Suggested Answers for Mini Mock Exam

Management Case Study – November 2023 / February 2024

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Section 1

Briefing Paper

The challenges Cuppcar will face in complying with the three main dealership conditions of KMW and how we can overcome those challenges

Marketing alignment:

Joint marketing initiatives necessitate the right balance between preserving Cuppcar's unique brand identity and effectively promoting KMW's hybrid vehicles and services in the Welland market. This challenge involves ensuring brand consistency, identifying the most relevant target audience, and allocating resources wisely to create and manage marketing campaigns that reflect both companies' objectives. Achieving this alignment while maintaining a cohesive message can be a complex task that requires careful planning and execution.

In order to overcome the challenge of marketing alignment, Cuppcar needs to adopt a collaborative and strategic approach. First, both companies should initiate comprehensive discussions to identify common goals and shared values that can form the foundation of joint marketing efforts. Establishing a clear brand messaging framework that highlights the strengths of both Cuppcar and KMW can help create a unified voice in marketing campaigns. Furthermore, dedicated cross-functional teams from both companies can work together to ensure campaigns are well-coordinated and aligned with the target audience's preferences. Regular reviews and assessments of marketing strategies should be conducted to measure their effectiveness and make necessary adjustments.

Complexity in communication:

Establishing effective communication channels and decision-making processes between Cuppcar and KMW can be challenging. Potential differences in corporate cultures, decision-making methods, and operating timelines can create complexities. Additionally, if there are geographic distances or language barriers, it would further complicate communication efforts.

Overcoming the challenges posed by communication complexity requires a structured approach. Cuppcar should establish well-defined communication protocols and channels to ensure that information flows smoothly between the two companies. This can include regular meetings, video conferences, and project management tools to keep everyone on the same page. In cases where geographic distances exist, leveraging technology for virtual meetings and document sharing becomes essential. Language barriers can be addressed by hiring bilingual or multilingual staff, using translation services, or providing language training for employees. In order to address the differences in corporate culture between the two companies, it is necessary to provide cross-cultural training and cultural sensitivity workshops for the employees of both organizations.

Costs of sustainable operations:

The requirement to implement sustainable practices at the new dealerships presents Cuppcar with a set of cost-related challenges. Notably, the initial costs associated with adopting eco-friendly measures, such as waste reduction and energy-efficient technologies, can be significant. Moreover, a trained and committed workforce is needed for the successful implementation of sustainable practices across the dealerships.

To navigate the sustainability challenge, Cuppcar may need to adopt a phased approach that balances short-term costs with long-term benefits. Initiatives should begin with a thorough sustainability assessment to identify areas where improvements are most needed and provide a roadmap for implementation. Rational allocation of resources is crucial, focusing on high-impact projects that can yield quick returns. Employee training and awareness programs should be implemented to ensure that staff understand the importance of sustainability and are equipped with the knowledge and skills to participate actively. Cuppcar should also explore potential grants, incentives, or tax breaks available for sustainable business operations to offset some of the initial costs.

Tutorial Note: Candidates will be also rewarded for discussing any other appropriate challenges for the above requirement.

Characteristics of debt and equity that should be considered when sourcing the funds for the investment

Debt finance

Debt is generally a cheaper source of finance when compared to equity because lenders generally face less risk than shareholders and so require a lower rate of return. There is also the advantage that interest on debt is tax deductible, which gives the borrower (Cuppcar) tax relief on interest and so further reduces the net cost of borrowing in comparison to the cost of equity. However, lenders generally require security in order to protect them from loss in the event that the borrower defaults on the loan repayments. Hence, Cuppcar should be able to pledge appropriate assets as collateral to the lender in order to obtain the loan. The advantage for Cuppcar here is that banks would be willing to accept cars owned by Cuppcar as collateral against loans.

Another key consideration of debt finance is its impact on the company's gearing. Cuppcar's gearing (D/D+E) will increase from 22.5% to 26.6% (650+160 / 650+160 +2,238.5) if the investment is fully funded through a bank loan. This increases the financial risk of the company because if the company cannot service the bank loan, it will run into difficulties. Then again, since the increase in gearing is only 4.1 percentage points (26.6% – 22.5%), it can be argued that it is unlikely to significantly change the financial risk of the company.

Equity finance

Issuing shares will increase equity and thereby reduce the gearing of the company. However, equity is a relatively more expensive source of finance than debt because the shareholders are taking a greater risk as the owners of the company, and so expect a higher return on their investment. And since the return on equity (dividend) is paid out of profit after tax, there is no tax benefit associated with issuing further shares.

There are also significant formalities associated with issuing new shares, which makes it time consuming and expensive to do so. Moreover, shareholders expect a very convincing business proposal to consider investing further in the ordinary shares of a company. The current ordinary share capital of Cuppcar is W$ 200M

and it is highly questionable whether existing or new shareholders would wish to invest a further W$ 160M based on the KMW business proposal alone. Cuppcar currently owns 214 car dealerships, and it is doubtful whether investors would consider the addition of 8 more dealerships with a new car manufacturer a convincing business proposal to invest further in the equity shares of the company.

