CGMA FEBRUARY 2016 EXAM ANSWERS

Variant 3

The February 2016 CGMA exam can be viewed at

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SECTION 1

Briefing paper on the proposal to operate 100 franchised stores in the Middle East

Strategic benefits of the proposal to operate 100 franchised stores in the Middle East

Franchising with Jamil Touma in the Middle East would generate many benefits for Rio:

Franchising brings local knowledge

Jamil Touma has other successful franchised retail businesses in the Middle East so he obviously knows and understands the target customers and the demands of local customers. Clearly he understands and knows how to operate franchised stores.

Lower risks of international growth

By using franchising as a method to expand into the Middle East, Rio is reducing the risks of international growth as the franchisee knows and understands the political and economic factors that could affect the success of new stores. The franchisee will also understand and be able to manage the social factors, such as which fashion trends will appeal to the Middle East market.

Enables faster growth

Franchising with Jamil Touma will generate faster growth in Rio stores. Expansion to the Middle East region was not in Rio's current geographical expansion plans at all. Rio would not be required to fund any capital expenditure for the fixtures and fittings for the 100 franchised stores, as this capital cost is incurred by the franchisee, Jamil Touma.

Additional profits for Rio

At present Rio operates just 90 franchised stores in total, all of which are in Asia, which generate franchising fee revenue for Rio. An additional 100 franchised stores will generate a large amount of franchising fee revenue. This will flow almost straight down to Rio's bottom line as Rio does not incur hardly any operating expenses, such as employee or lease costs. These are incurred by the franchisee directly for franchised stores. The only operating costs incurred are the marketing and franchising support costs. Therefore, this proposal could generate substantial additional profits for Rio. This will please its shareholders.

Strategic risks of the proposal to operate franchises in the Middle East

International growth

Even though franchising does reduce the risks of international growth, as the franchisee has extensive local knowledge, it does not eliminate all of the risks. The risks can be analysed using the PEST factors, which are Political risks, Economic risks, Social risks and Technological risks. The biggest risk facing Rio with regard to the proposal is the political risk of having 100 franchised stores in the Middle East region. Some parts of the Middle East region are undergoing a turbulent time at present. Is the Middle East a region that Rio, and its shareholders, are satisfied is a safe and stable enough region to have a retail presence in? Any adverse event at any of the proposed 100 franchised stores would reflect on the entire Rio brand reputation.

Rio brand reputation and merchandise

It is a term of the franchising contract between Rio and the franchisee that **only** Rio branded products supplied **solely** by Rio are stocked and sold in Rio franchised stores. Rio must monitor how the franchisee operates the stores and the level of customer service provided, to ensure that the franchisee does nothing to damage the value of Rio's brand.

Logistics of moving Rio products to the Middle East

Currently Rio has two distribution centres in Europe and one in Asia. If it were to have 100 franchised stores in the Middle East, then this would complicate the logistics of getting products to these stores. This would almost definitely require Rio to open a new distribution centre in the Middle East. This will take time to establish and to link into Rio's IT systems and its supply chain to ensure efficient movement of products from outsourced suppliers to the nearest distribution centre.

Franchisee not managing stores effectively

There is the risk that Jamil Touma will not take an active interest in the franchised Rio stores and will move onto his next project, and that the franchised stores are not managed effectively.

Whether franchised stores would prohibit Rio from managing its own stores in the Middle East

Depending on contract negotiations, Rio needs to fully understand whether it is granting Jamil Touma full geographical rights for Rio stores to be franchised in the Middle East region and which specific countries and what length of time the franchising contract covers. If the franchised stores are a success, then Rio may wish to open its own Middle East stores – will this be permitted?

Risk of Jamil Touma franchising with a competitor

There is the risk that if Rio does not accept the franchising proposal for 100 stores with Jamil Touma, that he will approach one of Rio's competitors. This will make it harder for Rio to penetrate the Middle East market at a later stage. Therefore if this franchising proposal is rejected by Rio, this could damage Rio's long-term ability to compete in the Middle East market.

How we might deal with these risks

International growth

Rio's management should ask Jamil Touma for an analysis by country of the proposed 100 franchised stores, to ascertain which countries are planned for franchised stores.

