# Student Notes

## Module B (Dec 2011)

## Workshop Outline and Learning Methodologies

<table>
<tr><th>Session</th><th>Methodologies</th><th>Chapters covered</th><th>Student Notes</th></tr>
<tr><td colspan="4">Workshop 1</td></tr>
<tr><td>1. Introduction</td><td>• Presentation<br>• Group discussion</td><td></td><td rowspan="4">Please refer to Workshop 1 Student Notes</td></tr>
<tr><td>2. Ethics in business</td><td>• Case study<br>• Group Discussion</td><td>Ch. 1 & 15</td></tr>
<tr><td>3. Executive management</td><td>• Case study<br>• Formal presentations</td><td>Ch. 2</td></tr>
<tr><td>4. Management reporting</td><td>• Case study<br>• Formal presentations</td><td>Ch. 4 & 5</td></tr>
<tr><td colspan="4">Workshop 2</td></tr>
<tr><td>5. Reboot</td><td>• Presentation<br>• Group discussion</td><td></td><td></td></tr>
<tr><td>6. Treasury operations</td><td>• Case study<br>• Formal presentations</td><td>Ch. 8, 10 & 11</td><td>Pg. 1 – 13</td></tr>
<tr><td>7. Corporate finance</td><td>• Case study<br>• Formal presentations</td><td>Ch. 16, 17 & 18</td><td>Pg. 14 – 27</td></tr>
<tr><td>8. Conclusion</td><td>• Presentation<br>• Group discussion</td><td></td><td></td></tr>
</table>

# Treasury Operations: Pre-workshop exercise

**LP reference**

LP Chapter 8, Sections 3 and 5.

**Key learning points**

The pre-workshop exercise will lead on to the workshop exercise. At this stage, students need to be aware of the **cash cycle** and the implications for investment and cash flow of inefficient working capital management.

Students should also demonstrate an awareness that ratios based on limited amounts of information should be treated with caution, but should be prepared to comment on the **deterioration** in the **accounts receivable and inventory turnover periods**, and the large amount of **accounts payable**.

The cash cycle is much shorter for sales through retail distribution channels than for sales through wholesale channels. For sales through retail channels, working capital (inventory in this case) is being financed entirely by trade payables.

However the cash cycle was longer in 2011 than in 2010, and students should be able to specify by how much cash flows have been affected by working capital changes and dividend policy. This information is easily accessible in the cash flow statement in the case study.

**Suggested solution**

**End-of-year figures** in the balance sheet are used here to calculate average turnover periods for the year. This assumes that the end-of-year figures are typical for the year as a whole. End-of-year figures are used because this is the only way, with the figures available, to compare working capital turnover ratios and changes in those ratios between 2010 and 2011.

**Assumptions:**

**Inventory turnover period** = (Inventory at end of year/Costs of goods sold) × 365 days

It is assumed that the **accounts receivable** settlement period is **0 days** for sales through **retail** distribution channels and that all sales are for cash. Receivables represent owners of the **wholesale** distribution channels, who are given a period of **credit** before being required to pay.

**Accounts receivable settlement period** = (Accounts receivable at end of year/Sales through wholesale distribution channels) × 365 days

**Accounts payable payment period** = (Accounts payable at end of year/Trade payables) × 365 days

| **Sales through retail channels** | | **2011** | | **2010** |
|---|---|---|---|---|
| | | days | | days |
| Inventory turnover period | (3,037/15,835) × 365 | 70 | (2,757/15,702) × 365 | 64 |
| Accounts receivable settlement period | | 0 | | 0 |
| Accounts payable payment period | (3,720/15,835) × 365 | (86) | (3,541/15,702) × 365 | (82) |
| **Cash cycle** | | (16) | | (18) |

| Sales through wholesale channels | | 2011 | | 2010 |
|---|---|---|---|---|
| | | days | | days |
| Inventory turnover period | As above | 70 | As above | 64 |
| Accounts receivable settlement period | [3,071/14,214] × 365 | 79 | [2,781/16,537] × 365 | 61 |
| Accounts payable payment period | As above | (86) | As above | (82) |
| **Cash cycle** | | 63 | | 43 |

For sales through **retail distribution channels**, the cash cycle is **negative**, which means that trade payables are more than inventory. Consequently, it can be argued that inventory is being financed in full by suppliers, and on average goods are sold through retail outlets and the cash is received from customers before suppliers have to be paid.

However, the cash cycle 'deteriorated' by two days in 2011, compared with 2010.

For sales through **wholesale distribution channels**, the cash cycle **deteriorated significantly** in 2011, as a consequence mainly of the much longer time to collect amounts receivable.

There was also some **deterioration** in the average **inventory turnover** period.

This suggests that Dong Li's **concerns** about working capital management are **justified**.

| | | 2011 | | 2010 |
|---|---|---|---|---|
| Current ratio | (11,695/4,707) | 2.5 | (10,621/4,553) | 2.3 |
| Quick ratio | (11,695 – 3,037)/ 4,707 | 1.8 | (10,621 – 2,757)/ 4,553 | 1.7 |

The **liquidity ratios improved** slightly in 2011. The company had a large amount of cash at 30 June 2011 and does not appear to have a liquidity problem.

The statement of **cash flows** shows the reasons for the change in cash position during 2011. If working capital is defined as inventory plus receivables and prepayments, minus trade payables and accrued expenses, there was an **increase in working capital** (excluding cash) of HK$186 million, which meant that cash flows were reduced by this amount. (Note: From the statement of cash flows, 280 + 85 – 179 = 186.)

The statement of cash flows also shows that the most important **reasons for the reduction in cash flows** below what might have been expected are:

(a) **high dividend payments**

(b) **large investment** in property, plant and equipment, well in excess of the depreciation charge for the year.

If the company had not obtained its **bank loans** during the year, cash flows would have been **negative**.

# Part D Treasury Operations: Case 1

Dong Li has asked the head of Treasury Operations at HFIC to recommend ways in which **working capital management** could be improved. As a separate matter, he would also like some advice about **dividend policy**, which will be discussed at the next meeting of the HFIC board of directors.

He would like to prepare a paper for presentation to the other directors at this meeting.

You should divide into four groups. Each group should be asked to discuss one of the following **four requirements**. You should refer to the information in the case study and the pre-workshop exercise as well as the additional information provided below.

## Case A (Inventory Management)

The analysis of working capital management shows that inventory levels are too high, and that most of the inventory consists of **unsold goods**. A problem for the fashion industry is that goods that are unsold at the end of a season are very difficult to sell in a subsequent season. These inventories are held in both the retail and wholesale outlets around the world.

