Diploma in Financial Management

Module B

PROJECT DB2, INCORPORATING SUBJECT AREAS
– FINANCIAL STRATEGY
– RISK MANAGEMENT

All questions are compulsory and MUST be answered

The project MUST be written in English.

The maximum word count (including appendices and tables but excluding references and bibliography) is 5,000.

The project MUST be TYPED in black ink, one-sided, double-spaced, using a minimum 12-point font size and a 1-inch margin at each side. HANDWRITTEN SUBMISSIONS WILL NOT BE ACCEPTED. The project must be submitted by post, electronic submissions are not acceptable.

The project should be submitted on A4 paper with your student number, project name, date and page number at the top of each page.

A project submission form MUST be completed for each project submitted and attached to the front of the project.

The Association of Chartered Certified Accountants

Section 1 – incorporating subject areas – Financial Strategy and Risk Management.

This ONE question is compulsory and MUST be attempted

Plutus plc

1 Plutus plc is a manufacturer and retailer of premium confectionery and cakes. The company began in 1989 when Arthur Plutus set up a small manufacturing operation to produce confectionery and cakes for shops in the county of Lincolnshire. The operation was an immediate success and the company quickly established a strong reputation for the quality of its goods, which are sold under the Plutus brand. The company now operates a large manufacturing facility in Lincolnshire and has one hundred and fifty shops throughout the UK. Around 40% of the confectionery and cakes is sold through the company's shops and the remainder is sold through the internet, mail order and gift shops. The company was listed on the Alternative Investment Market in 1998.

The draft financial statements for the year that has just ended are set out below:

Draft balance sheet as at 31 July 2005

	£000	£000	£000
Fixed assets (at written down values)			
Freehold land and buildings			11,860
Retail fittings and equipment			3,510
Plant, vehicles and equipment			13,230
			28,600
Current assets			
Stocks		4,650	
Debtors		4,170	
Cash in hand		1,024	
		9,844	
Less **Creditors: Amounts due within one year**			
Trade creditors	6,848		
Corporation tax	870		
Dividends	622	8,340	1,504
			30,104
Less **Creditors: Amounts due after more than one year**			
5% Debentures (secured on freehold buildings)			6,800
			23,304
Capital and reserves			
£0·25 ordinary shares issued			8,000
Retained profit			15,304
			23,304

Draft profit and loss account for the year ended 31 July 2005

	£000	£000
Sales		55,460
Cost of sales		26,190
Gross profit		29,270
Less:		
Selling and distribution expenses	19,610	
Administration expenses	5,832	25,442
Operating profit		3,828
Finance expenses		348
Net profit before tax		3,480
Corporation tax (25%)		870
Net profit after tax		2,610
Dividends proposed		522
Retained profit for the year		2,088

The Plutus family still owns 40% of the shares in the company but is no longer involved in the day-to-day management of the company. However, the family members still expect to be consulted on any key decisions to be made. A new chief executive, David Ceto, undertook a thorough review of the company's operations soon after taking office. He found that the company had experienced very little growth in recent years as sales of confectionery and cakes have been increasingly concentrated in the hands of large supermarkets. Supermarket sales now account for 50% of total market sales and this percentage is predicted to grow in the future through aggressive advertising and discounting campaigns.

A recent forecast of sales for Plutus plc over the next five years has been produced by the Marketing Director, which provides gloomy reading:

Forecast sales for the year ended 31 July

	2006	2007	2008	2009	2010
Sales (£m)	55·8	52·6	49·5	46·1	42·4

In addition, the Finance Director has provided further forecast information concerning the company for the next five years:

Forecast information for the year ended 31 July

	2006	2007	2008	2009	2010
Operating profit margin (%)	6·5	6·0	5·8	5·6	5·3
Depreciation (£m)	3·1	3·5	4·6	4·6	4·8
Capital expenditure (£m)	4·3	2·5	12·2	3·4	4·6

The prospect of falling sales and falling margins convinced David Ceto that the company needed to seek new strategic directions in order to survive and prosper. Within days of arriving at this conclusion, Plutus plc was approached by another company, Maia plc, with a view to a possible joint venture. Maia plc is a large coffee company, which imports, roasts and blends coffees from all over the world and sells its produce to wholesale distributors, restaurants and retailers. Until recently, Maia plc enjoyed an unrivalled reputation for the quality of its coffee products. However, the company has failed to keep pace with the changing taste of its customers and has suffered a fall in sales and profits as a result. In order to revive the company, the chief executive of Maia plc is keen to diversify by exploiting the growing demand for coffee shops.

In recent years, a number of coffee shop chains originating from the US have flourished in the UK. Although these coffee shops are popular among younger people, they have often been criticised for providing characterless surroundings and for selling inferior quality coffee. The chief executive of Maia plc believes that there is a gap in the market and that coffee shops selling high-quality coffee, confectionery and cakes would be successful. He is therefore keen to build a large chain of coffee shops that will be located in major high streets and in 'up market' stores. The coffee shops will provide surroundings based on those found in cafes situated in fashionable parts of Paris and the ambience provided will be designed to appeal to affluent shoppers over 25 years of age.

The proposed joint venture would involve Maia plc providing the coffee and Plutus plc providing the confectionery and cakes. Maia plc has proposed that a separate company should be formed with 60% of the shares being held by Maia plc and 40% of the shares being held by Plutus plc. The joint venture would last for a five-year period, after which time the chain of coffee shops would be floated on the Stock Exchange with each company retaining a maximum of 10% of the ordinary shares in the newly-floated company.