Rio brand reputation and merchandise

Ralf Helber and his franchising team will need to work closely with, and monitor, the franchised stores if an agreement is reached with Jamil Touma, to ensure that the franchised stores do not undertake any activities that could damage Rio's brand reputation. Ralf Helber and his franchising team will need to audit, including unannounced spot-checks, to ensure that the franchised stores stock only Rio products. Rio's franchising team also needs to monitor, perhaps through the use of 'secret shoppers' the level of customer service provided in franchised stores.

Logistics of moving Rio products to the Middle East

Rio would need to invest in a new, fairly small distribution centre in the Middle East and change its IT systems for this new aspect of its supply chain.

Franchisee not managing stores effectively

There needs to be a tight franchising contract which states the agreed rollout plan for the 100 stores and sets sales revenue targets and penalty payments for substantial underperformance.

Whether franchised stores would prohibit Rio from managing its own stores in the Middle East

Before the proposed franchising contract is signed, Rio's management (and the franchising contract) need to be clear as to which Middle East countries are covered, whether Rio is giving Jamil Touma exclusive rights to that country or region (or not) and the length of the franchising contract period.

Franchising with a Rio competitor

There is no specific way of managing the risk of Jamil Touma entering into a franchising deal with a competitor of Rio, if Rio were to reject the proposal.

Section 2

The financial impact of franchising with Jamil Touma

If Rio were to accept the franchising proposal from Jamil Touma, then this would generate additional franchising fee income to Rio of €25 million each year. Rio would still have to provide support for these franchised stores including marketing support, which will reduce this figure by €4 million, and therefore the additional operating profit from franchising in the Middle East could generate €21 million each year. In 2015, Rio's operating profit was €401 million, and therefore even €21 million represents an increase of 5.2% in profitability.

This increase in profits could be higher if the franchising fee is negotiated to be at a higher level than the fee requested by Jamil Touma.

Franchising fee

The reference material attached to your email states that the fee required by Jamil Touma at €25 million is 35% lower than the current franchising fee paid by Rio's other smaller franchisees. This is a substantial difference. However, many of Rio's other franchisees only operate a small number of franchised stores in the six Asian countries.

The question is whether the 35% reduction from comparable franchisee fees is reasonable and acceptable to Rio. This is a key area to negotiate on.

This also has implications for franchising fee revenue for any future franchisees, and whether the franchising contract details could be kept totally confidential. There could be problems if any of Rio's current franchisees discovered the high level of reduction in the franchising fee that Jamil Touma would be paying, and they perhaps would try to negotiate a lower franchising fee as well.

The franchising proposal is forecast to generate an NPV of €75 million over 10 years, which is a considerable positive cash flow for Rio. As the proposal does generate a positive NPV, this proposal is recommended to be accepted, although the level of the franchising fee should be negotiated to a higher level, which is more acceptable to Rio.

The financial impact of Rio setting up and managing its own managed stores instead of franchising

Sabine Roos has identified that, without specialist knowledge of the region, Rio would be unable to identify and negotiate the leases for 100 stores within a two year period, which the proposed franchisee, Jamil Touma considers that he can do. Therefore, if Rio were to open its own managed stores, the rollout would be slower and the NPV could be €40 million, with a range up to €100 million. Therefore, the 10 year NPV at the highest level of €100 million is higher than the NPV that could be achieved by franchising but this comes with many risks to Rio:

- All of the upfront capital expenditure for store fixtures and working capital for inventory would need to be financed
- The rollout of stores in the Middle East would be slower than with franchising as Sabine Roos cannot locate suitable sites for 100 stores in a two year period
- Rio lacks local knowledge
- Rio could face a competitor in the region if Jamil Touma's proposal were to be rejected and he chose to franchise with a competitor of Rio's.

Therefore, due to the need for local knowledge in the Middle East market, franchising with Jamil Touma carries a much lower risk and generates only a slightly lower NPV at €75 million than the forecast highest NPV of €100 million if Rio were to manage its own stores.

The financial risks of franchising in the Middle East and whether to accept or reject this franchising proposal

Currency risks

There is a transaction risk as the franchising fee would be based on a percentage of revenues based in three Middle East currencies, which could move adversely against the Euro. This could be hedged using external hedging methods.

Islamic financing

Franchising with an experienced Middle Eastern businessman, Jamil Touma, overcomes the lack of local knowledge and risk due to Middle Eastern financing restrictions.

