless and until the proposed investment generate decent return, which seems not the case at least for the first few years of investment as per the Company's current estimation.

(ii) Reduction of the control of existing shareholders due to share dilution may affect the ability of existing shareholders to control the direction of the Company. Although only 20% new shares are issued, influence from new shareholders with probably affect the efficiency of decision making, or even the direction of future development.

(iii) Share price will be based on current valuation only, the value of unconfirmed future expansion plans may not be fully reflected or undermined.

Example of recommendation (assume convertible loan is preferred)

To finance the new investments of coming 5 years, the Company intends to raise an additional medium-term funding of RMB100 million. Both options will provide sufficient amount for our expansion and fits for the 5 years tenure requirement.

By comparing the two alternatives, convertible loan and issuance of new shares, the former is more preferrable.

From a shareholders' point of view, it will delay the dilution of shares, even if is finally converted.

In the meantime, earning per shares is likely improved, as the return of new investment is probably higher than the interests of 4.5% as per our estimation. At the end of the term, the Company is probably able to obtain a higher valuation if it successfully goes for IPO, while our business portfolio is significantly improved. With such loan financing, our existing shareholders interest will be well protected in both short and medium terms, without risking to loss the control of the Company.

From a management's point of view, a convertible loan will induce less influence from potential new investors, thus easier to maintain the existing strategy and direction. If based on the current estimation, the Company is very likely to be able to generate sufficient cash to repay the loan within 5 years. Though the additional interest expenses will unavoidably add pressure to the Company's performance in the short run, the new investments will provide a better platform for the Company's future growth, with more product lines and direct stores and so JV with well-known partner, which will in turn benefit the management and so the Company in long run, i.e. benefits will outweigh the costs.

The most critical issue is the refinancing risk, if the Company fails to go for a listing by the end of 5 years and does not able to generate sufficient cash to repay the loan. In view of the current performance of the Company, the risk seems to be remote. It is suggested that the Company should arrange the issuance of the convertible loan, and set an interim review about the Company's cashflow position at the middle of the 5 years term to plan for any changes/actions needed.

Hope the above provide sufficient information for your consideration. Please feel free to contact me if you would like to have any further information/clarification.

Lin Chan
Finance Manager

<u>Answer 3</u>

Date: XXX

<u>Report on the implication of acquiring Ningbo Garment Limited ("NB") and how to mitigate/reduce the associated risks</u>

Background

To accommodate the Company's expansion plan, we are considering a direct acquisition of NB, a manufacturer of the Company located in Ningbo with long-established relationship. As the existing owner is going to retire, the owner is considering selling his stakes on NB, and this is a good opportunity for our Company to acquire NB and make it our own production arm.

Content

The report will cover:

1. Analyses of the Implication of the proposed acquisition of NB: both the advantages and disadvantages of the proposal will be evaluated and summarised.

2. Evaluation on the potential risks associated with the acquisition transaction, with suggested actions to mitigate the risks.

Analysis of Advantages and Disadvantages of the Proposed Acquisition

Acquiring NB in substance is a vertical integration of our Company. Through the acquisition of a manufacturing facility, the Company extends its business from design and sales to manufacturing, which the Company has little experience of. The implications are summarised as below:

Strategic

Pros:

- The acquisition fits in with the Company's strategic direction, maintaining control over the manufacturer, rather than partnering with large manufacturers. Our strategy has always been having factories worked exclusively for our brand to retain the highest level of controllability and confidentiality.
- For the Company's future development, there is more operating flexibility in terms of production capacity and capability, especially if any niche/ unique production requirements are needed. As the Company plans to expand the product line with new product variety, the control of production capability will help to accommodate such changes more efficiently.
- Vertical integration leads to better control of the production process, including both output volume and quality control. This is a potential competitive advantage to the Company, which helps fit into the Company's promotion & marketing schedule, and avoid supply disruption.
- Acquiring the manufacturer will add a new profit centre to the Company, and widen our business scope.

Cons:

- As the management has no experience to manufacturing industry, diversify into a such area may reduce the focus on our core business, as management needs to devote significant amount of time and resources to such business.
- Design and sale can be regarded as a relatively light investment and higher margin business, compared to manufacturing which is a low margin and relatively capital-intensive business. Combination of both may reduce the attractiveness of the Company from the investors' point of view, especially when the manufacturing business is very dependant to the Company's order.
- After acquisition, the Company will have less flexibility in switching manufacturers. Other manufacturers may also view the Company's manufacturing arm as a competitor.

