Free Mock – Suggested Answers

Strategic Case Study – May & August 2024

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Section 1

Financial Analysts' Comment

According to financial analysts, implementing this strategy will lead to higher net operating cash flows in the future, resulting in increased profitability. Although the initial cost of introducing the new Eco-Intel service will be significant, operational efficiencies will eventually lead to cost savings.

Introducing the new service will open new revenue streams as well, since environmentally conscious customers will prefer to use them. However, Saefwell needs to closely monitor any additional operating costs the clients will have to incur due to this venture, such as in relation to software integration.

The increased cashflows would mean that Saefwell will be able to pay higher dividends, which would satisfy its shareholders. Further, the existence of additional revenue will increase profits, which would further increase the share price, thereby strengthening investor confidence.

The increased beta implies that the volatility of Saefwell's shares would increase. The current beta of the company stands at 0.88, which is lower than 1.00. This indicates that Saefwell's stock is relatively less risky, when considered as part of a diversified portfolio.

The increased beta (post diversification), will make our shares riskier, imposing a downward pressure on Saefwell's share price. The higher beta will also increase the cost of equity as it reflects higher returns investors demand for taking on more risk.

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It’s important to note that while equity financing might become more expensive, the strategic benefits and potential returns from the Eco-Intel service could justify the higher costs.

Also, given the eco-conscious appeal of Eco-Intel services, the Environmental & Social Governance (ESG) factors will drive investor interest, thus potentially enhancing Saefwell’s market valuation. Investors increasingly value sustainability, which could counteract some of the concerns about increased risk and cost of equity.

Further, the additional risk will not be a major problem, given the probability for enhanced revenues and profitability in the future. This could counterbalance the perceived risk, making the investment attractive to certain investors seeking growth opportunities.

Saefwell's move to include eco-intel services within its intelligence-led service portfolio also brings forth an intersection of systematic and specific risks. The systematic risk, pervasive across the entire industry, remains ever-present.

On the other hand, the new endeavour introduces specific risks tied to the design, implementation, and maintenance of Eco-Intel services, and these need to be monitored and controlled appropriately. For instance, employing robust project management practices, continuous monitoring of technological advancements, and engaging in stakeholder consultations could mitigate these risks.

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Director's Bonus

Granting Murat a bonus would serve as a testament to Saefwell's recognition of his exemplary leadership in the successful rollout of the Eco-Intel service. This initiative, critical to Saefwell's strategic expansion into sustainable intelligence-led security solutions, required meticulous planning and execution.

Saefwell's robust governance framework, which includes a remuneration committee of non-executive directors, ensures that Murat's bonus is subject to stringent review and justification. This structure, as indicated by CEO Greg Hainge's intention to propose the bonus to the committee, underlines a commitment to transparency and fairness in executive compensation, aligning with shareholder expectations.

Nonetheless, the bonus proposal may invite scrutiny from shareholders who could question the necessity of additional remuneration given the existing compensation packages. Such concerns are often amplified in public discourse on executive pay.

There may also be risks of discontent among other executives who might view the recognition of individual contributions as overlooking the collective effort of the Board.

To address potential discord, the Board should consider a communication strategy that clearly articulates the rationale behind individual bonuses, highlighting specific achievements and their alignment with corporate goals.

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It may also be beneficial to review the compensation structure to ensure it incentivizes teamwork and the successful completion of company-wide strategic initiatives.

In conclusion, while Murat’s bonus is merited based on his project leadership, careful consideration of the broader implications on corporate culture and shareholder sentiment is imperative.

The Board's decision to reward Murat should not only celebrate his achievements but also reinforce a culture of collective effort and shared success across Saefwell’s leadership.

Managing Stakeholders

To address the privacy concerns spotlighted in the “Digital Now!” article, Saefwell should undertake a multifaceted stakeholder engagement strategy focused on transparency, compliance, innovation, and advocacy.

Saefwell should consider how best to deal with advocacy groups, who have a high interest in privacy issues but relatively little power of their own. They could, however, harness the power of other powerful stakeholders such as the government.