Retail banking

The local knowledge and connections that Jamil Touma has established will reduce the risks that would be faced by a European company. Franchising would be the ideal way to enter the Middle East market due to Jamil's knowledge and established business connections.

Interest rate risk

Rio would not face any capital costs in the Middle East region, apart from establishing a distribution centre, if it were to franchise with Jamil. Rio would not need to try to borrow any funds in the Middle East to fund the working capital requirements of expansion as the franchisee would need to finance the new stores and the cost of working capital for store staff salaries and inventory.

Level of franchising fee

Jamil Touma is requesting a much reduced franchising fee, some 35% lower than Rio's other franchisees, as he plans to open 100 franchised stores. However, there is the risk that he will open a lower number of stores or generate a lower level of revenues than forecast.

Risk that sales will be lower than forecast by Rio and that the NPV is lower than €75 million

The forecast NPV assumes a certain level of sales, which could be higher or lower in reality.

Risk that the cost of the new distribution centre and IT upgrades could be higher

The NPV assumes a certain level of capital expenditure by Rio for establishing a new distribution centre in the Middle East and for the required IT upgrade costs. There could be cost over-runs for either, or both, of these two items.

Whether to accept or reject this franchising proposal with reasons

Rio must gather as much information as possible relating to the decision, including the risks and benefits and the impact of the decision on the stakeholders of Rio. Rio must also consider the potential range of alternatives to this proposal, such as operating our own managed stores in the Middle East or indeed, not opening stores in the Middle East at all.

It should be considered whether losing this opportunity to franchise with Jamil Touma would affect Rio's long-term plans to have Rio stores in the Middle East region in the future, irrespective of whether they are managed stores or with a different franchisee.

<u>My recommendation is that Rio accepts the proposal to open 100 franchised stores with Jamil Touma in the Middle East.</u>

The benefits outweigh the risks of the proposal and the financial impact is positive. The alternatives of either operating our own managed stores or not operating in the Middle East at all are not viable proposals for Rio, given the current competitive market conditions.

The proposal fits with our long-term direction of growth. As Rio currently operates franchised businesses elsewhere, this would be suitable strategic fit with our current culture.

The proposal to franchise 100 stores in the Middle East region is financially viable and generates a forecast NPV over the 10 year franchising agreement period of €75 million.

Three Key Performance Indicators (KPIs) for principles of Rio's brand reputation

1. ***Customer satisfaction KPIs***

Customer satisfaction is a critical success factor for Rio in such a highly competitive, fast fashion environment and it is central to our brand reputation. Rio relies on the loyalty of its customers and must ensure high levels of customer satisfaction to ensure customer retention. Examples of customer satisfaction rating KPI's could include **repeat purchases per customer** or **customer satisfaction ratings** identified using customer surveys.

2. ***Staff satisfaction KPIs***

Rio prides itself on the fair and ethical treatment of its staff and this must extend to franchised stores as well as those managed by Rio. Therefore Rio must monitor the behaviour of franchisees towards the staff that it employs. Staff who are treated fairly and ethically are more likely to present a positive image for Rio and also enhance long-term business performance. Therefore a KPI such as **staff turnover per store** or **training days per employee** will be a useful indicator of how a franchisee is treating its employees.

3. ***Attractiveness of store layout KPIs***

A key determinant of the Rio brand is the store layout, the presentation of the products, the cleanliness of the stores and the appeal for customers to browse. Therefore a KPI measuring the **number of customers entering the store per day** would be an indicator of store appeal or **number of customers making a purchase as a percentage of customers entering the store per day**.

Section 3

Briefing Report: Franchising in the Middle East

What we should communicate to market analysts

As soon as an announcement is made to shareholders about the newly approved franchising agreement with Jamil Touma, then this will be reflected in Rio's share price on the stock exchange. This is based on the efficient market hypothesis (EMH). This principle is that share prices reflects the news relating to each company.

Rio should liaise with market analysts to explain the franchising agreement in more detail concerning the timing of the rollout of the 100 stores and which countries in the Middle East will be targeted for these 100 franchised stores. No confidential information, such as the scale of the franchising fee, should be given to the stock market analysts.

Market analysts should be briefed that Jamil Touma chose to franchise with Rio and not any of our competitors, which demonstrates the good brand reputation that Rio has established internationally.

