

QUESTION 2

100 marks

Zimrod (Pty) Ltd ('Zimrod') supplies corporate clothing and gifts to a diversified customer base in South Africa. Zimrod's head office is based in Midrand, Gauteng. This 4 500 m² facility houses the company's main warehouse and the procurement and administrative divisions, together with an impressive showroom. Zimrod also has branches in Cape Town, Durban and Port Elizabeth, which service customers in those regions.

Zimrod imports clothing from various suppliers based in India, China and Taiwan. The clothing range includes T-shirts, golf shirts, lounge shirts, work wear, sweaters, jackets and track suits. The company currently does not supply retailers, but sells directly to corporate customers or marketing and promotions companies only. Clothing can be branded to customer specifications using embroidery and printing.

The company also purchases and sells a range of corporate gifts to its customers, including –

- carry bags and luggage items;
- water bottles, coffee mugs and flasks;
- memory sticks;
- key chains;
- umbrellas;
- business card holders;
- stationery items, such as pens, pencils, folders and notebooks;
- iPad holders; and
- first-aid kits.

The gift range can also be branded with company logos and marketing material.

The executive directors of Zimrod collectively own 100% of the shares in issue of the company (there are 100 000 ordinary shares in issue). These shareholders have provided non-interest-bearing loans to the company in proportion to their shareholdings. Shareholder loans totalled R12 500 000 in 2011 and 2012.

The statement of comprehensive income of Zimrod for the year ended 30 September 2012 and the statement of financial position at 30 September 2012 are set out below.

ZIMROD (PTY) LTD		
STATEMENT OF COMPREHENSIVE INCOME		
FOR THE YEAR ENDED 30 SEPTEMBER 2012		
	2012	2011
	R'000	R'000
Revenue	317 438	274 600
Cost of sales	(183 479)	(159 268)
Gross profit	133 959	115 332
Operating expenses	(98 937)	(87 710)
Operating profit	35 022	27 622
Finance costs	(1 630)	(1 500)
Profit before taxation	33 392	26 122
Taxation	(9 350)	(7 314)
Profit for the year	24 042	18 808

ZIMROD (PTY) LTD STATEMENT OF FINANCIAL POSITION AT 30 SEPTEMBER 2012		
	2012	2011
	R'000	R'000
Non-current assets		
Property, plant and equipment	17 380	12 500
Current assets	111 496	91 554
Inventories	50 268	41 453
Trade and other receivables	60 878	48 901
Cash and cash equivalents	350	1 200
Total assets	128 876	104 054
Equity		
Share capital	100	100
Retained income	65 917	41 875
	66 017	41 975
Non-current liabilities		
Loans from shareholders	12 500	12 500
Current liabilities	50 359	49 579
Current tax payable	1 402	1 096
Trade and other payables	32 674	30 545
Bank overdraft	16 283	17 938
Total equity and liabilities	128 876	104 054

Ms Jennifer Ireland, the Chief Executive Officer (CEO) of Zimrod, is concerned about the cash flow generation of the company. Operating profit grew by 26,8% in the 2012 financial year ('FY2012') yet the net cash position only improved marginally. Ms Ireland is of the opinion that the poor cash flow generation of the company is due to poor working capital management. She would like her shareholder's loan to be repaid as soon as possible, as she plans to buy a holiday home in Cape Town.

Jaxx Work & Leisure Wear

Zimrod has historically adopted a strategy of importing and selling its own line of clothing, branded 'Zimrod', or sourcing clothing to be branded to customers' requirements. However, the company has been in discussions with Jaxx Work & Leisure Wear ('Jaxx'), a major North American clothing group which sells Jaxx branded merchandise to clothing retailers in North America and Europe. Jaxx also has its own retail outlets which sell its extensive clothing range and related accessories (sunglasses, gloves, belts, headwear and socks).

Jaxx has offered Zimrod the exclusive right to distribute its product range in sub-Saharan Africa. Jaxx currently does not have a presence in Africa and perceives an opportunity to grow its global sales by entering emerging markets.

The opportunity to import and distribute the Jaxx product range is appealing to Zimrod for the following reasons:

- It will provide its customers with access to a leading global work and leisure wear brand;
- It will diversify revenue streams, as Zimrod could supply branded merchandise to South African clothing retailers; and
- It will enable Zimrod to enter the retail market directly, should Zimrod decide to open its own retail outlets under the Jaxx brand.

