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EXECUTIVE SUMMARY

The purpose of this report is to achieve corporate value enhancement and sustainable growth for HFIC, by critically assessing its financial and operational practices, evaluating strategic options, and solving ethical conundrum.

PART I COMPANY APPRAISAL

Global apparel market has become increasingly volatile (Appendix 1), shaped by fast changing movements in consumer preference, supply chain integration, distribution landscape and technological innovation.

1. Financial analysis

Emphasis has been put on cash flow and working capital analysis, which exposed problems in liquidity, profitability and supply chain management. 11 peer companies (Appendix 2) are selected to set the arithmetic mean as prime benchmark.

Figure 1. Sources of Cash

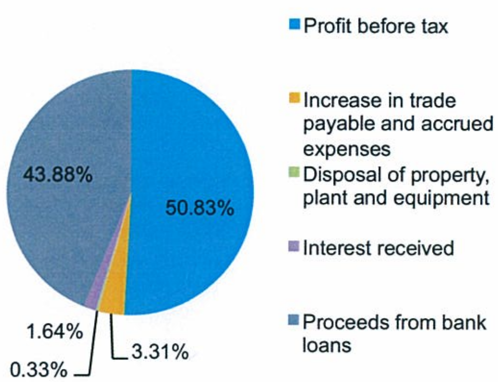
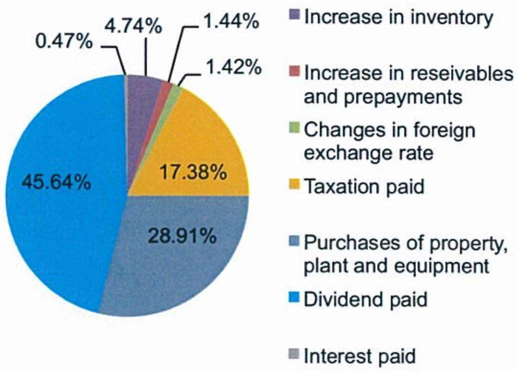


Figure 2. Uses of Cash



Cash Inflow: HFIC experienced more severe operating cash flow decline than its peers in the adverse economic environment (Figure 1), as operating profit margin dropped 9.97% year-on-year.

Cash Outflow: HFIC has a large bank loan and increasing current liabilities (by 5.1%), which is unsustainable as credits would eventually be limited (Figure 2). Cash flow adequacy ratio was below one in 2012, indicating expansion activities might not be sufficiently supported by its own operations. This reveals potential liquidity problems including future cash shortages, impaired financial flexibility and declining trade credit.

Figure 3. Profitability Ratios

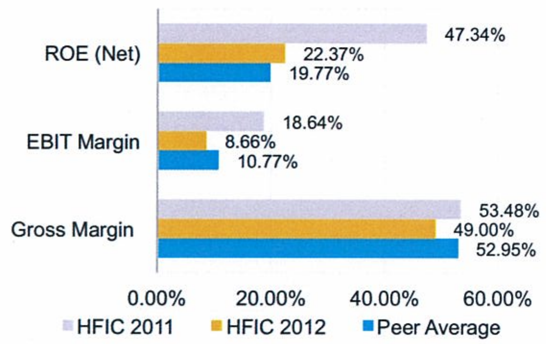
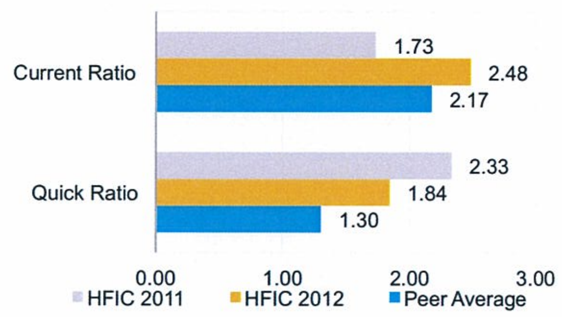


Figure 4. Liquidity Ratios



For the time being, HFIC's liquidity is still sufficient with an above-average current ratio of 2.48. However, working capital and supply chain management have been deteriorating, as DIO, DSO, DPO and CCC have all increased (Appendix 3), suggesting slower order response, bill collection and bill payment.