***Required***

**You should prepare a presentation for Dong Li which deals with the following issues:**

**(a) The consequences for HFIC of holding high inventory levels.**

**(b) Measures that might be taken to reduce inventory levels below their current level, and to maintain them at lower levels in the future.**

**(c) The financial benefits that HFIC might expect to obtain from reductions in inventory. The financing cost is currently 5% p.a.**

## Case B (Receivables Management)

The **increase in receivables** in 2011, in spite of falling sales through wholesale outlets, has annoyed Dong Li. He knows that the rest of the board of directors will want an explanation for this situation, and will want to hear the measures that Dong Li intends to take to improve the situation.

***Required***

**You should prepare a presentation for Dong Li which deals with the following issues:**

**(a) Reasons for the increase in the time taken to receive payment from customers and for the high level of receivables written off as uncollectible.**

**(b) Measures that might be taken to reduce accounts receivable to a more efficient and acceptable level, and your views about which of these measures should be recommended to Dong Li and the board of HFIC.**

**(c) An estimate of the possible savings that might be obtained from more efficient receivables management. The financing cost is currently 5% p.a.**

Note: You may wish to refer to information in the case study for the purpose of this presentation.

## Case C (Accounts Payable Management)

Dong Li is aware that a substantial number of the manufacturing firms that supply HFIC are in **financial difficulty**. Many of these produce only High Fashion and HF Star products. Dong Li is concerned that a large number of these businesses might collapse in the next year or two. He is wondering whether the risks could be reduced through careful management of accounts payable.

***Required***

**You should prepare a presentation for Dong Li which deals with the following issues:**

**(a) The effect on HFIC of a financial collapse of several manufacturing companies that supply HFIC.**

**(b) Ways in which management of accounts payable might reduce the risk of wholesale distribution outlets going out of business.**

## Case D (Dividend Policy)

When the board announced its intention to **change** its dividend payout ratio to 60% in future years, the market price of HFIC shares fell. This made some directors question whether the board made a correct decision about future dividend policy. Dong Li is concerned about the effect of dividend payments on cash flows.

***Required***

**You should prepare a presentation for Dong Li which deals with the following issues:**

**(a) The arguments in favour of the new dividend policy.**

**(b) The arguments against the new dividend policy.**

**(c) A recommendation, with reasons, about whether the board of directors should continue with the new dividend policy, or whether the dividend policy should be changed again**

# Treasury Operations: Case 1

This exercise requires students in their groups to look at an aspect of treasury management: **inventory management, accounts receivable management, accounts payable management and dividend policy**. The answers provided by students will indicate their understanding of these different issues.

There are **four different exercises** or Cases.

Some of the exercises combine a small amount of computational work with a discussion of the financial, management and strategic issues. The focus, however, is on an understanding of the issues involved in **working capital management** and **dividend policy**.

## Case A Suggested solution

### LP reference

Inventory ratios and inventory management are covered by LP references Chapter 8 Section 5 and Section 6.

### Key learning points

Students need to recognise that there are **costs associated with high levels of inventory**, particularly in an industry such as fashion goods where unsold inventory may quickly become ‘unfashionable’ and difficult to sell. Students may also mention other costs, such as the finance costs of holding and insuring, and costs of operating warehouses. The exercise also requires students to suggest how inventory levels might be reduced: **the sale of ‘old’ inventory at bargain sale prices** should be one key suggestion. An **increase in the use of just-in-time procurement** is another key issue.

Although there is no ‘correct’ answer to any of the Cases, students should be expected to produce estimates of the **possible benefits** of improvements in **inventory management**.

### Suggested solution

A presentation to Dong Li might cover the following points.

(a) **Fashion goods** have a **limited life** and can become ‘outdated’ very quickly after the end of a fashion season. If HFIC has large quantities of inventory, there is a risk that large amounts will remain unsold at the end of the season, and may have to be disposed of at a loss.

There is also a **finance cost** in holding excessive amounts of **inventory**.

Higher levels of inventory also require more storage space, and HFIC may have to pay **additional costs** to **store excess inventory**. Inventory must also be insured against damage, theft or loss, and higher inventory levels will cost more in insurance premiums.

HFIC now uses **just-in-time** procurement for some of its goods. With just-in-time purchasing or manufacture, goods are ordered only when they are needed. In the case of HFIC, additional quantities of goods will be ordered only when the strength of sales demand for the item is known, from feedback on sales in stores. In this way, HFIC can produce what customers want to buy, and will not produce large quantities of items that are difficult to sell. In this respect, **pre-ordering goods** for the season instead of **just-in-time procurement** could mean that HFIC is failing to **optimise sales volumes and profits**. A policy of just-in-time purchasing and holding smaller quantities of inventory could be much more profitable than the ‘traditional’ system of pre-ordering and buying full quantities in advance for each sales season.

(b) **Measures** to reduce inventory levels:

(1) Unsold inventory should be **sold at a large discount** at the end of each fashion season (in end-of-season 'sales').

(2) Increase the use of **just-in-time purchasing** and manufacturing systems. This point is explained in (a) above.

(3) **Give store managers greater control over selling prices** during the sales season, so that they are able to adjust prices to encourage more sales of slower-moving items.

(4) **Better forecasting of likely sales demand for fashion items.** If forecasts of sales of each fashion item could be estimated with greater accuracy, inventories would be bought by customers more quickly, and average inventories would be lower.

(c) **Recommendations**

Retail outlets should have **regular sales of unsold items at a large discount** to market value (and possibly at a discount to cost). Selling items at discount prices might begin **before** the end of each season, rather than when the season has ended, for items that are not selling well during the season.

Measures should be taken to **match supply and sales demand more closely**. Just-in-time purchasing is one possibility.

**Possible financial benefits**

The financial benefit from **selling off unsold inventory** at a discount is that it will **earn** HFIC **some income** rather than no income at all.

In addition, reductions in inventory will reduce the average investment in working capital. In 2011, the average **inventory turnover** period increased by **6 days** (70 - 64). The cost of goods sold was (in HK$ millions) 15,835. An increase of 1 day in the inventory turnover period would mean additional inventory of (15,835/365) equalling HK$43.4 million. If the inventory turnover period could be reduced, say, by 10 days, the reduction in inventory would be about HK$434 million. If the cost of capital is 5%, finance cost benefits would be about HK$22 million each year.

## Case B Suggested solution

**LP reference**

The receivables turnover ratio and receivables management are covered by LP references Chapter 8 Section 5 and Section 7.

**Key learning points**

This exercise requires students to identify the **reasons why accounts receivable might be high**, the possible consequences of a high level of receivables and measures that might be taken to improve the efficiency of receivables management. The answers will probably follow 'text book' guidance.

Students need to remember that a large proportion of total sales are through **retail outlets** that are **managed by HFIC** itself, and receivables represent **money owed** by **wholesale** distribution outlets that are not owned by HFIC.

