

Case Background and Questions

Speed Eater Limited

Overview

Speed Eater Limited (“Speed Eater” or “SEL”) began operations in Hong Kong 35 years ago, as a small family-based company. It was founded in 1978 by Matthew Chan and his wife Cindy as a single noodle-specialist restaurant. Matthew and his wife had a dream to do for noodles what other fast food restaurants had done for the burger – make noodles a cheap and cheerful fast food staple. They followed this dream and soon Speed Eater noodle restaurants began to spring up all over Hong Kong, with up to ten new outlets opening each year. The business continued to develop successfully over time, but it became much more difficult to find suitable premises for new outlets in areas where the company did not already have existing outlets. Matthew therefore began to expand the business into mainland China.

Since 1998, SEL's growth in mainland China has been fast. SEL now has a large chain of fast food outlets in Hong Kong and mainland China, which all operate under the name of Speed Eater Bars (“SEB”). The company also operates a small chain of Hokkien Food House (“HFH”) restaurants in Hong Kong. In total, there are now 135 outlets in Hong Kong and 56 outlets in mainland China (Beijing, Shanghai and Shenzhen).

The company does not run on a franchise model; rather all outlets are owned and operated by SEL. Matthew considered that franchising SEB would create too much risk of damage to the Speed Eater brand name reputation.

The family business was listed on the Hong Kong Stock Exchange in 1998, when Cindy retired from the company. Matthew became Chairman, a position he still holds, and has also acted as Chief Executive Officer (CEO) for a number of years. In 2005, his son David Chan (Hong Kong CPA) took over as CEO, after spending several years as the Chief Operating Officer. Although there are other Board members, Matthew and David Chan exercise firm control over the business - sixty per cent (60%) of the shares in SEL are owned by the Chan family.

More recently David Chan's daughter, Vicky, has also become involved in the business. She started up a small side business, supplying the Hong Kong corporate market with in-house catering (lunches and evening functions). This is known internally as the SEL Corporate Catering business unit, and it has now been in operation for just over two years. Vicky is a young (26 years old) and ambitious entrepreneur. She has an Economics degree and has recently become a Hong Kong CPA. This is the first business venture she has been involved with, and may consider herself fortunate that her father was prepared to give her the opportunity to demonstrate her entrepreneurial ability. David Chan has put his trust in Vicky to leverage off the reputation and business of SEB and HFH, and is allowing her to run the business with a high level of autonomy. She supplies monthly reports to the CEO and Board on the performance of the business unit.

SEL has always prided itself on its excellent reputation for food and workplace safety with its high levels of customers and staff satisfaction leading to strong customer loyalty and staff retention rates. Matthew is viewed as a retail business leader in the Hong Kong corporate community and is a chair and member of various business and charitable boards. The entire family are perceived as valuable and philanthropic members of the Hong Kong community.



Recent developments

After a period of fairly rapid growth throughout the 2000s, expansion of the business has slowed down in the last two to three years. Although annual sales revenue continues to rise, SEL did not open any new outlets in 2014. It has been unable to find suitable new premises in Hong Kong, a severe constraint on business growth.

The Board has seen that competition has been strong in Hong Kong and mainland China. This is keeping prices down, whilst rising costs of materials and labour have put pressure on profit margins. Hong Kong is also the origin of Hong Kong style tea restaurants ("Cha Chaan Teng"), its cuisine has a long history that has gained popularity over the years; there has been high local and mainland China demand for good quality Cha Chaan Teng cuisine which commonly has noodles in its menu. There is also a market trend that restaurants are broadening the choice of beverages in their menus. A recent survey revealed that the consumer interest in coffee has continued to rise in South-east Asia. In response to the growing demand, coffee specialists and premium coffee brands have been targeting the growing group of sophisticated consumers, coffee drinking has been popular among the younger population in Hong Kong and mainland China. Many restaurants now serve premium and/or speciality coffees.

Over the recent years, the number of visitors to Hong Kong has grown fast under the multi-entry permit individual travel scheme. More than 40 million mainland Chinese tourists visited Hong Kong in 2014 and this has helped to boost SEL's revenue in Hong Kong. External forces such as government policies, economic environment and customer tastes would also impact the profitability of SEL, yet SEL's senior management believes a significant proportion of revenue would still come from tourists in the coming years.