2. Performance positioning and SWOT analysis

Our performance positioning for HFIC indicates that it has not promptly adapted to the evolving apparel market (Appendix 5, 6). To achieve sustainable strategic growth, we evaluated existing four strategies and explored other possibilities.

PART II STRATEGIC OPTIONS ANALYSIS

1. Rapid expansion in the PRC

Expansion in the PRC can be a new growth point for HFIC as Chinese apparel market has outperformed Europe and U.S. for five years (Figure 5). Gap analysis is used to assess the 25% PRC market share target in HFIC's 5-year plan (Appendix 7).

To close the gap between projected momentum line and the ultimate target, HFIC is suggested to develop a low-priced product line to cater to Chinese consumers' needs. Merger and acquisition, strategic alliance and internal organic growth are evaluated as three implementation options. However, downside risks should not be neglected, such as regulatory complications and blurred brand positioning.

Figure 5. Emerging Markets, Eurozone & US: Apparel Market Growth 2007-2012

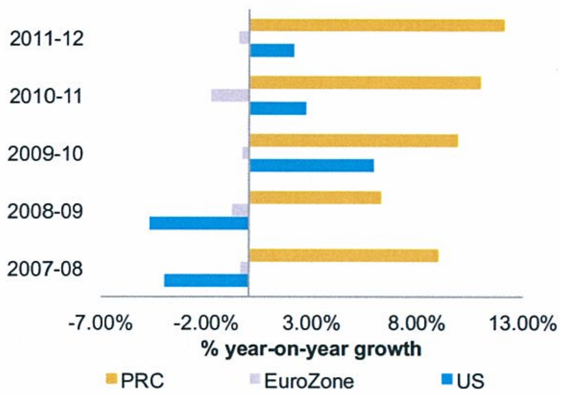
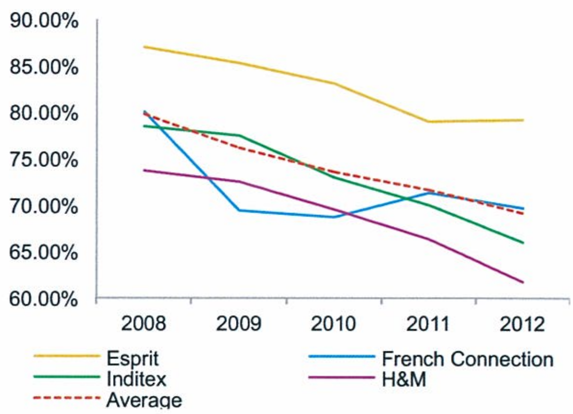


Figure 6. European Sales as % of Company Total



2. Expansion in Europe with existing products

Compared with Asian apparel market, European market has been stumbling under unfavorable macroeconomic circumstances (Figure 5, 6). In Europe, HFIC's same store sales (SSS) are estimated to have dropped by 9.18% (Appendix 8) due to factors including industrial slowdown, market saturation and inefficient operational practices. We use cost-volume-profit analysis and find that if HFIC were to expand in Europe, refurbishment investment would involve risks such as lower-than-target in-store traffic and inferior project ROI. While in contrast, online-shopping has its advantage in lower distribution cost and higher level of customization, but potential risk of cannibalization of existing sales needs to be further examined.

3. New products for existing markets

Product development strategy is assessed in face of increasingly segmented customer base. A more diversified product portfolio may better capture demand but it is also riskier in requiring major investment in product development, production and promotion.