There is little point in negotiating directly with the advocacy groups because they are unlikely to withdraw their criticisms about the industry under any circumstances. Indeed, any direct engagement with advocacy groups could simply generate additional adverse publicity.

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Saefwell should thus aim to engage with these advocacy groups through media. Saefwell should aim to offer its own perspective of any point raised by advocacy groups to ensure that the public recognize that Saefwell is not necessarily as guilty as suggested, with regards to breaching privacy laws.

Saefwell should engage directly with the government. The government has a great deal of power, and it appears that their level of interest is high in this instance as per the information which appears on the article.

The law would clearly not apply to Saefwell alone; many others in the industry would be left in a position where they would face disruption in business activities which would inevitably affect business operations adversely. Thus, costs will rise, at the same time, harming the relationship between us and clients.

Engagement with other stakeholders, such as suppliers and clients, is equally important. Saefwell should work with them to ensure that their practices align with Saefwell's privacy standards, thereby presenting a united front that underscores industry-wide commitment to privacy.

Saefwell could potentially make changes that would convince the government that the proposed change in the law is unnecessary. This would allow the government to claim that it has taken steps to address the issue and avoid losing the support of citizens who would be negatively affected by the change.

Care should be taken to ensure that the tone of any lobbying is managed carefully to avoid creating the impression that the government is being bullied. The focus should be on protecting the livelihoods of employees and the investment of shareholders.

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Saefwell should also work with its closest competitor, Brotto which will inevitably display a high level of interest in the matter. If both entities can work together, it will result in creating some power to resist the proposed law.

Further, Saefwell should attempt to address the root cause of the criticism. Ideally, it should carry out its own internal investigation to figure out whether the facts which appeared on the magazine article is true.

If that is the case, Saefwell should accept their fault publicly, and inform customers of the steps it will take to uphold privacy, thus adhering to regulations in the future. The information should be publicized on Saefwell's website as well.

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Best Regards,

Senior Finance Manager

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Section 2

Ethics

The decision to license Saefwell's proprietary Eco-Intel technology to competitors encapsulates an ethical dilemma that must be navigated with care to reflect the company's mission, vision, and values.

Saefwell's mission to provide tailored security solutions aligns with the concept of licensing Eco-Intel. By allowing competitors to use this technology, Saefwell expands its impact, promoting operational efficiency and environmental sustainability across the industry.

This step echoes the company's innovative spirit, showcasing a commitment to advancing security practices while ensuring operational focus for clients.

The vision to be the most trusted provider in the security sector reinforces the ethical imperative to establish trust through transparency and responsible sharing of technology.

By controlling the release of Eco-Intel's source code via escrow arrangements and reinforcing confidentiality through NDAs, Saefwell not only safeguards its innovations but also cultivates a collaborative environment that enriches the industry's standard for sustainability.

Licensing Eco-Intel can also exemplify Saefwell's value of responsiveness. Engaging with competitors in a way that fosters broader adoption of sustainable technologies without compromising Saefwell's competitive advantage demonstrates agility in meeting market needs and industry challenges.

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Furthermore, the value Saefwell places on employee welfare suggests that any licensing arrangement would need to ensure continued job security and safety, potentially fostering growth and elevating industry-wide safety standards.

The licensing arrangement could create opportunities for staff development, such as upskilling to work with new clients brought in through the licensing agreements, which would help in illustrating the company's dedication to its employees' growth and wellbeing.

Ethically, while the source code is a valued asset integral to Saefwell's competitive position, sharing it under controlled conditions for fair compensation adheres to business ethics, providing a model for how innovation can be leveraged for collective advancement without diminishing proprietary value.

Releasing Saefwell's source code could potentially violate confidentiality principles, as the code is a valuable asset owned by Saefwell and its shareholders. Licensing the software to competitors without a compelling commercial justification could be considered unethical.

However, should the Board opt to monetize this intellectual property by selling it at a fair price that recognizes its value, and concurrently safeguard confidentiality with robust NDAs and source code escrow agreements, such a decision would be ethically sound.

Also, Saefwell should approach the decision to license objectively. Licensing should be considered if it is in the best interest of all stakeholders, especially shareholders and employees, and aligns with the company's mission of enabling clients to focus on their core businesses, without sacrificing Saefwell's competitive edge.

