<u>WRITTEN QUESTIONS</u> (Total: 75 marks)

Note: This case study is a work of fiction. Any resemblance to actual events or persons is entirely coincidental.

Refer to the Pre-seen case information previously provided and the additional information, you should answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

<u>Question 1</u> (25 marks – approximately 80 minutes)

Conversations between Yang and Zhang:

Yang: "Looking at the Company's performance for recent years, I think it is a good time to go for IPO."

Zhang: "Definitely! Through IPO, we can raise additional funds for business expansion as well as to establish an international image and reputation for our Company and its brands."

Yang: "I have been considering a few places, say Shanghai, Hong Kong and some other reputable stock exchanges overseas. So far, I think Hong Kong or overseas are most suitable for us. What do you think?"

Zhang: "We have better knowledge of the mainland market and its tax, financial and regulatory framework, but less knowledge in that of other exchanges. I'm therefore not sure if we can meet their listing requirements. I suggest going for IPO in Shanghai first, then we may aim for a secondary listing overseas. We will also be able to maintain a better relationship with bankers and investors in Shanghai."

Yang: "True , but, if possible, I would prefer to have our Company listed at least in Hong Kong if not other overseas exchanges, as we can establish an international image for the Company. Moreover, with such an international presence, we can attract more international talents to join us as designers. As you know it's on our roadmap to build up an internal designer portfolio with world-wide interactions and international fashion design mindset."

Zhang: "Yes definitely. We should also bear in mind that in order to attract overseas talents, we will likely have to offer more attractive salaries, which are higher than the offers made to local designers, or adopt other methods and strategies. Let me do more research on that and see."

Based on a preliminary study of the range of salaries offered to young designers in international fashion hubs, Yang and Zhang note that there is in fact no clear indication of how salaries are fixed or calculated. Salaries vary a lot even within the cities of Milan, Paris, London and New York. As such, Yang and Zhang cannot make any conclusion in defining the package for attracting and retaining international designers.

A further concern is that if the Company offers better packages to international designers, local designers will likely be demotivated if they discover such discrepancies. In addition, Yang and Zhang wonder if they do not disclose differences in pay scale would such a practice constitute any unethical behaviour from a legal and regulatory perspective, professional perspective or business and social perspective. To Yang and Zhang it seems a normal practice to keep employment contract terms confidential. However, they are afraid that even if they keep this confidential, such information may be accidentally disclosed, and may cause a disaster within the Company.

As the Finance Manager, you are required to:

(a) **analyse and recommend whether it would be a better choice to go for listing in Shanghai, or in Hong Kong, or in other overseas city. Your reasoning should be based on the objectives of going for listing and the possible advantages and disadvantages among the locations specified above.**

Note: Assume that the Company meets all the listing requirements in these places. You are not required to directly compare Shanghai Stock Exchange to Hong Kong Stock Exchange or any specific oversea stock exchange, such as New York Stock Exchange. A general discussion of the advantages and disadvantages for listing in Shanghai, Hong Kong or an oversea city is sufficient.

(10 marks)

(b) **evaluate whether it is unethical from different perspectives to develop an undercover premium compensation package for international designers in general.**

(8 marks)

(c) **identify some important issues that Yang and Zhang need to consider before proceeding to recruit international young designers and propose some possible actions and activities that could be taken, by Yang and Zhang, in recruiting and attracting international young designers to join the Company.**

(7 marks)

<u>Question 2</u> (25 marks – approximately 80 minutes)

Various development opportunities have come to the Company's attention:

(i) <u>Joint venturing with Evergo Group</u>

Evergo Group Limited ("EG"), a long-established European sports footwear group, recently approached the Company to discuss about cooperation after EG spotted the success of *Simply Sporty* in the Tokyo Fashion Week. EG proposed to form a joint venture ("JV") between the two companies on a 50:50 basis to develop the new sport product line *Simply Sporty*, including both sportswear and sports footwear. The products will be distributed by the Company and EG in the PRC and Europe respectively through their own distribution networks.

Yang and Zhang considered the proposal to be in line with the Company's strategic direction. That is, to develop new products and distribute outside the PRC, through partnering with companies with well-established distribution networks. Moreover, partnering with a well-known company like EG is a definite asset for the Company's future development outside the PRC.

The initial investment to start the JV is RMB30 million for each partner. A follow-up investment of RMB20 million for each partner may be required in the second year. Yang believes that the JV is unlikely to declare any dividend in the first three to five years, as it is a new start-up introducing a new product line into a new market, i.e., Europe. Marketing costs are expected to be high.

(ii) <u>Simply Black</u>

Yang has identified Mr Ma, a well-known and excellent designer in the PRC, to take the lead in the Company's new product line *Simply Black* for menswear.

As a new product line with a totally different customer segment, Yang intends to invest RMB20-30 million in the first two years of launch, and expects the line to bring a positive cash flow from the third year onwards. He also targets to have the investment costs paid back in five years' time.

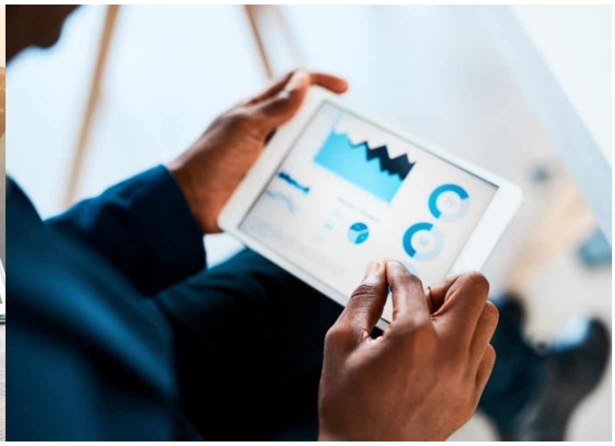
(iii) Opening of new direct management stores

To cope with the expansion strategy, the management has reviewed both the production capacity and the distribution network of the Company. The review exercise suggests that the current production capability can accommodate the expansion plan, however, the distribution network will need a further expansion, especially, in the number of direct management stores.