Students should also recognise that some of the 'text book' methods of reducing the amount of receivables – offering discounts for early payment and **factoring debts** – are **inappropriate** for HFIC, because HFIC has a **large amount of cash**, and so has **no reason to incur costs** (factoring fees or costs of discounts) in order to receive payments more quickly.

**Suggested solution**

A presentation to Dong Li might cover the following points (answering all parts of the question):

(a) The **problem** with accounts receivable concerns money owed by **wholesale distribution outlets**. The average payment period from these outlets increased from 61 days to 79 days between 2010 and 2011.

(b) A reason for this could be that a **large number** of **wholesale** distribution outlets had serious **financial problems** in 2011, and consequently delayed making payments to their creditors. Their financial problems may be linked to the fact that total sales through these distribution outlets fell in 2011 (compared with 2010). If wholesalers were suffering from lower sales demand, they may not have been generating sufficient cash to pay their creditors promptly.

(c) Accounts receivable are generally too high when **collection procedures** become **less efficient**, and customers are not 'chased' for payment of overdue amounts. A big increase in the average time to pay should not have been ignored by HFIC management. There is no evidence that the problem has been considered by management yet. If so, this would indicate poor management control within the Treasury or accounting department.

(c) **Financial difficulties** for **wholesale** distribution outlets and **poor collection management** together would possibly explain the large amount of receivables written off as bad debts in 2011.

(d) Another possibility is that HFIC management were aware of the **financial difficulties** of some of its **customers**, and agreed to allow them more time to pay, in order to prevent them from going out of business or in order to avoid losing sales to these customers. Dong Li should investigate the discussions and negotiations that may have occurred between struggling customers and HFIC's receivables collections team.

(e) Following on from this, if HFIC management have been **allowing** customers **more time to pay** in order to preserve business, the costs and benefits of this policy should be reviewed.

(f) **Measures to improve** (answering question **part b**) the accounts receivable settlement period should include more efficient receivables collection procedures and management.

- Better credit checking procedures
- Strict policies on agreeing credit terms with customers
- Monitoring overdue payments, through aged receivables analysis
- Procedures for chasing overdue payments (reminder letters, telephone calls)
- Making the credit control manager accountable for poor performance

Offering a **discount** for early settlement is **not recommended**, because HFIC is cash-rich and the cost of the discounts is likely to be higher than the financial benefits of earlier receipt of payments.

Similarly, the use of debt **factoring** is **not recommended**, because the cost of using a factor is likely to be more than the benefits from earlier payment. In addition, **factoring** is much more **costly** and difficult when customers are located in other countries.

Over time, total receivables should reduce in size as the proportion of HFIC sales through its retail outlets increases, and the proportion of sales through wholesale channels falls.

(g) The potential benefits from better receivables management can be estimated [answering question **part (c)** – potential savings].

- Sales through **wholesale outlets** in 2011 were (in HK$ million) 14,214 in 2011. The average collection period increased by **18 days** (79 - 61). As a consequence of the longer collection period, average receivables were higher than they would have been if the collection period had been the same as in 2010.

- The amount by which average receivables were higher because of the longer collection period was (18 days/365 days × 14,214) = about HK$700 million. If the **cost of capital** is **5%**, finance cost benefits would be about HK$35 million each year.
- A separate matter that management may wish to consider is the **length of the credit** offered. Longer credit terms might result in higher annual sales revenue, and may help to prevent the financial collapse of some wholesale customers. There would be some cost in terms of a higher investment in receivables and possibly a bigger write-off of bad debts.

## Case C Suggested solution

**LP reference**

The LP reference is Chapter 8 Section 8 for payables management.

**Key learning points**

Students need to recognise that HFIC presents itself as an ethical business, and suggestions that payments to suppliers should be delayed as long as possible would be inappropriate. The key issue is that if important **suppliers** are in **financial difficulty**, HFIC must either find alternative suppliers as quickly as possible, or should consider supporting some suppliers financially, at least temporarily until their position improves.

**Suggested solution**

A presentation to Dong Li might cover the following points.

**Part (a)**

(1) Some **suppliers** are in **financial difficulty**. There is no information about which suppliers are in difficulty, or how important they are for HFIC.

(2) If some suppliers are unable to continue in business, HFIC will **lose sources of supply**. Unless there are alternative suppliers to provide the same goods, HFIC will lose sales and (presumably) profits will fall.

(3) The financial difficulties of some suppliers may be caused by the **increases in their material costs and labour costs**. If so, other suppliers may be unwilling to make the same goods for HFIC, except at higher prices. HFIC may therefore have to pay more for the goods that it orders from suppliers.

(4) A search for **alternative suppliers** to replace suppliers who go out of business could be **expensive** in terms of management time as well as expenditure.

(5) For these reasons, HFIC should consider the costs and benefits of trying **to assist some of its suppliers** who are in difficulty.

**Part (b)**

HFIC should first of all establish **which suppliers** may be **in difficulty**, and should discuss the problem with those suppliers that it considers to be important for HFIC's business. There is no reason why the same approach should be taken with all suppliers, including those who are not in difficulty or those who are not important for HFIC's business.

HFIC could **pay suppliers more quickly**. In some cases, it might agree to **pay for orders in advance**. This would improve cash flows for the suppliers, and would therefore provide some **short-term benefits**.

HFIC might consider asking for a **settlement discount** for early payment, but the cost of these discounts to the suppliers could put them into deeper financial difficulty, and so is **not recommended**.

HFIC should consider as a matter of urgency whether to **stop buying from some suppliers** and switch to buying more from suppliers who are in a more **secure financial position**. Normal credit terms could be agreed with these suppliers.

If there is a risk of collapse of some key suppliers, HFIC might consider more urgent **longer-term measures**. One measure would be to lend money to suppliers for a longer term, and act as a 'banker' to those suppliers. Terms for the repayment of the debt over time would have to be agreed.

In urgent cases, HFIC may need to consider **taking over** the businesses of **struggling suppliers**, if these are very important for HFIC's business.

(**Note**: Students may disagree with these conclusions, but should be able to present good arguments to support their own conclusions.)

## Case D Suggested solution

### LP reference

Dividend policy is covered in Chapter 10. LP references are  all sections of Chapter 10.

### Key learning points

Part (d) considers dividend policy. HFIC has announced a **new dividend policy** for the future, and intends that dividends each year will be **60%** of profit after taxation. Students are required to present arguments in favour of the new policy and against it, and then to make a recommendation about whether the new policy should be retained or abandoned. The analysis calls for a consideration of most aspects of dividend policy and many of the issues discussed in Chapter 10 of the LP should be discussed.