Financials

Pros:

- The Company may enjoy economy of scale when they are able to cut costs while ramping up productions. Vertical integration eliminates overhead by consolidating management and streamlining processes. It leads to better cost control through streamline of production process.
- The acquisition provides additional profit contribution to the Company. With reference to the past performance of NB, they are able to maintain a profitable performance and stable operation.

- The target company NB has a significant tax loss carried forward; majority will be expired in coming three to five years' time. The Company may explore the possibility to utilise the tax loss and reduce tax liability in near future.
- The revenue source of the target company NB is solely within the control of the Company, which is relatively stable and secure. From the Company's point of view, the predictability of NB's business is high as compared with any other new business development.

Cons:

- After the vertical integration, the Company will carry both manufacturing and retail businesses. If the overall demand declines, the Company will suffer loss from both business operations, which may double the loss if sales are not doing well.
- The profitability of the target company shows a declining trend, the Company may not be able to turn it around as lack of manufacturing experience and potentially be dragged into a lossing business.
- Additional capex maybe required to enhance/ replace NB's equipment and facilities, which may add pressure to the Company's cashflow. From the experience and knowledge point of view, the Company may not be able to correctly estimate the funding requirement for such requirement, which induce some uncertainty for the acquisition.
- After acquisition, as the Company and NB become parent and subsidiary, transfer pricing consideration is required between the two companies for tax planning reasons, which may potentially subject to challenge from tax authority.
- After integration, fixed costs of the Group will increase, the cost structure will become less flexible. If market situation deteriorates, the Company will face greater costs pressure and need more time to adjust the position.

<u>Operation</u>

Pros:

- The acquisition target has a long working relationship with the Company, smooth cooperation is expected to continue after the acquisition.
- As per understanding from the existing NB owner, if the Company takes no action, it is likely the ownership of NB will switch to some large organisation with quite different business direction, which may lead to a change in operation mode and affect the Company as well.
- After acquisition, the manufacturing arm will be more accommodating to the Company's requirement, with better forward planning. With reference to the Company's expansion plan, it will be a value added as compared with the relatively stable requirement as before.

Cons:

- Senior management needs to monitor unfamiliar business operation, under different regulatory requirements and different company culture and operation mode. The Company management may face greater pressure under an aggressive expansion plan.
- After the acquisition, the management has to take care of the potential conflict of interest between the production team and the manufacturing team, while the former will focus more on the quality and the latter will focus more on costs effectiveness.

Potential Risks Identified and Suggested Actions

Direct acquisition of an existing operating company is new to us, especially as we have no experience of manufacturing business. For such an acquisition, potential risks and proposed mitigation actions are summarised as below:

Financials

Overpricing of acquisition price - valuation of a business may takes different approach, which may give rise to a range of potential offer price. The reasonableness of correct pricing is one of the key factors for a successful acquisition and needed to be determine carefully.

- We may consider benchmarking the selling price of recent transactions in similar/ same industry, and evaluate the asking price from the seller accordingly.
- Request a 5-year financial projection from existing owners to justify the asking price, review the projection with the owner about the reasonableness of the underlying assumptions.
- Detail financial due diligence of the target company is needed, which helps ensure the financial statements correctly reflect the NB's financial position.

Hidden liabilities on staff costs - different regions may have different regulatory requirement in relation to employee protection, especially for those long-serviced employees. It may not be fully reflected in the financial statement and needed to be clarified beforehand.

- Suggest reviewing the employment contracts terms and commitments made to existing staff, which will probably induce reasonable expectation and so hidden liabilities to NB.
- Clarify the relevant regulatory requirement, with professional party if needed, especially in relation to employer's obligation to long service employees, also the list of NB employees and so their corresponding years of service is required to ascertain any potential obligation.

Unrecorded/ Contingent liabilities or commitments – with reference to the financial statements provided by the seller, some long-term contracts or issues may induce liabilities or commitments not yet fully reflected. As potential future owner of NB, clarification of those hidden information is critical for understanding of the full financial position.

- Suggest asking for the list of contracts from the seller, and review those contracts to investigate any unrecorded/ contingent liabilities or commitments.

Explore if there is any outstanding claim from any parties, which may induce potential financial damages. Primarily thru discussion with the seller and request their formal representation.

- To reduce the Company's risk, we may ask for a letter of indemnity from the seller, which should cover both the undeclared liabilities and tax obligation of NB.

Tax exposure - before completing the acquisition process, the Company may not be able to clarify the tax position from any authority, but to rely solely on the representation from the seller. Occasionally, the seller may not be aware of any tax risk, therefore the Company need to be cautious about.

