# CGMA FEBRUARY 2016 EXAM ANSWERS

## Variant 4

## The February 2016 CGMA exam can be viewed at

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**SECTION 1**

**Briefing paper on the proposal to acquire 'Luiza'**

This briefing paper will identify the strategic benefits and strategic risks of this proposal and how we might deal with the risks identified.

**Strategic benefits of the proposal to acquire 'Luiza' as a way to expand into South America**

The proposed acquisition of 'Luiza' would generate many strategic benefits for Rio, which are:

*Aligned with Rio's business plans*

Rio's business plans, approved by the Board, states that it would like to expand into new geographical regions including Australia and South America. The proposal to acquire a chain of fashion stores that is already established would enable Rio to access the South American market quickly and with less risk than starting to grow organically by opening individual stores. The five year plan shows that Rio plans to increase the number of managed stores from 886 in 2015 to 1,436 by the end of 2020. This is a growth of 550 stores, which is very ambitious within a five year time frame. By acquiring 'Luiza', this will give Rio 160 new stores at once, assuming Rio chooses to retain all 160 store locations. Therefore this proposal is in line with the approved 5-year plan for fast geographical growth.

*Faster market penetration than organic growth*

If Rio were to expand into South America in an organic growth way, this would require the identification and negotiation for suitable locations for new stores and the recruitment of store employees. By acquiring an established chain of retail fashion stores, Rio would only need to refit all of the stores to meet the established brand style and display of Rio products, change all of the store names from 'Luiza' to 'Rio' and dispose of (by selling in bulk to other traders) 'Luiza's' current inventory. The re-fitted stores would then be stocked with Rio products. All of the employees of 'Luiza' would need to be trained in all aspects of Rio's products and its IT systems and in Rio's level of customer service. This would need to be closely monitored.

Even though this form of expansion is still costly to Rio, in terms of store refitting, new inventory and training of sales staff, it will be a far quicker way of entering into the South American market than trying to locate and open individual stores.

*Existing 'Luiza' supply chain*

The 'Luiza' chain of stores has an existing supply chain with its own distribution centre and outsourced suppliers. Perhaps Rio will choose not to use all of these outsourced suppliers in future, as it has its own existing selection of outsourced suppliers, which meet Rio's code of conduct. However, these suppliers exist and are local (in South America) in terms of speed to the market and low transportation costs. It will be for Kamal Singh and Veronique LeFevre to establish which of the 'Luiza' outsourced suppliers it may (or may not) wish to work with in future, taking into account Rio's code of conduct for all of its existing outsourced suppliers.

The 'Luiza' chain of stores also has established distribution centres, which is a key requirement to handle all of Rio's products going in to the stores in South America. South America is a very large geographical region and there would be a need to set up new distribution centres if Rio were to expand into South America in an organic way. By acquiring an established chain, the distribution centres, and their staffing, is already established. Whilst they may need updating and require IT investment for the logistics of products moving into and out of each centre, they are already in place.

*Lower manufacturing costs*

The additional volume of sales generated from an additional 160 new Rio stores in South America, will require additional volumes of Rio's products to be manufactured. This could result in economies of scales and Rio's ability to negotiate lower unit costs for longer production runs with its current outsourced suppliers.

*Additional sales and profits for Rio*

This proposal will require a large investment to acquire 'Luiza', and for re-branding and investment in store fittings and changes to Rio's IT systems, but the acquisition would generate substantial additional profits for Rio in future. This will please Rio's shareholders.

**Strategic risks of the proposal to acquire 'Luiza' as a way to expand into South America**

*International growth – new region for Rio*

By expanding into the new geographical region of South America, it exposes Rio to the risks of international growth, including the PEST factors. These are Political risks, Economic risks, Social risks and Technological risks.

The two biggest risks facing Rio with the proposal to expand into South America are:

1. The political risk of having 160 stores in the South American region and the risk of political instability. South America is a long way from Rio's Head Office in Europe, and Rio's management team may not fully understand or appreciate the problems faced in these countries. This may include the risk of government bribery or anti-European protesters, as the acquisition of 'Luiza' may be seen as the take-over of a small family run local company.
2. Economic risks. There are two aspects here – inflation and currency risks. Some South American countries are experiencing hyper-inflation due to poor government control of the economy. This would affect Rio's pricing policies and control of cash going into / out of the South American countries. There is also a risk of currency devaluation against the Euro.