### Suggested solution

| (a) In favour of 60% dividend payout ratio policy | (b) Against the policy |
|---|---|
| Shareholders will know what dividends to expect from the company in the form of dividends, and that dividend payments will **relate directly to profitability** each year. | Retained profits in some years may be less than the amount the company's management want to re-invest in for growth of the business. |
| A **constant dividend payout ratio removes the uncertainty** from dividend policy, except for any uncertainty about profitability. | Retained profits in some years may be more than the amount the company's management want to re-invest in for growth of the business. |
| If the company **needs more money** to reinvest in business development, it can borrow instead of cutting the dividend payment. This appears to have occurred with HFIC in 2011. | A 60% payout ratio will mean that dividends in each year will be more than the 'normal' amount of 40% in previous years, but less than the actual dividends paid in previous years. With special dividend payments, the actual payout ratio has been 75% to 80%. Shareholders may be disappointed by the fall in dividends, and this could explain the fall in the share price when the new dividend policy was announced. |

If the company has more cash than it needs in any year, it can **repurchase** and cancel some shares, rather than pay a higher dividend.

**Business planning is easier**, because management should be able to estimate the retained profits that will be available for reinvestment. Retaining some profits provides funds for investing in business growth.

The benefits of certainty about dividends will be lost if the company continues to pay special dividends in future years.

A fixed dividend payout ratio of 60% of profits each year is **too rigid**. The board of directors of HFIC should be more flexible and should be prepared to adjust dividend payments each year according to the circumstances of the business.

Shareholders may **want certainty** about future dividend payments, but they will prefer certainty about the actual dividend payments (dividend per share each year and growth in dividend per share) rather than certainty about the payout ratio. If profits fall in any year, dividend payments would fall if the payout ratio is maintained at 60%. In any year when profits fall, the board may wish to increase dividends in order to maintain the dividend per share at the same level as the previous year.

Changing dividend policy soon after a new policy has been announced may be seen as a **sign of weakness** in the board of directors.

**(c)** **There is no 'correct' recommendation.** It may be recommended, however, that dividends act as a '**signal**' to investors about the company's future prospects. The most **appropriate policy** may therefore be to establish **targets for annual growth in dividend** per share, rather than a fixed dividend payout ratio, and try to achieve the stated target every year.

## Part D Treasury Operations: Case 2

The board of High Fashion International Company Limited are concerned about the losses from adverse exchange rate movements that the company incurred during 2011, and they have asked Dong Li to explain the reasons for **exchange losses** in the accounts and explain measures that companies might take to manage the risk and reduce the potential losses.

The board would also like to know which of the measures to manage exchange risk would be appropriate for HFIC, and which would be inappropriate.

Dong Li has asked you to assist him, and to make a presentation to him about the matters that are of concern to the board of HFIC.

Your presentation should cover the following requirements.

***Required***

**(a)** **The possible reasons for exchange rate losses incurred by HFIC during 2011.**

**(b)** **Measures that companies can take to manage their exchange risk.**

**(c)** **An explanation of which of these exchange risk management methods would be appropriate for HFIC and, with reasons, which methods would be inappropriate or impractical.**

# Treasury Operations: Case 2

This exercise is about foreign exchange risk and the management of this risk. The problem is simplified because the exchange risk for HFIC is limited to the HK dollar/euro exchange rate, which (in the exercise) has been volatile.

Students are required to identify **how losses arise from adverse exchange rate movements**. They should also recognise that profits can arise from favourable exchange rate movements. However, unless the risk is kept within limits, the company may find that its profits or losses each year depend more on exchange losses or gains than on the profitability of its underlying business.

## Suggested solution

### LP reference

The LP reference is Chapter 11 Section 8.

### Key learning points

Exchange losses can arise because of **economic risk**, **translation risk** or **transaction risk**.

There are various ways of managing exposures to risk, but many are not always relevant to a company's circumstances. HFIC has exposures to risk from variability in the euro/HK dollar exchange rate, but methods for hedging exposures to risk are limited.

### Suggested solution

Your presentation should cover the following points.

**(a) Reasons for exchange losses**

HFIC is exposed to exchange risk from the **volatility** in the **euro/HK dollar** exchange rate. The risk is greater when volatility in the exchange rate is higher.

During 2011, the euro fell in value against the HK dollar, and the reporting currency for HFIC's financial statements is the HK dollar. HFIC will hold a large amount of **assets denominated in euros**, such as cash and property, plant and equipment. These will lose value in terms of HK dollars as the euro falls in value. As a consequence there will be some losses on **translation** of euro assets into HK dollars for the purpose of financial reporting.

HFIC **invoices its customers in Europe in euros**, and when the payments are received from customers, many of these euros will be converted into HK dollars. (This is because many of HFIC's expenditures are in HK dollars, so the company needs to convert euro income into HK dollars, to pay its expenses.) If the euro falls in value between the time that a customer is invoiced in euros and the time that payment is received, there will be a **transaction** loss – unless the exposure to risk has been hedged.

It can also be argued that HFIC is also exposed to **economic risk**, by locating its operations and incurring costs in a 'strong currency' area, rather than in a country where the currency is weaker. As a consequence of operating with HK dollars as its main expenditure currency, HFIC is exposed to long term exchange risks, and may lose competitiveness over time against global competitors who operate in a country with a weaker currency.

**Measures for managing exchange risk and relevance to HFIC**

| (b) Method of managing FX risk | (c) Appropriate for HFIC? |
| --- | --- |
| Require customers to **pay in HK dollars** instead of euros | **Impractical** for sales through retail distribution channels. Consumers in Europe will not pay for goods in HK dollars. Wholesale distribution customers may be persuaded to pay in HK dollars, but there is some risk that they will refuse to do so. |
| **Forward exchange contracts**, to fix the exchange rate for converting euro receipts into HK dollars. | An **important method** of hedging exposures to transaction risk, but forward contracts can be used only for relatively short-term exposures of up to a few months. |
| **Money market transactions**, to fix the exchange rate for converting euro receipts into HK dollars. | Another **important method** of hedging exposures to transaction risk, and an alternative to forward exchange contracts. |
| **Currency futures**, to manage the exchange rate for converting euro receipts into HK dollars. | **Unlikely** to be appropriate. To use currency futures to hedge transaction exposures would involve dealing in HK dollar/US dollar futures and euro/US dollar futures. Too complex for a non-bank organisation. |
| **Currency swaps** | **Not appropriate**, unless HFIC borrows in euros. |
| **Currency options** | **Unlikely** to be appropriate, unless HFIC expects to receive a large payment in euros in the next few months. Buying an option would then allow the company to hedge against the risk of a fall in the euro, but benefit from any increase in the value of the euro. |
| **Matching assets and liabilities** in the same currency, to reduce exposures to translation risk | **Inappropriate**, unless HFIC borrows large amounts of euros to crease euro liabilities. |
| **Matching income and expenditure** in the same currency. | **Impractical**, unless HFIC moves its business operations to the euro zone countries and incurs more expenditures in euros. |

The **main recommendation** is therefore that HFIC should give its Treasury department responsibility for managing the foreign exchange risk, using **forward exchange contracts** or **money market transactions** where appropriate to create a hedge for transaction exposures. However, where the Treasury department believes that the foreign exchange risk at any time is more likely to be in favour of HFIC, it may decide to leave its transaction exposures un-hedged.