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Further, to maintain integrity and ethical standards, the Board should ensure transparency regarding its decision to pursue a licensing agreement. Soliciting input from shareholders prior to finalizing such agreements exemplifies respect for their contributions and fosters a culture of trust and open communication, aligning with principles of responsible governance and ethical business practices.

Internal audit

The internal audit department should initiate a comprehensive risk assessment focused on the potential vulnerabilities and threats associated with licensing Eco-Intel's technology. This involves identifying areas where intellectual property rights could be compromised, evaluating the sufficiency of current security measures, and determining the risk exposure from potential licensing agreements.

Following the risk assessment, the audit team should review and verify the effectiveness of the proposed source code escrow arrangements. This would entail assessing the credibility and reliability of the escrow service provider, ensuring that the terms of the escrow agreement align with Saefwell's objectives for security and control, and that the conditions for release of the source code are clearly defined and enforceable.

The audit department must also scrutinize the structure and enforcement capabilities of the non-disclosure agreements (NDAs). This includes ensuring that the NDAs are comprehensive, covering all aspects of confidentiality and unauthorized usage, and that they are legally binding with clear penalties for breaches. The team should also assess the process for monitoring compliance with these agreements by potential licensees.

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Additionally, the internal audit should evaluate the internal controls surrounding access to the Eco-Intel source code within Saefwell. This includes reviewing access rights management, change control procedures, and the security of digital and physical storage environments. The goal is to ensure that only authorized personnel have access to the source code and that all modifications are properly documented and authorized.

Finally, the audit department should develop an ongoing monitoring plan to oversee the security of the Eco-Intel source code post-licensing. This plan should include regular audits of both the escrow arrangements and the adherence to NDAs by licensees. It should also incorporate mechanisms for detecting unauthorized access or usage of the source code, ensuring that Saefwell can quickly respond to and mitigate any security breaches.

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Section 3

Funding Options

The upgrade, entailing both hardware setup and an annual licensing fee, represents a significant investment of C$ 500 million (equivalent to B$ 1,500 million).

Escrow Setup & Integration

For the long-term setup and integration costs amounting to C$ 300 million (B$ 900 million), Saefwell should consider funding options aligned with the digital asset's longevity, such as long-term loans or issuing equity.

However, it's important to be cautious of the company's gearing ratio, which currently stands at 40%. Leveraging additional debt risks pushing this ratio close to 50% (since the actual gearing will increase to 49%), potentially portraying Saefwell as a high-risk entity to lenders and inviting higher interest rates.

Further, securing a loan for this sum (B$ 900m) may prove difficult due to the nature of the assets being acquired. This is a common concern when seeking debt financing for investments primarily in intangible assets like software escrow services.

Lenders typically prefer to secure loans against tangible assets that can be appraised and potentially liquidated in case of default. Intangible assets, do not offer the same level of collateral security.

Additionally, the setup cost, an integral part of this investment, holds negligible resale value and therefore cannot be leveraged as security in a lending scenario.

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This limitation is compounded by the fact that Saefwell's current debt levels are already higher relative to its property, plant, and equipment, suggesting limited capacity to incur additional debt secured against these assets.

Given these constraints, Saefwell might consider turning to equity financing, specifically through a rights issue, to fund this vital upgrade. A rights issue would allow the company to raise capital directly from its existing shareholders. This approach not only avoids increasing the company's debt load but also aligns shareholder interests with the company's strategic direction.

Convincing shareholders of the long-term value and potential positive net present value of this investment is crucial. This escrow services represents a significant enhancement of a licencing the Eco-Intel software, and as such, shareholders may appreciate the opportunity to directly contribute to and benefit from this strategic development.

Alternatively, if Saefwell uses its retained earnings (B$ 2,893m) to fund the investment in the escrow service setup, it would not increase the company's debt, thus leaving the gearing ratio unchanged. This approach also avoids the potential dilution of shareholder equity that might occur if new shares were issued to raise capital.