*Logistics of moving Rio products to South America*

The 'Luiza' chain already has distribution centres operational, but they would need to be updated and the IT systems changed and <u>integrated with Rio's current Information Systems</u>. An amendment to Rio's supply chain would need to be put in place, to enable the shipping of products that are not sourced from 'Luiza's' current outsourced suppliers in South America, to move them from where they are manufactured, either in Europe or in Asia. There is a risk concerning the time it would take, and the cost, of changing Rio's IT systems to link the South American distribution centres into Rio's supply chain, to ensure efficient movement of products from all outsourced suppliers (whether in South America, Asia or Europe) to the appropriate distribution centre in South America.

*Risks of using 'Luiza's' current outsourced suppliers*

It is possible that some, or even all, of 'Luiza's' outsourced suppliers do not meet many aspects of Rio's code of conduct for its suppliers. Rio is very strict in its selection and ongoing audit of its outsourced suppliers, to ensure that it meets all of its rigorous guidelines on safety, fair remuneration, zero tolerance on exploitation of the work force, documented employment records, product and material traceability and exclusivity of the use of designs.

A recent newspaper report *(Pre-seen material page 28)* stated that "over 70% of South American fashion retailers failed to protect the interests of their suppliers' workers" and explained that "the fashion retailers kept no information at all about what they were doing to ensure fair conditions for the outsourced suppliers workers". Therefore there is a real risk that some or potentially all of 'Luiza's' outsourced suppliers would not meet Rio's code of conduct.

The outsourced suppliers would need to be assessed by Kamal Singh and Stavros Axis to establish whether the outsourced suppliers are amenable to making the changes required in order to continue to produce products for the Rio stores in South America.

*Alternative way to expand in to South America*

Rio's management lacks the local knowledge to expand into the South American market in an organic way, and is therefore considering this acquisition proposal. However, there is a risk that Rio's management does not have the experience and knowledge of the South American market or understand the needs of its potential customers. An alternative, lower risk, way to expand, could be through the use of franchised stores in South America.

**How we might deal with these risks**

*International growth – new region for Rio*

Before Rio carries on with negotiations concerning the acquisition of 'Luiza', it should undertake a thorough analysis of the PEST factors (Political risks, Economic risks, Social risks and Technological risks). Rio's management should also seek the professional services of a consultancy group that specialise in the South American fashion retail business. Rio may wish to tie the current management team of 'Luiza' into an 'earn-out' contract to retain their knowledge and skills for the next few years.

*Logistics of moving Rio products to South America*

The style and age of the distribution centres currently owned by 'Luiza' should be assessed by Rio's management (Sabine Roos and also by Mani Kaur), to ensure that these distribution centres could be updated to meet Rio's needs. Rio's IT department should prepare an estimate of the IT change work required to alter Rio's supply chain, to enable the shipping of products that are not sourced from 'Luiza's' current outsourced suppliers in South America, to move them from where they are manufactured, either in Europe or in Asia. By understanding the work required and the cost and time required for the IT changes, this will enable Rio's management to minimise and manage these risks. The integration of IT systems of Luiza's and Rio's would be required for logistics and for management control purposes.

*Alternative way to expand in to South America*

The Board of Rio needs to assess the potential acquisition of 'Luiza' against the alternative of expanding into the South American market through the use of franchised stores. Only when this strategic decision has been made, can the proposal to acquire this potential company be pursued.

**Section 2**

**From:** Senior Finance Manager
**To:** Stella Erikson, Finance Director
**Date:** xx February, 2016

Hi Stella

Set out below are the explanations of the issues for which you requested my advice in your earlier email:

**Explanation of what the different values represent in respect of negotiating a price to acquire 'Luiza'**

There are many ways to value a proposed target company for acquisition, but it is not an exact science and depends on the negotiating skills of both companies, and how keen Rio is to acquire 'Luiza' to help achieve its strategic desire to expand into the South American market. In principle, Rio should not pay more than the NPV of the forecast future cash flows. However, it is difficult to accurately forecast what those cash flows could be and what synergies could be achieved.

Should the acquisition price be based on the figures provided by 'Luiza's' MD, which could be overstated, or should they be based on past real figures from published (and audited) accounts? As 'Luiza' is a family-run unlisted company its shares are held by family members and are not listed on any stock exchange. Therefore there is no 'market' value to be used as a guideline for negotiations.

The data provided states that the founder and driving force for the business retired five years ago and that there has been a decline in revenues and profitability over the last three years. Clearly the current management of 'Luiza' is not as focussed or as experienced at managing this chain of stores as the original founder, as revenues and profits have fallen recently. This fall in profitability could be due to many reasons; new competition, designs of new products not being as appealing to target customers or inefficiency in the management of the stores and the logistics or the stores could be outdated and need investment to modernise them.