If at any time in the future HFIC wishes to borrow, it should **consider borrowing in euros**, to match more closely the currencies of its assets and liabilities, and also to match the currencies of its  income and expenditure (interest payments).

# Corporate Finance: Pre-workshop exercise

**LP reference**

Chapter 18 Section 3.

**Key Learning Points**

The pre-workshop exercise requires students to explain the reasons for a **due diligence** exercise before making a formal takeover bid, and the issues that should be investigated in the due diligence exercise. **Students therefore need to understand what due diligence involves and why it is carried out**. As professional accountants, they may well be involved in due diligence exercises during the course of their future career, since accountancy firms are often asked to do the due diligence work on behalf of the company that is considering the acquisition.

There is a Hong Kong Stock Exchange Listing Rules requirement (Chapter 3A of the Listing Rules, Rule 3A.11) that the **sponsor** of a company must carry out a due diligence exercise on their sponsored company when it applies for a listing and initial public offering (IPO).

Although there is no requirement for a due diligence exercise when a listed company is planning an acquisition, it is nevertheless a prudent and sensible measure. If the acquisition is large, it could require shareholder approval, and shareholders would want to receive information about the proposed takeover before agreeing to it. They would expect due diligence to have been carried out. If the company intends to raise money to finance the acquisition from the stock market, potential investors would also want to know details about the proposed takeover and the target company.

This exercise should make students think about what information should be obtained from a due diligence exercise, and why.

## Suggested solution

**(a) Purpose of a due diligence exercise**

A due diligence exercise is an **investigation** into a company to obtain information about the company and its business.

(1) What is it buying?

(2) What is it worth?

In order to obtain all the required information to make a **well-informed takeover bid**, the takeover bid should be a **friendly one**, and the board of directors of the target company should be willing to provide the potential buyer with all the information that it requires. The information should be provided **in confidence**, if it is not publicly available.

The potential buyer will use the information to decide whether it wishes to continue with the acquisition and if so what price it is prepared to offer.

HFIC is not required to carry out due diligence for the takeover of a private company, although it would be expected if the acquisition target is so large that shareholder approval is required for the deal.

However, the board of HFIC is correct to insist on due diligence. **Without careful due diligence**, there is a high risk that the company **will pay too much** for the acquisition. If the purchase price for the takeover is high, the board would be risking a large loss on the deal. Even worse, it may make a **strategic mistake** by buying an unsuitable company at an excessive price.

Due diligence also helps to reassure shareholders that the board of directors is taking a **well-considered decision** when making the acquisition.

**(b) The matters to be investigated**

| Matter to be investigated | Reason |
|---|---|
| Company constitution: its registration as a company and details of its **share capital**. This information should be obtained from a study of company documents. Also whether there are any share options. | To ensure that the company is properly and legally constituted, and to establish how many actual shares (and potential shares, if share options are exercised) it would be acquiring. |
| **Ownership** | To establish whether the company's ownership is widely spread, or whether there are major shareholders whose support for a takeover bid may be important. |
| **Board of directors** | A check should be carried out on the members of the board of directors, to establish that they have a good business record and do not have a criminal history or history of bad business practices. |
| **The business** | |
| The company's business and **business history**. If possible, information should be obtained about the current business strategies of the target company. | To learn about how the business develops, what its business operations are, and its current position in the market. Also what the board's objectives are for the company's future. |
| **Material contracts**. Whether the company has significant contracts with any customers or suppliers, which are critical for the profitability of the company's business. | To establish whether there is any risk from a loss of a major contract after the takeover. |
| **Competition** | To establish who the major competitors are. (The case study refers to one, Diamond Fashions). Also the relative position of the target company and its main competitors in the market. |
| **Profitability** | |
| The **profits** and **cash flows** of the company. This should be available from the financial statements, although **management accounts** should also be obtained from the target company. | To establish the potential value of the business. |
| **Assets** | |
| There should be a check on the **quality** of the target company's assets – what they are and their condition. This will involve a study of the statement of financial position and physical inspections. The **value** of any intangible assets, if any, should be considered. | To establish the existence and quality of the assets that would be acquired, and their potential value. Most intangible assets, particularly goodwill, are unlikely to have value. |

**Liabilities**

| | |
|---|---|
| There should also be a check on the liabilities of the company, both current and non-current, and whether the target company has been settling its liabilities promptly. Also whether any **long-term borrowings** are secured against assets of the company. | To establish that the acquisition will not involve taking over large and excessive amounts of debt. |

**Legal issues**

| | |
|---|---|
| The target company should be asked about a range of **legal issues**, such as whether it is in compliance with laws and regulations, such as employment laws, health and safety laws and environmental laws. Also whether the company is involved in any major litigation. | To establish whether there are any risks from non-compliance with laws and regulations, and whether a liability might arise from litigation in progress. |
| **Tax issues** | Check that the company is in compliance with tax laws and regulations, and is up to date with payments of tax. |

**Employment issues**

| | |
|---|---|
| Information should be obtained about the work force: **numbers of employees**, the **nature of any work agreements** that are in place. Or the nature of any recent or current labour disputes. | To establish whether there will be any issues relating to the work force after a takeover, that may affect labour relations, operational procedures, or costs |
| Management. Information should be obtained about the **numbers and quality of management staff,** and whether **key staff** might be prepared to continue with the company after a takeover. | There has to be a reliable management structure in place after the takeover. |

There should also be investigation into the nature of any **regulatory approval** from the government authorities that would be required before a takeover can occur.

# Part E Corporate Finance: Case 1

The board of HFIC has decided, after the due diligence exercise on Brilliance Fashions, that it should make an **offer to buy** 100% of the share capital of the company. The board of Brilliance Fashions has indicated that it will seriously consider an offer at a **fair price**, but has indicated that before any acquisition occurs, it will pay a **special dividend** to its shareholders, leaving only enough cash in the company to meet payments of current liabilities.