SEL operates most of its outlets from leased premises. Typically, lease agreements are for periods of 3 – 9 years, with rental reviews every two, three or four years. Shortage of retail outlet space in Hong Kong means that rental costs are rising quickly, putting additional pressure on profit margins. This pressure can be expected to continue as leases come up for renewal.

During the previous financial year, the company ended a long-running legal dispute with the lessor of two Hong Kong premises. As a result of the legal settlement, SEL received a one-off payment, after legal expenses, of HK\$2,000,000 (net) during the year. The legal dispute has created ill-will between the lessor and SEL, and the Board of SEL is aware that the lessor may be unwilling to renew the leases when the current agreements end. The first lease renewal will be in three years' time.

Although the business did not open any new outlets last year, both Matthew and David Chan agree that SEL needs to look for opportunities for growth in the business. They believe that sales revenue growth will not continue without substantial new investment. David Chan is also of the opinion that although the company is very profitable, there are weaknesses in the management of costs and working capital. Action to deal with these problems should have a beneficial effect on profitability.

2015 strategic development

Matthew and David have instructed Kim Ho, the Chief Financial Officer, to put together a strategy group (the "Investment Strategy Group") to assess the operating environment of the business and come up with any proposed strategies. Two strategies have been identified by the Investment Strategy Group:

- (1) Diversify its business and invest in Hong Kong style tea restaurants ("Cha Chaan Teng") in mainland China.
- (2) Enter into a coffee shop business in Hong Kong and mainland China through a franchising agreement with a renowned coffee shop brand in the US, as referred by Thomas Chan, cousin of Matthew Chan who is SEL's Chief Investment Officer.

The implementation of the strategies would require substantial investment which SEL is required to raise funds in the capital market, but many alternatives may be considered such as offering right issues, public offering of new shares or obtaining bank loans.

Earnings, dividends and share price

During the year ended 31 December 2014, the company enjoyed very good growth in sales revenue. It is not clear why revenue growth was so strong, since the company did not open any new outlets in the year, and growth in the corporate catering business unit, although satisfactory, did not account for all the growth.

Of much greater concern is the fall in profitability between 2013 and 2014. Earnings and earnings per share fell by nearly 30%. The company's share price has fallen in response to this disappointing performance. However in view of the large fall in earnings, the share price has not fallen by as much as might have been expected, suggesting perhaps that investors continue to have some confidence in the company's management. On 31 December 2013, the share price peaked at \$7.90. It is currently \$6.67 – a fall of about 15% since that time. The company has 300 million shares in issue, so the fall in share price has resulted in a fall in the market value of the company's equity from \$2,370 million to \$2,000 million since December 2013.

The company has a large amount of cash and short-term investments, and the Board has taken the view that, given the limited opportunities for high returns from investments in financial securities, there is no reason to accumulate more cash until new business investment opportunities arise. The company has a normal dividend policy as 40% to 50% of net profit attributable to its shareholders. Cash has been invested mostly in savings accounts to obtain a return, but in 2014, the company also began to invest in sovereign bonds. Since the Board decided in 2012 that there was no need to accumulate more cash, the company paid special dividends in 2013 and 2014, when most profits were distributed to shareholders as dividends. This creates an expectation from the shareholders for a high dividend pay-out ratio in the coming years and the Board believes this may be one of the reasons for supporting the share price even though profitability is declining.



The Board of Directors

The Board of Directors has firm leadership from its Chairman Matthew Chan and the CEO David Chan.

There are two other executive directors:

- Robert Yang, the Chief Operating Officer. Robert has extensive experience in the fast food business, and was recruited to his position in SEL in 2005, when David Chan became the CEO.
- Kim Ho, the Chief Financial Officer. Kim is a CPA and has a small accountancy team operating at the head office.

They each own a small quantity of shares in the company.

The company also has six non-executive directors; of these four are independent.

Business operations

Due to the nature of the company's main business operations, most of its sales are for cash. The only exception is the SEL Corporate Catering business unit, where sales to all corporate customers are on credit terms. Information about trade receivables, prepayments and deposits are provided in Appendix 2.

Currently all supplies of food are purchased from external suppliers. Purchased supplies are held in SEL-operated distribution centres in the relevant city of operation, from where they are distributed to the local SEB and HFH outlets.