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Section 2

Hi Pavarit,

Please find below my response to your queries.

How we can present a more informative investment appraisal to the board to determine the financial viability of the investment

To begin with, the project has a positive NPV of W$ 21.8 million as per the calculations performed by the finance officer. This suggests that the investment will increase shareholder wealth by this amount; however there are a number of factors that should be considered before making the final decision.

In the NPV appraisal carried out by the finance officer, the cash flows have been based on a “moderate” level of demand. However, when there are multiple outcomes, the probabilities of each outcome should be identified and the “expected value” should be calculated by multiplying each outcome against their respective probabilities, and summing them up. This expected value should be incorporated into the NPV appraisal.

It is also important to note that in the event demand turns out to be “low”, the NPV will be lower or even negative. Hence, it is advisable to calculate the NPV considering a worst-case scenario. We can also perform a sensitivity analysis (also known as “what if?” analysis) to identify how a change in the value of each variable can affect the NPV.

Furthermore, the finance officer has used the bank loan interest rate as the discount factor in the NPV appraisal. This is incorrect. We should instead use Cuppcar’s Weighted Average Cost of Capital (WACC) as the discount factor in the NPV appraisal. The WACC represents the average cost of an entity's total pool of funds. The WACC is derived by first estimating the cost of each source of finance separately (ordinary shares and debt for Cuppcar) and then weighting each source according to their respective proportion in the total pool of funds.

The new funds raised through the bank loan are being put into Cuppcar’s pool of funds, and the company is using all its funding to operate the business. It is therefore more appropriate to use the WACC as the discounting factor instead of the cost of debt (interest rate).

In addition to the NPV, it is useful to calculate the internal rate of return (IRR) of the project. IRR is the relative return (% return) of an investment, calculated based on the same principles as that of NPV. IRR also provides an indication of by how much the cost of capital can fall before the NPV of the project becomes negative (similar to margin of safety). Hence, higher the IRR, the better it is.

Tutorial Note: Candidates will be also rewarded for mentioning any other appropriate financial considerations for the above requirement.

Addressing HR director’s concern

While the HR director raises a valid concern, it should be stressed that NPV is a superior method in comparison to payback period from a financial perspective.

Payback provides a measure of liquidity and risk, as the quicker we recover the money, the lower the risk and the quicker we can reinvest that money elsewhere.

Payback does not consider the entire project life or the ultimate return from the project. But, in order to determine the viability of any investment, we should consider the ultimate return from the project in addition to the payback period, and this is where the NPV method is helpful.

NPV is the net return from an investment considering the relevant cash inflows and outflows throughout the project life, discounted to present value at the company's cost of capital. A positive NPV indicates an increase in shareholder wealth. Hence, a project with a positive NPV is a viable and can be pursued.

How the lease should be treated in our financial statements

The lease should be accounted for in our financial statements as per IFRS 16 Leases. Since Cuppcar is the owner of the cars, Cuppcar is the lessor here and the lease should be accounted for accordingly.

Firstly, we have to determine whether this is a finance lease or an operating lease. The treatment for a finance lease is significantly different from an operating lease. As per IFRS 16, the following characteristics are indicative of a finance lease:

- Ownership is transferred to the lessee at the end of the lease.
- The lessee has the option to purchase the asset for a price substantially below the fair value of the asset and it is reasonably certain the option will be exercised.
- The lease term is for the major part of the asset's useful life.
- The present value of the minimum lease payments amounts to substantially all of the fair value of the asset.
- The leased assets are of such a specialised nature that only the lessee can use them without major modification.
- The lessee bears losses arising from cancelling the lease.
- Lessee has the ability to continue the lease for a secondary period at a rate below market rent.

(Tutorial note: It is not necessary for a candidate to list out all the characteristics of a finance lease. However, all the characteristics relevant for the given scenario must be set out)

As per the terms of our lease agreement, the lessee (United Holdings) has to bear the cost of cancelling lease during the period. While this is a feature of finance lease, consideration should also be made to more significant factors such as the lease period. Cuppcar's mechanics have confirmed that the cars are in good running condition and can be used for at least eight more years without any major technical issues. This indicates the useful economic life of the cars. The lease with United Holdings is for a 2 year period which does constitute a major portion of the cars' remaining useful life, and it is therefore not a characteristic of a finance lease.

Furthermore, although the lessee has the option to renew the lease for a secondary period, it cannot be renewed at a rate below market rent as in the case of a finance lease. Hence, it can be concluded that this lease should be treated as an operating lease in our accounts.

Accounting treatment for an operating lease

As per IFRS 16, lease receipts are shown as income in the statement of profit or loss on a straight-line basis over the 2 year term of the lease, unless another systematic basis is more appropriate. In our case, we should recognise a lease income of $240,000 p.a. Any difference between amounts charged and amounts paid will be recognised as accrued income or deferred income in the statement of financial position.

Subsequent treatment

The carrying amount of the lease receivable is increased by the finance income earned and decreased by the cash receipts.

I hope you find this information helpful.

Regards,
FM

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