For the purpose of deciding on an offer price, a current statement of financial position has been produced. This is not audited, but is considered to be fairly reliable.

| **Brilliance Fashion Limited**<br>**Current consolidated statement of financial position** | **RMB 000** |
|---|---|
| **Non-current assets** | |
| Intangible assets | 52,000 |
| Property, plant and equipment | 77,000 |
| | 129,000 |
| **Current assets** | |
| Inventory | 86,000 |
| Receivables | 91,000 |
| Prepayments for materials/supplies | 23,000 |
| Cash and cash equivalents | 308,000 |
| | 508,000 |
| **Total assets** | 637,000 |
| **Equity and liabilities** | |
| Equity attributable to owners of the parent company | |
| Share capital | 1,000 |
| Reserves | 481,000 |
| **Total equity** | 482,000 |
| **Non-current liabilities** | 19,000 |
| **Current liabilities** | 136,000 |
| **Total equity and liabilities** | 637,000 |

The best estimate of profitability is obtained from the most recent annual income statement, for the year to 30 June 2011.

**Brilliance Fashion Limited**

| **Consolidated income statement for the year ended 30 June 2011** | **RMB 000** |
|---|---|
| Turnover | 622,000 |
| Cost of goods sold | (304,000) |
| **Gross profit** | **318,000** |
| Distribution and selling costs | (122,000) |
| Administration costs | (26,000) |
| Depreciation | (3,000) |
| Amortisation | (2,000) |
| Impairment losses | (10,000) |
| Other operating costs (note 1) | (11,000) |
| **Operating profit** | **144,000** |
| Interest income | 8,200 |
| Finance costs | (1,000) |
| **Profit before taxation** | **151,200** |
| Taxation | (46,000) |
| **Profit after taxation** (attributable to shareholders) | 105,200 |

**Notes:**

(1) Other operating costs include an increase in the allowance for bad debts of RMB 4.8 million.
(2) Dividend payments to shareholders for the year to 30 June 2011 were RMB 58 million.

To help with reaching a decision about a suitable offer price for the company, the following information has been obtained:

(1) **Growth** in the annual **dividend** payments by Brilliance Fashion has been on average 6% each year for the previous five years.

(2) **Diamond Fashions**, which is the market leader for producing and selling clothing in the PRC, is a listed company on the Stock Exchange of Hong Kong. Its shares currently trade on a price/earnings multiple of 16. The shares of **HFIC** currently trade on a **P/E ratio** multiple of 14.5.

(3) If HFIC acquired Brilliance Fashion Limited there would be some **cost savings**, but at the moment it is not expected that the savings would be significant. The best estimate of savings through cost efficiencies is RMB 18 million each year (before taxation). You should assume that the rate of taxation is 30%.

(4) The board of directors of Brilliance Fashion as indicated that if an acquisition by HFIC is agreed, it will pay a **special dividend** of RMB 250 million to its shareholders before the acquisition occurs.

(5) It is also estimated that if HFIC acquired Brilliance Fashion, growth in profitability would not be significant without substantial **new investment** in the company by HFIC. It is estimated that earnings before interest, taxation, depreciation and amortisation (EBITDA) and before impairment losses would be as follows:

    (a) First year after acquisition: The same as in the year to 30 June 2011, plus the cost savings referred to above.

(b) Second and third years after acquisition: growth by 5% in each year.

(c) Fourth year onwards: No further growth in EBITDA.

(6) The **cost of capital** of HFIC is 5%, but the acquisition of Brilliance Fashion would be a high-risk venture, and it has been suggested that a more suitable cost of capital for this investment could be as high as 10%.

(7) The current exchange rate is RMB1 = HK$1.20.

**Members** of the HFIC board have made the following **comments**.

(1) There is a possibility that if HFIC does not acquire Brilliance Fashion, HFIC's competitor Diamond Fashions might try to acquire it.

(2) A higher rate of growth in earnings and free cash flows would be achieved by investing heavily in new plant and equipment after acquiring Brilliance Fashion. With substantial additional investment in the company, annual growth in the free cash flows of Brilliance Fashion might be 12% or more for at least five years and probably longer. However, the additional investment required is likely to be about HK$4,000 million over the next three or four years.

You have been asked to recommend a **valuation** for the equity capital of Brilliance Fashion, based on this available information. The board of HFIC is aware that there are different ways of estimating the value of a private company, and would like to see estimates based on **asset values**, **dividends** and **earnings**, as well as a valuation based on the **present value of future expected cash flows**.

***Required***

**(a) Prepare valuations for the equity of Brilliance Fashion using the information in this handout using each of the following methods of valuation:**

**(1) assets basis**

**(2) dividends basis**

**(3) earnings basis**

**(4) present value of future cash flows basis.**

**For each method of valuation that you use, state the assumptions and estimates on which your valuation is based.**

**(b) Your answer to part (a) should produce a number of different valuations for the equity of Brilliance Fashion. Use your various estimates to recommend the price that HFIC should offer to acquire 100% of the equity shares of Brilliance Fashion, and explain the reasons for your recommendation.**

# Corporate Finance: Case 1

This exercise looks at methods of valuation for **non-listed** companies for the purpose of making a takeover offer. Students are required to prepare **several different valuations**, each using a different basis of valuation. Some of the valuations should not take a long time to prepare, but the exercise should help to make clear to students that valuations are based on estimates and assumptions, and there is **no 'exact' or 'correct' valuation**.

The **FCFF valuation** is likely to take the most time to prepare, and the exercise invites students to make some assumptions about what future free cash flows will be, and what discount rate to use in order to reach a DCF valuation. Students should complete the valuations and recognise the **positives and negatives** of each **valuation method**.

**LP reference**

The LP reference is Chapter 17 Sections 2, 3, 4 and 5. Comparisons of valuation methods are discussed in Chapter 17 Section 8.

**Part (a): Alternative valuations**

**Key learning points**

Students must recognise that the valuation methods to consider are the **assets**, **dividends**, **earnings** and **free cash flow** to the firm methods. This should not be a problem, since these methods are specified in the exercise.

To prepare an **assets-based valuation**, students need to consider the probable difference between the valuation of assets in the statement of financial position, and their market value or **disposal value**, which may be difficult to assess. They should also recognise that **intangible assets**, particularly goodwill, **do not have value**. Finally, they must remember to deduct the value of **liabilities** in order to reach an assets-based estimate of the value of the equity.

A **dividends-based valuation** is relevant because it may help to indicate an **offer price that shareholders in Brilliance Fashion would consider acceptable**. The exercise indicates that there has been some **dividend growth** in the past, and shareholders in Brilliance Fashion are likely to expect further dividend growth in the future. To prepare a dividends-based valuation, students have to make **two estimates** or assumptions. Students should reach a view about what the **expected future rate of growth in dividends** would be if there is no takeover by HFIC, and what is a suitable **expected return on equity** for the shareholders in Brilliance Fashion.