Responsibility for business operations is divided. David Chan has the overall responsibility for business performance. Three senior managers report to David. Robert Yang is responsible for the fast-food business operations in Hong Kong and mainland China and is regarded as the "Deputy CEO" within the company. Vicky Chan has the responsibility for the SEL Corporate Catering business unit, reporting directly to her father David, and not to Robert. Thomas Chan has the responsibility for identifying new investment opportunities.

Financial affairs are the responsibility of Kim Ho, who produces quarterly performance reports for the company. She is also responsible for treasury operations and the management of the company's cash and investments.

Summary financial statements for the year to 31 December 2014, and comparative figures for the previous year, are shown in Appendix 1.

David Chan is dissatisfied with the relatively poor performance during 2014. He is convinced that measures can be taken to improve profitability through better cost control, but he is also concerned that management of working capital throughout the company may be inefficient. David suspects that because the company has a lot of cash, it has not given enough consideration to cash management or the cash cycle of the business.

Appendix 1: Summary financial statements

SEL Company

Statement of financial position as at 31 December:

	2014 HK\$'000	2013 HK\$'000
Non-current assets		
Property, plant and equipment	1,169,261	1,135,284
Current assets		
Inventories (note 1)	97,131	82,677
Trade and other receivables	43,114	36,433
Prepayments and deposits (note 2)	49,620	54,865
Short-term investments	43,084	—
Cash and cash equivalents	478,878	561,144
Total assets	<u>1,881,088</u>	<u>1,870,403</u>
Equity		
Share capital	30,000	30,000
Non-distributable reserves	461,828	461,828
Retained earnings	1,131,353	1,114,759
Total equity	<u>1,623,181</u>	<u>1,606,587</u>
Current liabilities		
Trade payables	69,262	70,635
Other creditors and accrued liabilities	174,125	171,008
Current income tax liabilities	14,520	22,173
Total liabilities	<u>257,907</u>	<u>263,816</u>
Total equity and liabilities	<u>1,881,088</u>	<u>1,870,403</u>
Number of shares in issue	<u>300 million</u>	<u>300 million</u>

Notes:

- 1 Inventories consist of food and consumable stores.
- 2 Prepayments and deposits consist of deposits and prepayments for rented premises and utilities, and for some purchases of plant and equipment.
- 3 Exchange gains or losses have been kept out of these summary financial statements to prevent complication of the data.

Income statement for the year to 31 December

	2014 HK\$'000	2013 HK\$'000
Revenue	2,984,900	2,665,080
Cost of sales	<u>(2,558,653)</u>	<u>(2,170,966)</u>
Gross profit	426,247	494,114
Administrative expenses	<u>(157,688)</u>	<u>(136,852)</u>
Operating profit	268,559	357,262
Finance income and net income from legal settlement (note 4)	<u>12,926</u>	<u>11,857</u>
Profit before income tax	281,485	369,119
Income tax expense	<u>(46,318)</u>	<u>(60,160)</u>
Profit for the year	<u>235,167</u>	<u>308,959</u>
Dividends	218,573	284,240
Number of shares in issue	300 million	300 million
Earnings per share	78.39 cents	102.99 cents

Note 4:

A legal settlement during the year to 31 December 2014 resulted in net income for the company of HK\$2,000,000.

Expenses by nature

Expenses included in cost of sales and administrative expenses are analysed as follows:

In the year to 31 December

	2014 HK\$'000	2013 HK\$'000
Cost of food and consumables used	1,061,624	895,467
Depreciation	120,280	104,345
Operating lease rentals in respect of rented premises	313,415	266,532
Employee cost	713,391	588,983
Electricity, water and gas costs	163,448	143,935
Advertising and promotion expenses	38,654	35,840
Provision for impairment of trade receivables	150	—
Other expenses	<u>305,379</u>	<u>272,716</u>
	<u>2,716,341</u>	<u>2,307,818</u>
Representing		
Cost of sales	2,558,653	2,170,966
Administrative expenses	<u>157,688</u>	<u>136,852</u>
	<u>2,716,341</u>	<u>2,307,818</u>

Appendix 2: Trade and other receivables, prepayments and deposits

At 31 December:

	2014 HK\$'000	2013 HK\$'000
Trade receivables	24,025	20,172
Less provision for impairment of receivables	<u>(212)</u>	<u>(262)</u>
Trade receivables – net	<u>23,813</u>	<u>19,910</u>
Trade and other receivables	43,114	36,433
Prepayments and deposits	<u>49,620</u>	<u>54,865</u>
	<u>92,734</u>	<u>91,298</u>

The company's sales to customers are mainly on a cash basis. However the company allows credit of between 30 to 45 days to corporate customers for the provision of the corporate catering services.

