SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

CASE

Hydrofarm Group Limited ("the Group") has been engaged in hydroponic vegetable cultivation for ten years and recently listed on the Main Board of the Hong Kong Stock Exchange. Even though it is a small-cap listed company, the business has been expanding rapidly due to the continuous growth in demand of fresh hydroponic vegetables in the Hong Kong and Mainland markets. The Group has been seeking collaboration with overseas business partners and acquisition of other hydroponic vegetable cultivation companies in the region.

The Group is planning for an acquisition of another hydroponic vegetables cultivation private limited company called Blue Sky Limited ("BSL") that is owned by a few substantial shareholders (together holding more than 50% of BSL's shares) and other minority shareholders located in Hong Kong. BSL has a very strong distribution network of hydroponic vegetables in the Greater Bay Area that could help the Group sell their hydroponic vegetables in Southern China. Since there are other listed companies that are interested in acquiring BSL, the Group has decided to purchase the substantial shareholders' shares only so the Group could obtain control of BSL. The Group has no intention of buying the other minority shares of BSL once it obtains control of BSL. The offer has been made to the substantial shareholders of BSL only. The offering price information has only been provided to the substantial shareholders who have signed confidential agreements to keep all information private and confidential. One of the reasons why the Group would like to acquire BSL is that one of the managing directors, and also key shareholder of BSL, is the father-in-law of the executive director, Peter Lee, of the Group. Peter did not disclose the relationship in the negotiation of the acquisition. The Group hears that BSL has been considering an acquisition offer from another listed company in Shanghai, so the Group promises BSL that the Group will complete the acquisition in three weeks if BSL agrees with all terms offered by the Group. The Group's new financial controller, who is a certified public accountant, reviews the above acquisition terms and conditions and concludes that the acquisition should be postponed.

Green Nutrient Limited ("GNL") is a private limited company and is one of the subsidiaries of the Group. GNL has been engaged in the manufacturing, research and development of nutrition solutions for hydroponic vegetables cultivation owned by the Group and a business partner. The business partner owns and contributes a patented formula to make nutrition solutions for growing hydroponic vegetables. The Group has invested significantly in GNL because the Group requires a stable and secure supply of nutrition solutions to grow vegetables, and it is strategically important to own a nutrition solution manufacturing plant. 70% of the solutions are sold to the Group at cost plus 5%, and the rest are sold to other similar farms in Hong Kong at higher retail prices. Under the existing arrangement, GNL is operating in a breakeven situation in terms of profitability with negative shareholders' equity. It is currently financed by a few bank loans. Recently, GNL has been sued by a few suppliers for not being able to settle payments of chemical compounds to produce nutrition solutions. The Group and the business partner want to keep GNL as they have invested a lot of resources in it, and they believe that they could turn the business around. They have an expansion plan to expand the manufacturing capacity of GNL so it can sell more nutrient solutions at higher prices to other similar farms in Hong Kong. However, they do not know exactly how to handle the situation.

The Group receives an enquiry from one of the potential overseas business partners in the Netherlands, namely Green House B.V. ("GH"), who would like to look at the Group's environmental, social and governance ("ESG") report to understand the ESG performance of the Group before it decides to collaborate with the Group on an essential hydroponic vegetable cultivation research and development project. GH is not familiar with ESG reporting standards in Hong Kong. Particularly, GH would like to know the reporting principles that have been adopted to prepare the ESG report so that GH could more easily understand the ESG report of the Group better. Since GH is engaged in the agricultural business, it is particularly interested in the impact of hydroponic vegetable cultivation on the environment, including "comply or explain" environmental issues disclosures, electricity and water consumption, laws and regulations, and measurements of key performance indicators.