4. Consolidation strategy to improve efficiency and reduce costs

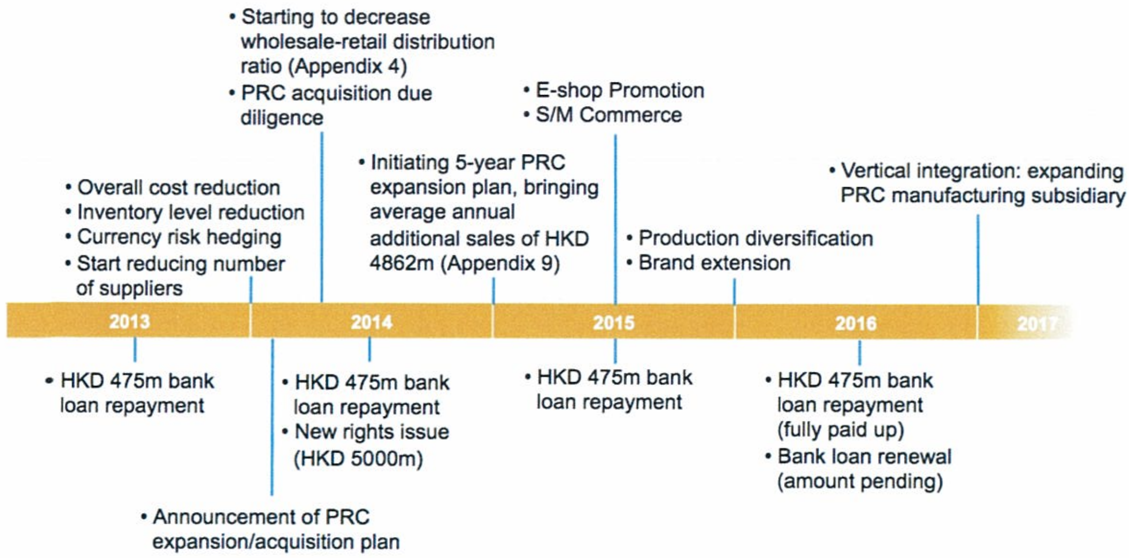
The insufficient level of vertical integration exposes HFIC to higher costs and slower market response (Appendix 3). Current JIT system and management restructuring are only partially successful, which requires HFIC to take further actions such as reducing the number of its suppliers and consolidating product sourcing under new corporate structure. However, supply chain integration and lean production might increase vulnerability in the absence of surplus stock or labor.

5. New Strategy: M/S-commerce as new promotion channels

To reach consumers beyond physical location, HFIC is recommended to develop mobile and social media commerce (M/S-commerce). With low investment in marketing campaigns and cheap maintenance costs on third-party platforms (e.g. Facebook, Twitter and Weibo), HFIC can boost its brand awareness among consumers and tap into their daily lives. However, potential low conversion rate creates uncertainty of its implementation.

PART III STRATEGY PRIORITIZATION AND IMPLEMENTATION

We adopt time box planning with MoSCoW method to prioritize the strategies above, and designed the following implementation plan:



PART IV ETHICAL CONUNDRUM

The American Accounting Association (AAA) seven-step model is adopted to analyze the ethical conundrum (Appendix 10), outlining the following three issues.

Chris' insider dealing falls into the category of market misconduct under Securities and Futures Ordinance, which has both a civil and a criminal regime once investigated by the Securities and Futures Commission.

Kenneth is obliged to take actions against Chris to uphold integrity, objectivity, professional competence and due care; and comply with the Ordinance and the Model Code in the Listing Rules.

Mary should not be consulted beforehand, as she should not be granted prior access to price sensitive information over other shareholders. Neither should Kenneth consult **Jian Jiang** due to his position as a SEHK enforcement officer.

We recommend that Kenneth discuss the issue with the board, report to authority and consult the professional legal service team instead. To guard the company against market misconduct, the board should focus on long-run internal control and conduct more effective financial due diligence when reviewing M&A deals.