The proposal interested David Ceto, who immediately began discussions with the chief executive of Maia plc to see whether such a joint venture was feasible. During these discussions, the following forecasts for the proposed chain of coffee shops over the five-year period were provided:

Forecasts for the year to 31 July

	2006	2007	2008	2009	2010
Sales (£m)	8·8	19·6	29·2	36·5	47·5
Fixed overheads (£m)	3·8	7·7	12·2	14·5	21·1
Capital expenditure (£m)	4·8	5·6	10·1	10·8	6·5
Gross profit percentage	60·0	62·0	62·0	63·0	65·0
Variable overheads as a percentage of sales	10·0	11·0	11·0	11·0	12·0

The new chain would trade under the name of Café Crème plc and would be financed by an immediate injection of share capital of £2m in total, consisting of £0·50 ordinary shares. In addition, a further £5m would be raised immediately by a 6%, four-year loan to be guaranteed by Maia plc and Plutus plc. Café Crème plc will issue no dividends, at least for the first five years, and any further finance required will be raised by internal sources or by the issue of further ordinary shares to Plutus plc and Maia plc where there is insufficient cash in a particular year. The fixed overheads mentioned above include depreciation, which is charged at the rate of 15% on cost per year on all fixed assets acquired. This is also the rate for tax purposes.

At the end of five years, Café Crème plc will be floated on the Stock Exchange and Plutus plc is likely to sell the whole of its stake in the company at this point. David Ceto sees the joint venture as a medium-term investment and believes that the coffee shop fad is likely to peak after five years with little prospect of future growth. The offer price for the shares is very difficult to judge, however, analysts have suggested that a price based on a P/E ratio of between 10 and 13 times is possible and that a P/E ratio of 12 times is most likely. Flotation costs are typically around 8% of the capital raised. The shares sold to the public will consist of shares already held by Plutus plc and Maia plc and so flotation costs will be borne by the existing shareholders.

As part of the joint venture agreement, Plutus plc will undertake to supply cakes and confectionery to Café Crème plc at cost price. This trading relationship will have no overall effect on profits or net cash flows of Plutus plc. The undertaking to supply Café Crème plc will end when the company is floated and will not be renewed as David Ceto believes that, in five years‘ time, Plutus plc will have more profitable opportunities to pursue.

The chief executive of Maia plc is keen to ensure that Café Crème plc implements good corporate governance practice from the outset in order to prepare the company for flotation. To this end, he has suggested a board comprising four executive directors and four non-executive directors. However, David Ceto is not convinced of the need for non-executive directors at such an early stage. The experience of having non-executive directors at Plutus plc has not been a happy one. There has been considerable suspicion and tension between the executive and non-executive directors over a number of years, which have interfered with board decision making. This has led to board resignations and a general feeling among the executive directors that non-executive directors were not adding value to the business. David Ceto felt, therefore, that the speed and quality of decision making would be improved if non-executive directors were not appointed to the board of Café Crème plc until much nearer the proposed flotation date.

A further source of disagreement between the chief executive of Maia plc and David Ceto concerned the way in which the risks associated with the venture should be identified, assessed and managed. Although both recognised the need for carrying out these tasks, they held different views as to how they should be carried out. The chief executive of Maia plc felt that they should be carried out ‘in-house’ and that a risk manager for Café Crème plc should be appointed as soon as possible. However, David Ceto felt that the risk management problem should be ‘outsourced’ for the first few years and that a firm of risk consultants should be employed. Three risk consultancy firms have been recommended to David Ceto and he argued that one of these should be appointed.

Although discussions were still at an early stage and final agreement over the proposal was still some way off, David Ceto felt that members of the Plutus family should be consulted over the proposed joint venture. He found that, although they were not opposed to the proposal, they did not want to see an issue of ordinary shares to finance the

proposal or for the gearing ratio of Plutus plc to increase to more than 33%. They made it clear that they wished to avoid any dilution of control or to add significantly to the financial risks of the company. They were also keen for the dividend payout of Plutus plc to be maintained.

When carrying out calculations, the following information should be taken into account:

1. Corporation tax is at the rate of 25% on operating profits and is payable nine months after the year end.
2. Plutus plc has an after-tax required rate of return for the investment of 12%.

Required:

(a) Prepare forecast annual cash flow statements for Café Crème plc to show the total amount that Plutus plc would have to invest in ordinary shares in the company over the five-year period. (12 marks)

(b) Assuming a decision to invest in Café Crème plc is made:

(i) prepare a forecast annual cash flow statement for Plutus plc for each of the next five years and discuss any financing issues that the company must confront.

(ii) suggest how any financing problems experienced by Plutus plc may be overcome, using appropriate calculations to support your arguments. (16 marks)

(c) Calculate the net present value of the investment in Café Crème plc from the perspective of Plutus plc and assess the sensitivity of these calculations to possible errors in the predicted P/E ratio on flotation of Café Crème plc. (12 marks)

(d) Discuss the possible benefits and problems that may arise for Plutus plc from a joint venture with Maia plc. (8 marks)

(e) Discuss the possible reasons why suspicion and tensions may exist between non-executive and executive directors of a company and suggest ways in which such suspicion and tensions may be managed. (15 marks)

(f) Outline the benefits and potential problems associated with the use of risk consultants to help in identifying and managing risk and suggest criteria that should be employed in selecting a suitable firm of consultants to help in this process. (10 marks)

(g) Identify the key risks associated with the investment in Café Crème plc by Plutus plc and state how these risks should be managed. (20 marks)

(h) Outline your views concerning the proposed investment in Café Crème plc and state whether you believe Plutus plc should agree to the proposal. (7 marks)

Notes.
In answering the case study questions:
1. All recommendations must be supported by reasons.
2. All key workings and assumptions must be clearly stated.
3. Workings should be in £millions and should be to one decimal place.
4. Ignore inflation.

(100 marks)

End of Project