The Group has just issued a two-year fixed rate note. There are 100,000 notes issued at a face value of HK$1,000 each. The note requires the Group to pay a 3% coupon rate annually. The fair value per note is valued at HK$990.5. The Group has 30 million ordinary shares outstanding listed at HK$10 per share. The Group has an equity beta of 2, the expected return on market is 5%, and the 10-year government bond rate is 1%. The Group is subject to a Hong Kong profits tax rate of 16.5%. The Group is considering purchasing a whole floor in an industrial building in the New Territories to further expand their plant capacity to meet the needs of increasing demand. The cost of the property is HK$200 million, which is a major bargain due to the pandemic situation. Therefore, the Group wants to purchase it as soon as possible, and the Group decides to obtain a loan of HK$200 million from a bank to finance this purchase. The loan rate for an industrial building is currently 4% p.a. The financial year end of the Group is 31 December 2021.

<u>Question 1</u> **(15 marks – approximately 27 minutes)**

(a) Advise the Board of Directors why the acquisition should be postponed based on regulatory requirements of business acquisition in Hong Kong and the negative consequences to the Group if the acquisition is not postponed.

(8 marks)

(b) Determine ethical issues of a professional accountant with examples that the new group financial controller has to consider in the acquisition of BSL.

(7 marks)

<u>Question 2</u> **(10 marks – approximately 18 minutes)**

Acting as the finance director of GNL,

(a) Advise GNL on how to handle the existing situation by negotiation with creditors so that GNL could operate continuously to pay off outstanding liabilities.

(6 marks)

(b) Describe the worst situation that could happen to GNL if GNL cannot resolve the situation.

(4 marks)

<u>Question 3</u> **(10 marks – approximately 18 minutes)**

Acting as the new financial controller of the Group, prepare an email to the chief financial officer of GH to introduce ESG reporting principles with relevant examples related to the environmental section when the Group prepares the ESG report.

Note: A maximum of 2 marks for communication skills will be awarded.

(10 marks)

<u>Question 4</u> **(15 marks – approximately 27 minutes)**

(a) Calculate the financial effects before and after the acquisition of the property on the weighted average cost of capital of the Group.

(13 marks)

(b) Assume there is an increase in weighted average cost of capital of the Group, explain major reasons that cause such financial effects.

(2 marks)

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End of Section A

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

Question 5 (21 marks – approximately 38 minutes)

Space Health Limited ("the Company") is a listed company in Hong Kong. The Company manufactures various health products and specialises in first-aid bundles, medical gloves and surgery cotton, distributing to hospitals and selling in pharmacies to retail customers. The Company engaged a new chief financial officer ("CFO"), Katherine who is a fellow member of HKICPA, to review the business strategy of the Company.

Katherine believes that under the current pandemic situation worldwide, medical masks and personal protective equipment ("PPE") kits will continue to have high demand. However, the Company does not have any medical mask and PPE kit production capacity at this moment, Katherine is considering to expand the Company's product line by acquiring a factory, Porterhouse Mask Limited (the "Target"), which is able to manufacture medical masks and PPE kits in Hong Kong, and its products are already certified with various international standards for use in surgery and virus prevention.

After several rounds of negotiation, the management and shareholders of the Target provided an offer of HK$300 million for selling 100% of the shares of the Target. The Company expects the payback period would be approximately six years (i.e. positive net cash inflow of HK$50 million every year after acquisition without any additional working capital and capital expenditure requirements at anytime during the period), and the equipment of the factory could be used for at least ten years. The Company has assessed few possible financing strategies including maturity matching, short-term financing and long-term financing to finance this acquisition.

Required:

(a) Referring to Porter's Five Forces, advise what external analysis should be performed to assess the impacts of the strategic decision of the above acquisition.
(9 marks)

(b) Assess and recommend how the Company could use the different financing strategies to determine its funding decisions.

Note: A maximum of 2 marks for analytical skills will be awarded.
(9 marks)

(c) Advise the Company, with appropriate legal and regulatory framework, the required process for the public offer (including those who are not professional investors) of the Company's corporate bond in Hong Kong.
(3 marks)

<u>Question 6</u> **(17 marks – approximately 30 minutes)**

Havana Limited ("the Company") is an IT accessories company that has two major subsidiaries, SL and Grandfort, focusing on two different product lines. Grandfort has a history of 20 years and focuses on traditional computer accessories such as mouses, keyboards and computer cameras. SL is a relatively new company which has just been incorporated for about five years and focuses on mobile phone accessories such as mobile phone cases, ear-phones, chargers and cables.