Negotiations between Zimrod and Jaxx have progressed well and agreement has been reached on the following key commercial arrangements:

- The initial licensing and distribution agreement will be for a three-year period commencing on 1 January 2013. The agreement will be automatically renewable for another three years thereafter, unless either party terminates the agreement by giving three months' written notice;
- Zimrod will order and purchase merchandise directly from Jaxx's head office in Seattle in the United States (US). Zimrod will not pay royalties to Jaxx but rather Jaxx will earn its normal mark ups on selling its product range. Prices will be denominated in US dollar;
- Zimrod will be required to spend a minimum of 2% of its annual sales value of Jaxx products on general marketing and promotion of the Jaxx brand in South Africa and in other territories in which Zimrod will sell Jaxx merchandise;
- Jaxx will supply Zimrod with free samples of products and advertising materials to assist Zimrod in marketing and promoting the brand. In addition, Jaxx will provide Zimrod with access to all forthcoming clothing and product ranges while these are in the planning stage to enable Zimrod to plan new product launches and place orders well in advance of changing seasons; and
- Payment terms for products purchased from Jaxx will be 30 days from statement, which will be e-mailed at the end of each month.

The Financial Manager of Zimrod, Mr Jarred Kirchner, was tasked with preparing a capital budget to assess the viability of importing and distributing the Jaxx product range. Mr Kirchner obtained inputs from key management at Zimrod and Jaxx and has incorporated these into the latest draft capital budget, which is summarised below.

For the sake of simplicity, the capital budget is based on the assumption that all cash flows occur at the end of each calendar year unless otherwise indicated and that the agreement with Jaxx will become effective on 1 January 2013:

JAXX VENTURE DRAFT CAPITAL BUDGET					
	Notes	2012	2013	2014	2015
		R'000	R'000	R'000	R'000
Sales	1	0	65 625	103 500	123 038
Purchases – landed cost	2	0	(43 750)	(69 000)	(82 025)
Gross profit		0	21 875	34 500	41 013
Initial marketing campaign	3	(2 500)	0	0	0
Warehousing costs	4	0	(2 188)	(3 450)	(4 101)
Delivery costs	5	0	(1 531)	(2 415)	(2 871)
Operating costs	6	0	(7 560)	(8 316)	(9 148)
Finance costs	7	0	(1 398)	(1 745)	(1 207)
Net profit for the year		(2 500)	9 198	18 574	23 686
Taxation	8	700	(2 576)	(5 201)	(6 632)
Inventory movements	9	(8 500)	(5 884)	(8 301)	(4 282)
Trade receivables movements	10		(13 485)	(7 783)	(4 015)
Trade payables movements	10		5 394	3 113	1 606
Net cash flow for the year		(10 300)	(7 353)	402	10 363
Internal rate of return (IRR)		-17,8%			
Funding required					
Opening balance		0	(10 300)	(17 653)	(17 251)
Net cash flow for the year		(10 300)	(7 353)	402	10 363
Closing balance		(10 300)	(17 653)	(17 251)	(6 888)

Notes

- 1 A mark-up on the landed cost of products of 50% has been assumed in the capital budget.
- 2 The cost of purchasing Jaxx products has been based on the forecast rand : US dollar exchange rates which were obtained from Zimrod's bankers.
- 3 Zimrod will need to launch a marketing campaign to introduce the Jaxx brand to South African retailers and consumers. It has been assumed that the campaign will be paid for by 31 December 2012.
- 4 Zimrod has sufficient capacity in its existing warehouse for storing Jaxx products and does not expect to incur any additional costs in handling these products at its warehouse. However, in order to evaluate the Jaxx project objectively, warehousing costs of 5% of the landed cost of products has been included in the capital budget (5% being the percentage Zimrod historical experienced for all product ranges).
- 5 Costs of delivering products sold to customers averages 3,5% of landed cost.

- 6 Zimrod plans to start a new division which will focus exclusively on Jaxx products. The additional operating expenditure relates to this division and costs will largely be fixed in nature and exclude advertising and marketing expenditure.
- 7 Zimrod will require additional funding to invest in initial inventory and to cover marketing expenditure and ongoing working capital requirements until the venture is cash positive. It has been assumed that loan finance will be obtained from commercial banks to fund the venture. Finance charges at a rate of 10% per annum have been assumed, based on the average loan balances during the forecast period. No interest income has been included (Zimrod earns 5% on cash deposits) since the venture is forecast to be cash negative for the first three years.
- 8 Taxation at 28% has been assumed on net profits generated by the Jaxx venture.
- 9 It has been assumed that Zimrod will initially purchase inventory to the value of R8 500 000 to get the venture off the ground. Thereafter, year-end inventories have been assumed to be 120 days' worth of purchases, as follows:

	2012	2013	2014	2015
	R'000	R'000	R'000	R'000
Initial inventory	8 500			
Year-end inventories, 2013 onwards (120 days)		14 384	22 685	26 967
Net movement for the year	(8 500)	(5 884)	(8 301)	(4 282)

- 10 Trade receivable days of 75 and trade payable days of 45 (based on landed cost of goods) have been assumed throughout the period, and net movements have been calculated as follows:

	2013	2014	2015
	R'000	R'000	R'000
Trade receivables			
Trade receivables at year end (75 days)	13 485	21 268	25 283
Net movement for the year	(13 485)	(7 783)	(4 015)
Trade payables			
Trade payables at year end (45 days)	5 394	8 507	10 113
Net movement for the year	5 394	3 113	1 606

Zimrod plans to delay the opening of any Jaxx retail outlets until 2016 to allow the company to establish this brand in South Africa before embarking on the next phase of the plan.