*Value based on 'Luiza's Managing Director's forecast NPV*

The current Managing Director of 'Luiza' has provided his forecast of the future cash flows for the next five years and this generates a NPV of €90 million. However, this forecast may be overstated and not achievable without further investment in stores and infrastructure. Therefore, this forecast suggests that the top value that Rio should pay would be €90 million. However, Rio will need to invest €32 million in store fittings, so a lower figure should be negotiated.

*Value based on data from 'Luiza's' latest published accounts*

Based on data from the latest set of Luiza's' published accounts, the NPV is lower at the equivalent of €60 million. This perhaps reflects the actual decline in revenues and profits and is a more realistic figure for the valuation of the company.

*Value of non-current assets*

The value of the non-current assets at €10 million is not relevant for the valuation of the company. This value represents only the original value of the assets less cumulative depreciation reserves, and is low as perhaps 'Luiza's' management has not invested in new store fittings and infrastructure and the assets may be almost fully depreciated. However, what Rio is interested in is buying the company as a going concern and not just buying the assets to dispose of. Rio needs to pay for the 'goodwill' and commercial location of its stores and the regular customers who buy their products. Therefore this valuation is not relevant except that this is the bottom figure that could be paid, as this represents the value that 'Luiza's' management could sell the assets of the company for, if the company were to close.

**Recommend, with reasons, what value would be useful to negotiate an acquisition price**

Consideration on the price to pay to acquire 'Luiza' will depend on many factors including the following:

- The level of staffing to be retained and any redundancy payments due.
- The cost of re-branding and refurbishing the stores which is €32 million.
- The cost of bringing 'Luiza's' distribution centres up to Rio's standards.
- The cost of IT upgrades to integrate the South American operations and distribution centres into Rio's existing Information Systems.
- The skill at negotiating with 'Luiza's' current family members who own the company.

Ultimately it will depend on how badly the family owners of 'Luiza' want to sell, with profits already declining and also how badly Rio wants to acquire this chain of 160 stores.

Overall, I recommend that the acquisition price for 'Luiza' should be **close to €60 million or lower**. The reason for recommending this acquisition price is that this is the NPV calculated based on the actual value of cash flows achieved in the past and this is the value that the Finance Director has calculated.

**Business and ethical risks of 'Luiza's' outsourced suppliers**

*The ethical risks*

Currently, 'Luiza' does not carry out audits of its outsourced suppliers to check factory conditions or the staffing of these factories. Therefore there are no checks carried out on health and safety of workers or the general safety and conditions of their working environment. Rio's own Code of Conduct clearly refers to the need for outsourced suppliers to adhere to Rio's Health and Safety systems, which clearly is not occurring in South America. The ethical risk is that the outsourced suppliers' employees could be operating in highly dangerous and unsafe conditions, which if not checked, could lead to injury or death. This is a clear ethical risk for Rio.

The lack of audit activities carried out by 'Luiza' on the staffing of its outsourced suppliers is also a concern. 'Luiza' does not currently audit the remuneration of the outsourced workers nor does it check on the use of child or forced labour. Rio's Code of Conduct for its suppliers clearly requires all outsourced suppliers to adhere to 'fair remuneration and working hours' and 'zero tolerance on the exploitation of the workforce'. Without regular audits, then there is a high risk that some outsourced suppliers will be in breach of these principles. There is a clear ethical risk for Rio if it should acquire 'Luiza', that some of the outsourced suppliers' are not treating their employees within the high ethical standards that Rio demands. This in turn is likely to be a reputational risk for Rio.

The information presented also suggests that 'Luiza' selects its outsourced suppliers based upon the criteria of price only. From the perspective of Rio, this is a highly unsuitable approach to take in the selection of suppliers and one which would be considered to be in breach of Rio's high ethical standards. Using outsourced suppliers based on lowest price is in fact encouraging those suppliers to cut costs in health and safety and to pay employees the lowest rate of pay possible.

*The business risks*

Most of the potential ethical risks outlined above will in turn likely result in a number of business risks for Rio. Firstly, any unethical behaviour carried out by outsourced suppliers is likely to have a reputational impact upon Rio which could affect our brand reputation and our sales. This in turn could result in the financial risk of loss of revenue as customers turn away from Rio if it is seen to be condoning the behaviour of these outsourced suppliers. Rio prides itself on its social and ethical principles and customers will have high expectation in terms of these principles. Any breach is likely to hit our bottom line and adversely affect sales in Europe and Asia. A further business risk is the potential lack of quality of the products manufactured, based upon the selection criteria used by 'Luiza' being based solely on price. Therefore there is a high risk that quality standards will not be achieved by 'Luiza's' outsourced suppliers.