- Suggest reviewing NB's tax records, check if there's any unsettled/ potential tax dispute. Consult any professional party for any specific requirement, or engage the professional firm to carry out the task.
- Review the viability of the tax loss carried forward, both the amount and the expiry timeframe, to ensure the correctness of the record and so assess its value to the Company.
- After acquisition, two companies will become parent and subsidiary. Transfer pricing issue may arise as both entities need to deal with different local tax authorities separately, external professional advice may be required.

Legal:

Unclear legal title of the company's ownership - shareholding structure varies from company to company. It is crucial to ascertain the ownership structure of the business substance before the acquisition is materialised, and ensure the correct legal form of the acquisition transaction is in place.

- Suggest carrying out a legal due diligence in relation to company ownership, to clarify the ownership structure and confirm the proposed acquisition arrangement is effective.
- An alternative method is to consider buying the business and assets only, not the legal structure of NB. However, it may complicate the proposed transaction and usually takes longer time, and more complex acquisition arrangement is required. In our situation, it may not be effective and less preferable.

Unclear legal title of the company's assets - NB owns different assets which contributed to the value of the company. Whether the ownership of those assets is properly recorded and registered correspondingly will substantially affect the company's valuation.

- As per our understanding, one of the major assets owned by NB is a piece of land, which was inherited from the owner's family. Suggest checking the legal title of the land, ensure there was a proper transfer from the owner's family to the target company.
- For better cashflow management, it is a common practice that purchase of machinery is under some hire purchase arrangement. To clarify the financing position of those assets, suggest checking if there's any outstanding assets pledge/ hire purchase arrangement.
- Note that there is a bank facility in NB, should check if there's any pledge of asset in relation to the bank facility, and review the terms of the facility as well.

Unsettled legal cases - some legal cases or claims may now be considered as remote and need not be declared in the financial statement, or the loss provision is based on the recent forecast of the probable outcome. However, those status may change as time goes, or the outcome may not be the same as per recent forecast.

- Suggest checking local filings with court, if available, clarify if there's any outstanding court case for the target company.
- Ask for a formal declaration from the seller about the list of outstanding claims and the expected outcome, and try to obtain a letter of indemnity from the seller, if possible.
- Consider negotiating a certain percentage, say 5-10%, of purchase price as retention money, kept by the Company for a period of time to safeguard our interest.

Restriction of transfer (shares and assets) - there may be some restriction clauses on transfer of shares/ assets, especially from bank as lender, require the company to obtain consent form the lender before any transfer.

- Suggest checking if there is any relevant term in legal contracts/ bank facilities letters, which require prior consent before any transfer. Ensure the seller comply with those requirements before the completion of the transaction.
- Check if there is any regulatory restriction on transfer of shares or assets, such as restriction related to transfer of ownership of land in particular areas, tax incentive granted by local authority etc.

Operation:

Obsolete of machinery/ equipment - technical review about the status of the machinery is required, as they are one of the key assets of NB.

- to carry out inspection of conditions of machinery/ equipment/ facilities to ascertain their valuation, and ensure they are properly functioning.
- Review the maintenance contracts for NB's machinery/ equipment, estimate accordingly the maintenance costs for coming years, and assess the reasonableness of continuous operation.

Loss of management/ key personnel - as our management have no experience in manufacturing industry, it is crucial to retain NB's management team, who have been with the company for long time, to ensure the smooth operation, at least for a few years after acquisition.

- Propose to include a retention agreement with management/ key personnel for a period, say three years, to secure commitment from the team. At the same time, it provides assurance from the Company to those personnel in relation to their job security.
- Add a non-compete clause in the sale and purchase agreement to prevent the seller from doing the same business as a direct competition and recruiting the company's staff. It is a common practice on sale of business arrangement, and usually cover a period, say three years in the same region/ country.
- To further motivate the company's management team and align the goal, may consider granting share options or introduce performance related incentive scheme to them. Review the existing remuneration package, see if there is any room for improvement, if feasible

Knowledge transfer - as the Company has little experience in manufacturing, to obtain the knowledge and experience from the existing team is critical for the Company to achieve a successful acquisition.

- We may request the seller to perform a formal handover and knowledge transfer process, e.g., handover of operation manuals, description of workflow, explanation of system walk-through etc. The transfer process must be well planned and structured, involve relevant personnel from both sides, and a reasonable timetable is required.

Conclusion

The report summarised the implications of the proposed acquisition. It appeared that it is more advantageous for the Company to proceed the acquisition deal, taking into consideration of the Company's expansion plan, and reviews from strategic, financial and operational point of view.

Though there are various risks associated with the acquisition transaction, with a careful planning and cautious execution, it is likely that those risks can be mitigated during the acquisition process.

* * * END OF EXAMINATION PAPER * * *