The CEO of Zimrod has reviewed the above draft capital budget and is dismayed by the negative forecast IRR. The Board of Directors of Zimrod has indicated that unless the projected IRR is higher than 30%, the proposed licensing and distribution arrangement with Jaxx will not be approved.

The directors derived the 30% hurdle rate on the following basis:

Zimrod weighted average cost of capital (WACC)	=	[80% x cost of equity] + [20% x after tax cost of debt]
		<i>20% representing the target debt : equity ratio</i>
Cost of equity	=	Risk free rate + market risk premium
	=	Government three-month treasury bill rate + 8,0%
	=	6,6% + 8,0%
	=	14,60%
Cost of debt	=	Current bank overdraft rate x 72%
	=	9,0% x 72%
	=	6,48%
WACC therefore	=	12,98%
Adjustment for Jaxx venture risk	=	17,02%
Hurdle rate	=	30,00%

The Board of Directors has also indicated that the capital budget should be based on the assumption that the Jaxx venture is a three-year project.

Funding for the Jaxx venture

Zimrod has approached its commercial bankers and other banks to provide a R20 million term loan to fund the Jaxx venture. All banks that were approached have declined the loan application, based on their perception that it would be a high-risk business venture. Zimrod's poor cash flow generation in FY2012 also did not help their cause in their bank finance application.

Morningstar Investments Ltd ('Morningstar'), a listed investment holding group, recently approached Zimrod with a view to acquiring a minority shareholding interest in the company. Morningstar has been actively searching for an entry into the corporate clothing and promotions industry and has received excellent feedback about Zimrod. Morningstar has submitted a letter of interest to the Board of Directors of Zimrod, stating amongst others the following:

- Morningstar is prepared to subscribe for a 30% shareholding in Zimrod based on a valuation of four times the audited profit after tax for the year ended 30 September 2012, as a price-earnings multiple of four is what Morningstar usually pays for stakes in private companies. In terms of this the value of Zimrod would be R96 168 000 based on the profit for the year ended 30 September 2012, and Morningstar would inject R28 850 400 into the company in return for a 30% shareholding; and
- Morningstar requires the right to appoint two non-executive directors to the Board of Directors of Zimrod.

REQUIRED

		Marks	
		Sub-total	Total
(a)	<p>Analyse the working capital of Zimrod for the years ended 30 September 2011 and 2012 and indicate, with reasons, whether you agree with the Zimrod CEO's contention that the poor cash generation of the company is due to poor working capital management.</p> <ul style="list-style-type: none"> Calculate relevant ratios and show all workings. Use 365 days of the year for your calculations where relevant. 	7	7
(b)	<p>Re-draft the capital budget to correct the errors and omissions that you have identified in the draft prepared by the Financial Manager. Also recalculate the projected IRR of the Jaxx venture. Briefly motivate each of your adjustments.</p> <p>Assume that the mathematical calculations of working capital in the original draft capital budget are correct.</p>	20	20
(c)	Critically discuss the derivation of the 30% hurdle rate required by the Board of Directors for the evaluation of the proposed licensing and distribution arrangement with Jaxx.	10	10
(d)	<p>With regard to the proposed licensing and distribution arrangement with Jaxx –</p> <p>(i) discuss whether this is an appropriate strategy for Zimrod to pursue, describing both the positive aspects of this alliance and potential concerns you may have from a strategic perspective; and</p> <p>(ii) identify and explain the key risks to which Zimrod will be subjected if it enters into and pursues the proposed arrangement with Jaxx.</p> <p><i>Communication skills – clarity of explanation and logical argument</i></p>	<p>14</p> <p>16</p> <p>2</p>	32
(e)	<p>Draft an executive summary to the Board of Directors in which you recommend, with reasons, whether or not Zimrod should enter into the licensing and distribution arrangement with Jaxx.</p> <p><i>Communication skills – appropriate and clear communication</i></p>	<p>6</p> <p>2</p>	8
(f)	Discuss the factors that the Board of Directors should consider in evaluating the Morningstar offer.	10	10
(g)	<p>Estimate the pro forma earnings per share of Zimrod for the year ending 30 September 2013, on the assumption that –</p> <ul style="list-style-type: none"> Morningstar subscribed for a 30% shareholding in Zimrod based on a pre-subscription valuation of Zimrod of R120 million on 1 October 2012; Zimrod's operating profit, before consideration of the Jaxx venture opportunity, increases by 15% in FY2013 in comparison to FY2012; and Zimrod does not enter into the licensing and distribution arrangement with Jaxx. <p><i>Communication skills – layout</i></p>	<p>12</p> <p>1</p>	13
Total			100