## Section 3

### Rio’s expansion into South America

This email covers a number of issues relating to the communication of the decision to acquire ‘Luiza’.

**Why we should communicate this decision to employees**

It is important for Rio to establish the relevance of its strategy with our employees in a way that makes them care more about the company and about the job they do. It should be at the core of all of our communications as strategy-specific messages linked to our purpose and long-term direction become tools to help our employees connect their day-to-day efforts with the aspiration of the company. For Rio’s staff to fully understand how our strategy is different and better than our competition they need to be in touch with market realities and our overall direction. If we can achieve this, then we can hopefully achieve a strong buy-in from all of our staff.

**Information required to communicate to Rio’s employees**

Communication to employees is likely to be best carried out through the staff newsletter and the weekly team briefs carried out by store managers. At Head Office, departmental managers will be responsible for communicating this information to departmental employees. All of Rio’s employees should be made aware of the market development opportunity that this presents to Rio. This will create a wider market for Rio’s product and give Rio’s brand a higher profile throughout the world. This wider market awareness should bring greater security to all of Rio’s employees in the long-term.

Demonstrating to employees the long-term potential of Rio should encourage employee retention. We should also ensure that we make employees aware that Rio is a growing and developing business in the retail fashion industry which should encourage a sense of employees pride and loyalty to Rio.

Rio should clearly emphasise to the employees its desire for growth and opportunities in the market place and that they continue to play a vital role in this successful growth. As the business continues to grow then there are also more opportunities for employees throughout the world.

It will also be important to ensure we communicate to all employees that, despite our growth ambitions, the focus will remain upon the fair treatment of employees and the importance of Rio’s employees to the business success. We must reassure employees that there will be continued investment and focus upon employee welfare and high standards of treatment, wherever they work in the world or in a managed or franchised store.

**Risks involved in integrating ‘Luiza’s’ employees into Rio’s company culture and ethos**

Rio’s culture and ethos is strongly focused upon its strong ethical principles in its behaviour towards its key stakeholders of customers, employees and suppliers.

A key aim of Rio is to optimise the customer experience. Rio’s current store employees are carefully recruited and trained to ensure that the customer experience is optimised in store. Rio’s in-store culture is one of customer focus and a primary concern of customer satisfaction. It is likely that ‘Luiza’s’ current store employees will not operate to the same level of customer focus and commitment and there may be a risk of some resistance to the need for a change in focus towards customers. ‘Luiza’s’ employees may not be used to undertaking any training and may not see the need for it.

A second key aspect of Rio's strong company culture and ethos is the importance it places on the fair and ethical treatment of its employees. One of Rio's five key CSR principles relates to *'operating ethically towards those who work for Rio'* and this must also be a priority for employees working in 'Luiza's' stores. This will relate to the expectations of the fair and ethical selection and recruitment of employees, the training of employees and their health and safety. Although we do not have any information relating to the recruitment and selection of 'Luiza's' employees, we are aware that 'Luiza' invests minimally in training. Therefore, a further risk for Rio is that the employees of 'Luiza' are unlikely to have the required and expected levels of training in ethical behaviour and health and safety procedures. Again, some employees of 'Luiza' may be resistant to this training and not understand the need for it.

Rio also has a clear ethos of team work and team building within stores to assist with both employee and customer retention. A further risk may be the lack of team building and team work within the current stores of 'Luiza'. Team building and the development of long-term working relationships for store employees is designed to improve customer care and importantly, develop employee retention. High staff turnover may be a risk with 'Luiza's' staff which may in turn add additional costs for Rio in recruitment and training.

**Actions to overcome employee integration challenges**

Firstly, all of 'Luiza's' store employees must undergo induction training which will introduce them to Rio's culture and ethos. Induction activities should also include training in a range of customer management and care activities and health and safety training. Induction training should be carried out as soon as possible after acquisition to ensure that store employees are fully compliant with Rio's customer care standards. In addition to induction training all store employees must have continual and on-going training in customer care and health and safety management.

This is a key principle of Rio's corporate social responsibility activities and all employees are expected to undertake regular and on-going training. 'Luiza's' store managers must undertake Rio's Ethical and Diversity training programme, which is a key part of our CSR aims. If the store managers are well trained in Rio's high standards of ethical behaviour, then this will assist Rio in ensuring that these high standards are then promoted and communicated to all of the store employees.

Store managers should also be given training in team building skills as this is a key aspect of Rio's success in encouraging employee commitment and retention. Store managers could be provided with a mentor, who could be an experienced store manager in existing store elsewhere in Rio. Store manager mentors could be used to provide advice and support on management and training issues. This less formal approach to training may be more acceptable to 'Luiza's' store managers.