An **earnings-based valuation** involves multiplying annual earnings by a suitable P/E ratio multiple. Students are likely to choose the earnings figure for the most recent year, and the only guide to an appropriate P/E ratio multiple is the current P/E ratio for Diamond Fashion. **A lower P/E ratio** should be used for Brilliance Fashion, since Diamond Fashion is a listed company and Brilliance Fashion is a smaller private company.

To prepare a **FCFF valuation**, students need to decide:

- How to produce a valuation. The suggested solution here suggests a valuation based on FCFF growth in perpetuity, but student groups may use a different approach. They might choose to prepare a valuation based on cash flows over a **given period of time** (say ten years), but a valuation based on cash flows in **perpetuity** is simpler.
- How to produce a **sensible estimate** of free cash flow each year.
- What **discount rate** to apply to obtain a valuation. The exercise indicates that 10% would be appropriate, but students may select a different discount rate – although they should justify their reasons for doing this.

The valuation depends on estimates of annual growth. The exercise indicates that there will be growth for two years, but then no further growth without substantial new investment in the business. New investment would presumably improve future growth in profits and cash flows, but should HFIC increase its offer price for the equity of Brilliance Fashion by making some allowance for the benefits from future investment?

Valuations by the different student groups could vary widely, but the principles they apply must be sound and the methodology they use must be technically correct.

**Suggested solution, part (a)**

**Assets-based valuation**

The value of the assets of Brilliance Fashion in its statement of financial position is RMB637 million. However this includes intangible assets which have no real value, and the board of the company will pay out RMB 250 million in dividends before an acquisition. Using the values in the statement of financial position, a valuation of the equity might be:

| | **RMB 000** |
|---|---|
| Total assets | 637,000 |
| Less: Intangible assets | (52,000) |
| Special dividend (reducing cash assets) | (250,000) |
| Adjusted value of assets | 335,000 |
| Less: Liabilities (19,000 + 136,000) | (155,000) |
| Assets-based valuation of equity | **180,000** |

Using an assets-based approach to valuation, the equity of Brilliance Fashion is **unlikely** to be **worth more** than **RMB 180 million**.

**Dividends-based valuation**

A dividends-based valuation is useful because it may indicate a price that the shareholders in Brilliance Fashion might be prepared to accept for their shares.

Growth in dividends has been on average 6% for the previous five years. It might be assumed that shareholders would expect this rate of growth to continue into the foreseeable future ('in perpetuity').

There is no indication of the dividend yield that might be applied to shares in Brilliance Fashion. The only indication of a suitable rate of return is the 10% return that HFIC might consider appropriate for the acquisition.

The a required return of 10% and future annual growth expectations of 6% are applied to the dividend payment by Brilliance Fashion in the year to 30 June 2011, a dividends-based valuation would be:

RMB 58 million (1.06)/(0.10 – 0.06) = **RMB 1,537 million**.

**Earnings-based valuation**

The earnings of Brilliance Fashion in 2011 were RMB105.2 million. The shares of Diamond Fashion are trading on a P/E ratio multiple of 16 and the shares of HFIC are on a multiple of 14.5.

To value the shares of Brilliance Fashion on a P/E ratio multiple, a lower P/E ratio should be used, since Brilliance Fashion is not a listed company and is smaller (and a higher investment risk) than the two listed companies.

A P/E ratio multiple of 10 might be considered appropriate, but this is a matter of debate and **other P/E ratio multiples may be agreed**.

Applying P/E ratio of 10 to the 2011 earnings, the value of Brilliance Fashion's equity would be RMB 105.2 million × 10 = **RMB 1,052 million**.

**Free cash flow to the firm valuation**

An issue is whether a company should be willing to pay for the value of its own future investments in an acquired company. In principle it should not. By investing in new plant and equipment after the acquisition, HFIC may be able to increase the value of its investment in Brilliance Fashion. However, these future increases in value are not directly relevant to the current value of Brilliance Fashion at the time of acquisition. New investments after the acquisition should be appraised separately, using normal DCF methods of appraisal.

**It is therefore assumed** that a valuation based on the present value of future expected cash flows from the acquisition should ignore the increase in profits and cash flows that should be expected from the additional investment that would be made in the company after the acquisition.

It is assumed for the purpose of this valuation that replacement capital expenditure would be equal to the annual charges for depreciation and amortisation, and that there would be no significant changes in working capital investment.

A valuation of the company on a FCFF basis should therefore be based on free cash flows of:

EBIT (1 – t).

| | **RMB 000** |
|---|---|
| Operating profit in 2011 | 144,000 |
| Savings from cost efficiencies | 18,000 |
| Earnings before interest and taxation | 162,000 |
| Taxation (30%) | (48,600) |
| Estimated cash flow in first year after acquisition | 113,400 |

A valuation will be based on the assumption that FCFF will be RMB**113.4** million in the **first year** and will rise by 5% each year for the next two years, and will then remain at a constant annual amount in perpetuity. A discount rate of 10% will be applied to make a valuation of the company.

| **Year** | **FCFF** | **Year 3 value (Note 1)** | **Discount factor at 10%** | **Present value** |
|---|---|---|---|---|
| | RMB000 | | | RMB 000 |
| 1 | 113,400 | | 1/1.10 | 103,091 |
| 2 | 119,070 | | $1/(1.10)^2$ | 98,405 |
| 3 | 125,024 | | $1/(1.10)^3$ | 93,932 |
| 4 onwards | 125,024 | **1,250,240** | $1/(1.10)^3$ | 939,324 |
| | | | | 1,234,752 |
| Less: Value of debt capital | | | | (19,000) |
| Estimated value of equity | | | | 1,215,752 |

Note 1: At a discount rate of 10%, the Year 3 discounted value of annual cash flows of RMB125.024 million in **perpetuity** is 125.024/0.10 = **RMB 1,250.24 million**.

**Summary of valuations**

The four valuations, using the assumptions and estimates stated, have produced the following valuations:

| | **RMB 000** |
|---|---|
| 1. Assets basis | 180,000 |
| 2. Dividend yield basis | 1,537,000 |
| 3. Earnings basis | 1,052,000 |
| 4. FCFF basis | 1,215,752 |

**Suggested solution, part (b)**

**LP reference**

In addition to the sections of the LP referred to above, students should refer briefly to Chapter 17 Section 8.

The shareholders of Brilliance Fashion will not accept an offer price based on the **value of the assets** in the company. It is therefore clear that if HFIC acquires Brilliance Fashion, it will acquire a company with only a small amount of assets in comparison with its purchase cost, and there will be a substantial amount of **goodwill** to include in the consolidated statement of financial position.

The **dividend yield basis** of valuation is the highest of the four valuations, although this has been based on assumptions/estimates about future dividend growth and a require dividend yield that might not be reliable.

It is recommended that the (initial) offer price should be much lower than this valuation.