Initial investment in newly required direct management stores will be RMB30 million for the first three years. The management is confident that the new direct management stores will contribute positively to the Company's performance. Nevertheless, for prudence sake, the Company does not include any contribution of profits from these stores for the first three years during the operation planning process. The management will perform an interim review after 18 months.

To evaluate the expansion plan, the management reviewed the Company's financial position and cash flow forecast. Banking facilities, the usual funding source of the Company, are currently far from sufficient to accommodate for the various expansion plans, and need to be re-negotiated. Yang noted that at the current level of performance, cashflow of the Company's existing business may only be able to sustain one new investment, but not all three.

In the past years, the Company distributed most of the profit for the year to shareholders. To support the expansion of the Company, Yang believes that the Company's existing shareholders will agree to retain 30-50% of the Company's annual profit for the new investments, providing that the board approves these expansion projects. The existing business will likely contribute to a healthy organic growth. Yang projects that on average, a net profit growth of at least 10% per annum will be achievable for the coming five years.



Understanding that all new development projects are still in a pre-mature stage, Yang would like to have more information on the overall cashflow of the Company. In the extreme scenario where all three projects are committed at the same time, what will the shortfall of funding be in coming few years, taking into consideration that certain percentage of profit will be reserved as liquid fund.

On the other hand, Yang considers that it may be the right moment to explore for new source of funding from outsiders. In fact, several private equities have approached the Company to discuss for investment opportunities. Some of them are famous investors and therefore beneficial to the Company for pre-IPO consideration. 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 five years, interest of 4.5% per annum payable annually in arrears to the investor. The loan will only be convertible if the Company lists 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 each anniversary date of issuance.

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

As the Finance Manager, for better planning of the Company funding requirements for the coming five years, you are required to write a memorandum to the Finance Director, Melaine Wong on the followings:

(a) prepare a high-level cash flow projection of the Company, incorporating the funding requirements of all three potential developments and cashflow generated by existing business, with explanatory notes on the cash flow pattern. State your assumptions if needed; and

Note: You are not required to prepare a detailed cash flow projection.

(8 marks)

(b) evaluate the two options on the source of funds and make a recommendation for the management's consideration.

(17 marks)

<u>Question 3</u> (25 marks – approximately 80 minutes)

The Company has started to outsource production to two small factories, Jiaxing Garment Limited in Jiaxing ("JX") and Ningbo Garment Limited in Ningbo ("NB"), since 1998. The production team head recently met NB's owner and understood that he intended to retire within a few months. It was noted that his only son expressed no interest in operating the factory. A large textile and garment manufacturing group has expressed interest in buying the factory. If the deal materialises, the factory may not work exclusively for the Company anymore. The production team head proposed that the Company should consider acquiring NB to maintain its control over the production process.

NB is a long-established manufacturer, 100% owned by the shareholder who managed the business directly. In the past few years, though the business has been running smooth with a group of talented and loyal staff, the increase of labour costs in the market has led to a gradual decline of profitability. If the owner is willing to invest on the machinery automation upgrade, though the existing machineries are still productive and not obsolete, the situation will be improved in medium term. As the son of owner expressed no interest to inherit the business, it will be a sensible decision to sell the business while it is still profitable.

The factory is located on a piece of land inherited from the shareholder's family, and recorded as NB's major asset. NB has a significant tax loss carried forward; a majority of the loss will be expired in coming three to five years' time. As NB is one of the largest tax-paying entities in the district, they have good relationship with the local tax authority. The local tax authority therefore keeps an eye on the ownership and future development of NB at all times.

NB has a bank overdraft facility that has not been fully utilised. Other than that, NB does not have any other loans from banks or third parties. NB has a very stable and capable management team, who are well experienced and loyal to the company. The salary package offered is basically in line with the market level. The staff turnover rate is much lower than the market norm.

The Company's management considers that both JX and NB may not be able to cope with all the requirements along the expansion plan. On the other hand, there are several small factories available in the market, which may be utilised as additional capacity if needed. The only issue is that the Company has to inspect these potential manufacturers to see if they are eligible to accommodate the Company's stringent production requirement. It is believed that only a few manufacturers can fulfil all the requirements.

Yang believes that the acquisition of NB will add value to the Company, as such vertical integration will provide flexibility to the Company's future development. Moreover, the Company has a long and cooperative working relationship with NB and their operating team. However, as the Company plans to expand its product lines to sportswear, further investment in NB will be required to enhance its production capability and acquire new equipment.

Yang also considers that the Company has no experience and expertise in business acquisition. He is worried about how to complete a successful acquisition transaction, and to reasonably protect the Company's interest while negotiating with the seller. He would like to explore for precautionary measures or planning activities that may help to reduce the relevant transaction risk.

Yang calls for a meeting with the management team to discuss the acquisition deal and their concerns.

As the Finance Manager, you are required to prepare a report to the Finance Director, Melaine Wong on the followings:

(a) **analyse the implication of the proposal to acquire NB, from the strategic, financial and operational point of view, on the Company as a whole; and**

(10 marks)

(b) **address Yang's concern, assuming the Company decides to acquire NB, identify potential risks of the acquisition transaction, which should cover financial, operational, and legal risks, and advise the management on how to reduce these risks.**

(15 marks)

Note: You are required to cover all of the above-listed areas in your report. Failure to do so will have a significant impact to your marks.

* * * END OF EXAMINATION PAPER * * *