Additionally, utilizing retained earnings circumvents the need to acquire external financing, which can be a resource-intensive process that often requires convincing lenders or shareholders of the viability of the investment.

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Using internal funds can be a more straightforward and cost-effective method of financing, provided it does not significantly deplete the company's cash reserves or negatively impact its financial stability and operational needs.

Annual Escrow Management Fee

With regards to escrow management fees amounting to C$ 200 million (B$ 600 million), a more fluid approach is advisable. Given this is a recurring operational expense, it could be financed from working capital. However, given Saefwell's net current assets of just B$ 353 million, this option is unsuitable for Saefwell.

Alternatively, a short-term loan, repayable in one year, could be repaid out of Saefwell's net cash flows from the use of this new service. A short-term loan would not have an impact on the company's gearing ratio as well, so it may not increase perceptions of risk.

Saefwell is well-positioned to negotiate a short-term loan by presenting lenders with a detailed cash flow forecast. The negotiations are further bolstered by Saefwell's strong Interest Cover of 13:1, underscoring its ability to comfortably cover interest expenses with it operating profits.

Debt Covenants

Under no conditions should Saefwell violate its debt covenants without securing approval from the creditors that set these stipulations. Should Saefwell fail to adhere to these covenants, creditors are entitled to demand the immediate return of the borrowed funds, a scenario that could lead to asset seizure and potentially result in the company's dissolution.

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Saefwell could present the argument to its lenders that enforcing these covenants may not be in their best interest, given the potential negative publicity from shutting down the company and the likelihood that liquidating Saefwell's assets would only cover a minor portion of the outstanding debts.

Should Saefwell consider taking on an additional B$ 900 million in debt, it must initially seek consent from its current creditors, necessitating a formal agreement that signifies their consent to modify the existing gearing ratio threshold.

Given that Saefwell's gearing was at 40% in 2023, indicating operation near its leverage limit for an extended period, it could be reasoned that the company has historically managed a gearing ratio near this upper limit effectively.

To persuade the lenders to ease the covenant terms, Saefwell's Board must provide incentives, as expecting lenders to accept higher risk without benefits is impractical.

A compelling argument might be that the intended investment would lead to increased net cash flows and equity, thereby diminishing the risk of payment defaults. Saefwell could also propose extra collateral as a loan safeguard, possibly through asset encumbrance.

Furthermore, the company might explore debt restructuring, obtaining a new loan to clear existing liabilities and finance the escrow service investment. This approach could facilitate negotiations for a loan with more favourable covenants, reducing the risk of covenant breach.

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Saefwell aims to showcase revenue projections from licensing the Eco-Intel software, potentially convincing new lenders of the low-risk profile and justifying the substantial loan.

Leveraging the repayment of the original loan could serve as a negotiation tool with the initial lenders, who might prefer to renegotiate the loan rather than lose interest income from early repayment. This renegotiation could lead to modified loan terms, including relaxed or removed gearing constraints.

Negotiating with the current lenders might also spare Saefwell any early repayment penalties as stipulated in the original loan agreements, emphasizing the importance of open dialogue and negotiation in navigating financial agreements and ensuring financial sustainability.

Currency Risk

Given the volatile nature of the C$ to B$ exchange rate, employing forward contracts could be a strategic move. These contracts would allow Saefwell to fix the exchange rate for future C$ payments, providing a hedge against adverse currency movements. While this wouldn't eradicate currency risk entirely, it would offer a degree of cost certainty.

An alternative strategy is the application of leading and lagging techniques. This would involve strategically timing payments to capitalize on favourable exchange rate movements, thereby optimizing the cost of transactions. If the exchange rate between the B$ and C$ appears to be in Saefwell's favour, then it would be possible to make an advance payment of some, or even all, of the annual fee.

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Cesco will gladly accept early payment because its revenues are in C$ anyway and there is no disadvantage to receiving payment at a time when the C$ is weak against a customer's home currency.

However, Saefwell should consider the potential opportunity costs associated with early payments. Careful monitoring of market forecasts and exchange rates would be essential to execute this strategy effectively.

Lastly, this plan should be communicated clearly to stakeholders to ensure transparency and confidence in Saefwell's fiscal strategy.

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