Candy is the newly joined CFO, and she would like to implement a more structured performance measurement system, especially on financial measurement, for the Company. She also believes that a better strategic control and governance framework for the Company would help the Company mitigate enterprise risks and act as a contributor to effective Enterprise Risk Management ("ERM").

The subsidiaries have a very similar financing cost due to the bank borrowings being at same rate, as these borrowings are guaranteed by their holding company. The loans are over seven years, borrowed two years ago to finance the acquisition of the machinery of the subsidiaries for production at floating rate at HIBOR + 25pts. Both subsidiaries have enjoyed a very low interest rate environment in recent years; however, Candy worries that the subsidiaries may face significant interest rate risk. Besides performing financing analysis, as one of the ERM measures, Candy would like to perform a stress test for both of their subsidiaries against their financing cost.

The Statements of Profits and Loss for the year ended 30 June 2021 of the two subsidiaries are stated below:

HK$'million	SL	Grandfort
Sales	4,000	12,000
Cost of sales	2,400	9,600
Gross margin	1,600	2,400
Advertising and promotion	320	720
Operating expense	360	780
Profit before interest and tax	920	900
Interest expense	184	135
Profit before tax	736	765

<u>Required:</u>

(a) (i) Prepare common-size analysis for the two subsidiaries.

(4 marks)

(ii) Based on your common-size analysis, analyse and compare the financial performance as well as the profitability of the two subsidiaries.

(5 marks)

(b) Advise how the financial analysis can contribute to enterprise risk management.

(2 marks)

(c) Assuming that the HIBOR is 0.07% in 2021, prepare a stress test against the SL's profitability by advising on the breakeven HIBOR where SL would start making a loss.

(4 marks)

(d) Advise Candy on the measure(s) to mitigate such risk of the HIBOR fluctuation.

(2 marks)

<u>Question 7</u> (12 marks – approximately 22 minutes)

Centric Hong Kong Limited ("Centric") is a healthcare group listed in Hong Kong. Centric has a wholly owned subsidiary, Regency, which is a private company focusing on providing laboratory tests including virus tests for various clinics and government departments.

Regency has recently been very successful in its business as demand for virus tests is very high. The annual net operating profit after tax ("NOPAT") of Regency was HK$50 million, and 85% of the NOPAT is distributed as dividend. Regency expects its future profit and its dividend policy will be the same in the coming years. The industrial price/ earnings ("P/E") ratio and the expected return on the market of the same type of listed companies is 15 times and 6.5% respectively. The risk-free rate is 0.3%, and the systematic risk (beta factor) of Regency is 1.25.

The management of Centric is considering the introduction of some strategic investors to invest in Regency, so the CFO of Centric, Vivian, is working on the valuation of Regency before providing an offer to any potential strategic investors.

<u>Required:</u>

(a) Based on the available information, propose two appropriate valuation methods for Regency, and calculate the valuation of Regency based on the valuation methods you proposed.

(7 marks)

(b) Vivian has doubts on the use of P/E ratio of 15 times (i.e. the expected return on the market of the same type of listed companies) for the calculation of Regency's valuation. Justify her comments.

(2 marks)

(c) **Centric has successfully found a potential strategic investor, Mars, to invest in Regency for 15%. Both of them have agreed the valuation of Regency is HK$500 million. Mars is based in Singapore and its functional currency is the Singapore Dollar ("SGD"). The transaction is expected to be completed in three months, and Mars is required to pay 50% of the consideration immediately after completion and 50% as final payment nine months after completion. The current exchange rate between SGD and HKD (i.e. SGD/HKD) is 5.77, and the bank forecasted the rate would be 5.8 after one year. Mars is considering if it is required to hedge its foreign risk exposure for its final payment of this transaction by entering into a currency forward. Below are the quotes from bank.**

SGD/HKD	
3 months forward	**= 5.77**
1 year forward	**= 5.76**

Based on the quotes provided by the bank, calculate the SGD requirement for Mars' final payment with and without hedging, and advise whether Mars should hedge the exposure.

(3 marks)

* * * END OF EXAMINATION PAPER * * *