Market analysts should be briefed with information about this entrepreneur, Jamil Touma, and his successful track record in the operation of franchised businesses. This should give the market and shareholders confidence that the franchised stores in the Middle East will have a high chance of success.

Some market analysts may be interested in the CSR impact of the decision and therefore Rio must also reassure them that all decisions made will also consider the wider social consequences. This would include the continued focus upon the environment and upon ensuring the fair and proper treatment of the employees in the franchised stores. Rio should communicate information about the support Rio will provide to Jamil Touma, including its plans for coaching and mentoring and its expectations for the high levels of customer service that Rio expects at all of its 100 franchised stores in the Middle East.

Whilst the stock market may not react as Rio expects, we can inform the market analysts about the benefits to Rio of this expansion and how it fits with Rio's approved 5 year plan and that it demonstrates that Rio is flexible in its plans to achieve its ambitions of growth in store numbers.

It would be expected that Rio's share price should increase due to investor confidence in this piece of good news demonstrating strong growth in Rio's future cash flows.

What we should tell our employees

Overall, employees are important stakeholders in Rio. We invest a great deal of time and effort in ensuring that we communicate effectively to our staff and therefore it is correct that we should communicate this decision to our employees.

Rio must ensure that it communicates effectively with its employees. Importantly, employees must be informed that if Rio were to forego this opportunity Rio could then be at a serious competitive disadvantage in the rapidly growing Middle East market. We must ensure that employees understand that this is an important strategic aim of Rio to grow and develop into other regions of the world and that this proposal should help us to achieve long term growth and continued success for Rio. Hopefully this will encourage staff pride in the business and encourage staff retention.

We also need to reassure employees that it is a highly lucrative opportunity for business growth and development. Rio has high expectations for revenue and profit growth as a result. Employees of Rio are also shareholders, some will have an interest in the financial impact of this decision and therefore we must communicate that although investment is required to set up a new distribution centre, that this will be off-set in the longer-term by the lower costs of operating in the Middle East market using franchised stores compared to managed stores and the additional business this will generate.

Some employees will also be interested in the CSR impact of the decision and therefore Rio must also reassure them that all decisions made will also consider the wider social consequences. This would include the continued focus upon the environment and upon ensuring the fair and proper treatment of the employees in the franchised stores.

Benefits of team building for future store managers

The store managers for the 100 newly franchised stores still need to be recruited by Jamil Touma. When these store managers have been recruited, then Rio need to explain the benefits of team building for the employees that will work for them in each of the franchised stores.

There are a number of benefits which can be gained by team building including:

- Jamil Touma and his management team will bring with them a mixture of skills and abilities to the team. Many will have operated other types of stores or franchises in the past and some may have had experience within Rio, all of which can be shared. A team building environment will facilitate this knowledge sharing.
- By using a team building approach this can lead to improved control, as Rio can take the opportunity to review and monitor for performance of franchisees. Team leaders can monitor activities within teams to assess performance and the integration of the new employees into Rio’s company ethos and expectations.
- Team building should also improve communication, between franchised store managers and Rio. This can also lead to increased motivation and also conformity to the Rio way of operating.

Benefits of Coaching and Mentoring for future store managers

Being part of a network of coaches and mentors fosters communication and encourages franchised store managers to share and develop each other’s knowledge and experience.

Mentoring would involve a store manager of Rio offering help, guidance, advice and long-term support to facilitate the learning and development of another, either newer or less experienced franchised store manager. A mentor would typically be a senior manager such as Ralf Helber or a very experienced Rio store manager, who would offer on-going support and advice to new franchised store managers and assist them in developing the skills, knowledge and abilities they will need to be successful. It is important that Rio selects appropriately experienced and motivated store managers to act as mentors so that they can pass on their skills and knowledge of our business to the new franchise store managers. Mentoring is also a motivational tool for the mentors themselves, who can experience personal satisfaction from assisting other managers in the business.

Coaching takes a similar approach to mentoring but targets high performance and improvement, usually lasting for a short period of time and focusing on specific skills and goals. For the store managers located in the Middle East, this could include specific coaching activities related to customer satisfaction and staff management. The benefit of coaching is that it will help to develop specific franchised store managers’ skills, so that their performance improves, hopefully leading to the achievement of Rio’s objectives and long-term improvements in business performance. An additional benefit is that Rio can identify a number of key activities or areas which it requires improved performance of franchised store managers and can specifically target those areas in a short space of time.