

Corporate Strategy and Contemporary Issues

Instructions to candidates

- (1) Time allowed: Reading and planning – 20 minutes
Writing – 3 hours
- (2) Total: 80 marks
- (3) The examination will be conducted as an open book examination.
- (4) This question paper should be answered entirely in the **ENGLISH** language.
- (5) Your answer must be submitted in the answer booklets provided at the Examination Hall.
- (6) Any pre-prepared papers included in your answer **WILL NOT** be marked.
- (7) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer booklet/s.

K
C
5

JUNE 2019

Herbz & Fusionz (Pvt) Ltd (H&F)

Following the special board meeting held on 25 January 2019 to discuss the continuing decline in sales, several rounds of negotiations were carried out with Mr. Katsui Watanabe, the potential Japanese importer with regard to exporting products of H&F to Japan. During these discussions, Mr. Watanabe insisted that H&F would need to supply at least one million bottles per annum in year 2020 which is their first year of operations in Japan. He further noted that there will be a 10% year on year volume growth based on market conditions in Japan. Having realised that their current capacity is only 500,000 bottles per annum, even under maximum utilisation of the present factory capacity, the directors of H&F requested their Accountant, Dilhan to prepare a brief report on this offer, of exporting products to Japan. Key findings from Dilhan's report are given in Table 1 below.

Table 1: Financial and economic forecasts

Year	2020	2021	2022	2023	2024
Price per bottle (JPY)	50.00	53.00	55.00	58.00	61.00
Variable cost per bottle (LKR)	30.00	32.00	34.00	36.00	38.00
Fixed costs excluding depreciation (LKR)	10,000,000	11,500,000	13,000,000	14,500,000	16,000,000
Japanese inflation rate	1.12%	1.17%	1.25%	1.39%	1.45%
Sri Lankan inflation rate	5.56%	5.80%	6.01%	6.95%	7.15%

In the event H&F decides to go ahead with the offer from the Japanese importer, their initial investment will be Rs. 100 million, which will be mainly utilised to construct a new factory, to meet the projected demand from Japan. Accordingly, it is expected that the revenue of the company will predominantly be export sales. The working capital requirement is Rs. 5 million per year for the first five years. Spot exchange rate is JPY 1 = LKR 1.55. The cost of debt will be considered as Sri Lanka Inter Bank Offered Rate (SLIBOR) plus 4%. Presently, SLIBOR is 11.81%.

Upon discussion with the other directors, Nipuna approached his uncle, Mr. Asanka Pathirana who lives in the UK, a Chartered Engineer by profession regarding funding for this export opportunity to Japan. He appeared very enthusiastic about it and through several subsequent conversations, Nipuna requested his uncle to think about investing in the company, and becoming a director of H&F. Prior to investing Mr. Pathirana requested the financial statements of H&F for the past 3 years, the 3 year strategic plan and the annual plan for the next year. Since the inception of the company, the sole focus of the directors has been on streamlining core operations. Therefore the directors felt that the current documents prepared by the company would not serve the needs of Mr. Pathirana, and for the first time, they realised the importance of addressing the lapses, in the present accounting and control systems. Hence the board of directors of H&F decided to address the concerns of Mr. Pathirana.

After several negotiations, Mr. Pathirana expressed his interest to serve as a board director and invest LKR 50 million. It was therefore decided that the rest of the funds would have to be sourced via a bank loan.

The board of directors of H&F wishes to get assistance from their consultant.

Additional information:

The beta for similar projects is 1.2, market risk premium is 10% and the average 5 year government treasury bond rate is 9%. It is expected that cash flows will grow at 3% per year, after first five years of operation.

Required:

As the consultant to H&F **write** a report to the board of directors advising whether they should cater to the Japanese market.

The following areas need to be addressed in your report:

- Business expansion strategies available to the company.
- Ability of the company to cope with the competition in the Japanese market.
- Financial feasibility of the project, and qualitative/other factors to be considered.
(Assume that all cash flows are nominal cash flows. State assumptions clearly if any).
- Issues related to the existing accounting and control systems as well as other functional areas of the company, and strategies to overcome such issues.
- Sustainability concerns in relation to the environment, that should be considered, when entering into the Japanese market.

Note: Use any model where appropriate, to support your answers.

(Total: 80 marks)

Mark allocation

	Marks
1. Business expansion strategies available to the company.	15
2. Ability of the company to cope with the competition in the Japanese market.	20
3. Financial feasibility of the project and qualitative/other factors to be considered.	20
4. Issues related to the existing accounting and control systems, as well as other functional areas of the company, and strategies to overcome such issues.	12
5. Sustainability concerns in relation to the environment that should be considered, when entering into the Japanese market.	08
6. Conclusion, clarity and language.	05
Total	80