The **earnings basis** of valuation has been made on the assumption that Brilliance Fashion should be valued on a P/E ratio multiple that is much lower than the P/E ratios that apply to Diamond Fashion and HFIC. A P/E ratio of 10 may seem fairly reasonable.

The **FCFF valuation** is higher, although this is based on estimates of annual earnings in perpetuity. A valuation based on free cash flows over, say, 10 years would produce a lower valuation.

**It is therefore recommended** that the (initial) offer price for the shares of Brilliance Fashion should be RMB 1,100 million (or HK$1,320 million).

# Corporate Finance: Case 2

HFIC has **made an offer** of HK$1,400 million for 100% of the equity shares of Brilliance Fashion, which has been accepted by all its shareholders. The board of HFIC considers that the offer price is a fair one, but to achieve its objectives from the acquisition, HFIC will have to invest substantial amounts of additional capital in the business of Brilliance Fashion after the acquisition has been made.

John Fordham, CEO of HFIC, and Dong Li, the CFO, are meeting soon to discuss **how** the acquisition should **be financed**. They have asked for your views and recommendations about the most suitable method or methods of financing.

***Required***

**Identify the different ways on which HFIC might finance the acquisition of Brilliance Fashion.**

**(1) Explain with reasons which method of financing you would recommend.**

**(2) You should also explain, with reasons, which of the methods of financing you consider would *not* be appropriate.**

# Corporate Finance: Case 2

The purpose of this exercise is for students to think about the **alternative methods of financing** an acquisition. In this case, it might be argued that HFIC has sufficient cash resources to pay for the acquisition in full in cash, although we do not know what cash resources will be required by the company in the future, for example to pay dividends, repay debts or invest extensively in the PRC after acquiring Brilliance Fashion.

There are several **financing options**: **retained profits**, **new equity issue**, a **bond issue** or even **bank loans**. A combination of these might be used.

**Suggested solution**

**LP reference**

This exercise covers various aspects of the capital markets and LP references are Chapter 16 Section 3.3 and Chapter 18 Section 12.

**Key learning points**

Students should try to recognise different methods of financing the acquisition and eliminate those that are not possible or inappropriate. They should then consider the methods that would be possible and to reach a view about which method of financing would be best.

In this case, students may reach the conclusion that the acquisition could be financed from **existing cash resources**. Since interest received on cash will be lower than the expected returns from the investment in Brilliance Fashion, using cash resources to pay for the acquisition should result in higher earnings per share.

Another possibility is to offer the shareholders in the target company new shares in HFIC for their shares in Brilliance Fashion, A **share exchange** could be an attractive proposition for shareholders in Brilliance Fashion who want to retain an investment in the industry, and who see strong growth prospects following the acquisition by HFIC. At a price of HK$1,400 million, the acquisition should not dilute earnings per share, because Brilliance Fashion would be purchased on a lower P/E ratio multiple at which HFIC shares are currently valued.

Yet another possibility would be to finance the acquisition by means of a **bond issue**. In view of the company's exposure to foreign exchange risk because of its revenue in euros, an international **bond issue denominated in euros** would have the advantage of providing a hedge against exchange risk in other parts of HFIC's business operations.

**Suggested solution**

The student's own views on this matter may differ and their view will need to be backed up by clear and supported argument. A suggested analysis and recommendation is given below.

There are several ways in which HFIC might try to raise the finance that it needs.

**Existing cash resources**

HFIC might use its existing cash resources (and retained profits) to finance the acquisition. Its statement of financial position at 30 June 2011 shows cash resources of HK$5,170 million, which is much more than the purchase price for Brilliance Fashion.

An advantage of using existing cash is that the interest income on the cash is likely to be quite low, and less than the return that would be earned on the investment in Brilliance Fashion. The earnings per share of HFIC would therefore increase.

However, HFIC may wish to use the cash for investment in Brilliance Fashion after the acquisition, or may wish to use its cash for future dividend payments. The management of HFIC would need to consider how much cash it has for making acquisitions. **If it has sufficient cash for the acquisition of Brilliance Fashion, this method of financing may be the most appropriate.**

**Share exchange**

HFIC could offer shareholders in Brilliance Fashion new shares in HFIC in exchange for their shares in Brilliance Fashion. If the valuation of Brilliance Fashion's equity is HK$1,400 million, the shares would be acquired at a lower P/E ratio multiple than the current P/E ratio of HFIC's shares. This method of financing would therefore not dilute earnings. It would also leave HFIC with cash for investing in its business operations.

Shareholders in Brilliance Fashion might be attracted by the opportunity to hold an investment in HFIC, particularly if they believe that the acquisition will result in strong profits and dividend growth for HFIC.

A share exchange offer should be accompanied by a cash alternative as the purchase consideration. A part-cash, part-share exchange offer could be considered.

**A share exchange offer would also be a realistic and attractive method of financing the acquisition, but only if a sufficient number of shareholders in Brilliance Fashion are attracted by this form of consideration.**

**New equity issue**

HFIC might consider issuing new shares to raise cash to finance the acquisition. The amount of finance required is fairly small relative to the current total value of HFIC's equity, and a rights issue would therefore be inappropriate. If new shares are issued to raise cash, a placing of the new shares should be used.

However, this method of financing the acquisition is less attractive than using retained profits (represented by cash holdings) or a share exchange.

**New bond issue**

HFIC could raised the required capital by issuing bonds. HFIC has not issued bonds before, and the market for Hong Kong dollar-denominated bonds is not yet very liquid. Issuing HK$ bonds is therefore not recommended.

However, HFIC might consider issuing **international bonds denominated in euros**. This would create liabilities in euros that could be matched against income and assets in euros, and so provide a **hedge against the company's exposures to foreign exchange risk**.

The maturity of the bonds would need to be considered. In view of the strong cash flows of HFIC (in spite of the cash flow difficulties described in the case study), five-year or seven-year bonds might be sufficient.

If bonds are used to finance the acquisition, straight bonds should be sufficient. There would be no obvious benefit from issuing convertible bonds.

**Bank loan**

HFIC could obtain a bank loan to raise cash to finance the acquisition. However, since it already has sufficient cash to pay for the acquisition, earning less in interest than it would cost to have a loan, this method of financing is not recommended.

**Recommendation**

The recommendation (although students and facilitators may disagree) is that the acquisition should be financed either:

(1) from the company's cash resources (and so from retained earnings)

(2) a share exchange, if shareholders in Brilliance Fashion are interested in this form of consideration, or issuing euro-denominated bonds, if HFIC wants to create a hedge against some of its exposures to foreign exchange risk.

[**Note**: Good students should be able to make a clear assessment of each method of financing and to justify their recommendations with relevant facts in a convincing way given by the background to the case study. Any conclusion is acceptable as long as it is supported with a valid argument.]