The ageing analysis of trade receivables is as follows:

At 31 December:

	2014 HK\$'000	2013 HK\$'000
0 – 30 days	14,315	12,709
31 – 60 days	4,936	4,438
61 – 90 days	1,420	1,008
Over 90 days	<u>3,354</u>	<u>2,017</u>
	<u>24,025</u>	<u>20,172</u>

Sales to corporate customers were HK\$203,900,000 in the year to 31 December 2014. (2013: HK\$188,790,000).

The trade and other receivables are denominated in the following currencies:

At 31 December:

	2014 HK\$'000	2013 HK\$'000
Denominated in HK dollar	28,751	28,295
Denominated in RMB	<u>14,363</u>	<u>8,138</u>
	<u>43,114</u>	<u>36,433</u>



Appendix 3: SEL management

Matthew Chan	One of the co-founders of SEL with his wife Cindy. Currently the company Chairman. Until 2005 was also the Chief Executive Officer.
Cindy Chan	One of the co-founders of SEL with her husband Matthew. Retired from the business in 1998.
Thomas Chan	Cousin of Matthew Chan. SEL's Chief Investment Officer. Reports to David Chan.
David Chan	CPA. Son of Matthew Chan and Cindy Chan. Chief Executive Officer of SEL since 2005. Formerly the Chief Operating Officer.
Vicky Chan	CPA. Daughter of David Chan. Head of the SEL Corporate Catering business unit, established just over two years ago. Reports to David Chan.
Robert Yang	Chief Operating Officer. Appointed in 2005 when David Chan became CEO. Regarded as the 'Deputy Chief Executive Officer' in SEL.
Kim Ho	CPA. Chief Financial Officer of SEL.

Questions:

- 1) Between the two strategies identified by the Investment Strategy Group, select a strategy with a funding plan that you perceive as mostly applicable to SEL. You are welcome to present any other strategies but in such case, explain why your proposed strategy is better than the two strategies identified. Prepare a business proposal to the Board to recommend a 3 to 5 year investment plan and funding arrangement for your proposed strategy.
- 2) Ethical scenario

For HK candidates:

To finance the future investment, Kim Ho, the Chief Financial Officer of SEL has solicited an asset management company to act as the financial advisor to SEL. SEL has been advised to raise finance through corporate bonds in order to support the business expansion. The underwriting commission has been agreed at 3% of the total amount of debts raised. Yet, Jerry Wong, the Financial Controller of SEL does not foresee a cashflow problem in the coming 3 years having conducted a comprehensive cashflow projection which has been concluded by the Board. Additionally, the normal market commission rate for underwriting the issuance of corporate bonds is around 1%. Jerry knows that the Head of the Corporate Finance Department of the asset management company is the husband of Kim Ho. Jerry understands that Kim is going to sign off his annual performance review with an "above expectation" bonus.

Assume you are Jerry Wong, outline the ethical issues and the actions you would take in addressing the issues.

For PRC candidates:

In late 2014, Robert Yang, the Chief Operating Officer of SEL, noted the recent food scandal that occurred in Yummy Cream Limited ("YCL"), a key supplier of SEL, in mainland China which is yet to be announced. YCL is owned by a close friend of David Chan. Notwithstanding that YCL submitted the highest offering price for supplying meats and sausages and without considering other relevant critical factors such as the tendering companies' operational and financial stabilities, the Procurement Service Department of SEL has granted the supplies contract to YCL. Robert Yang later noted the close friendship of David Chan and YCL and there is scepticism that David Chan has been offered a rebate for such a contract. In addition, Robert noted that Matthew is running for the re-election as the Chairman of a charitable board and believes that the disclosure of such food scandal and the relationship among David Chan and YCL may impair the reputation of the Chan family.

Assume you are Robert Yang, outline the ethical issues and the actions you would take in addressing the issues.

** This case question, all companies, brands, names, persons, financial data and figures portrayed in this case scenario are fictitious. No identification with actual companies, brands, names, persons, financial data and figures is intended or inferred.*