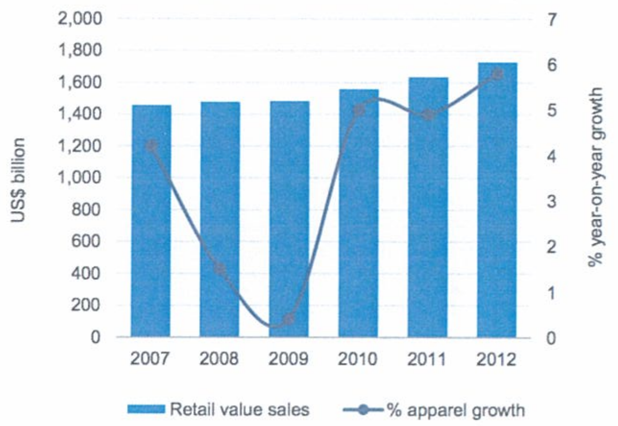
PART V CONCLUSION

In this highly competitive apparel industry, volatile topline and inefficient supply chain management (SCM) are lethal to any enterprise. Blue-blood HFIC needs a revival and holistic metamorphosis, for which we have designed a roadmap of SCM improvement, horizontal expansion and vertical integration to help HFIC solve current problems, enhance corporate value and achieve sustainable growth.

PART VI APPENDICES

Appendix 1

Global Apparel Market 2007-2012



Appendix 2

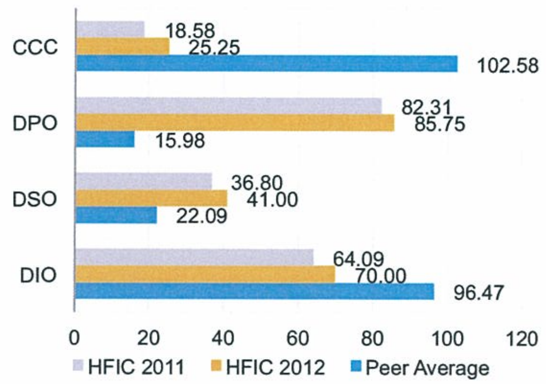
Peer Companies of HFIC

Abercrombie & Fitch Co.
Esprit Holdings Ltd.
Etam Developpement SA
Fast Retailing Co., Ltd.
French Connection Group PLC
Giordano International, Ltd.
GUESS ?, Inc.
Hennes & Mauritz AB
Industria De Diseno Textil (Inditex) SA
SuperGroup Plc, Cheltenham
The Gap, Inc.

__Peer selection criteria__: we use 164 companies from Primary SIC Code 5600 and Mergent Industry Code1.4. By targeting primary business nature as designing/distributing of affordable fashion clothing, taking scale of turnover and global footprint into consideration, and eliminating 2 companies with missing financial data, the list is then narrowed down to 11 companies.

Appendix 3

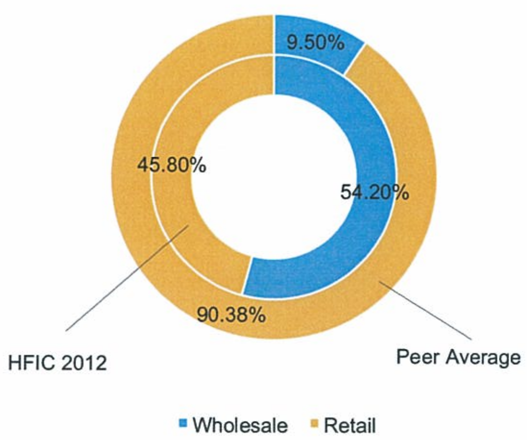
Working Capital Management



Note:
CCC-Cash Conversion Cycle (days)
DPO-Days Payable Outstanding (days)
DSO-Days Sales Outstanding (days)
DIO-Days Inventory Outstanding (days)

Appendix 4

Distribution Channels as % Total Sales



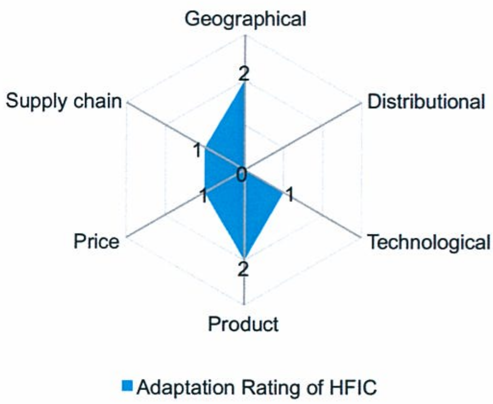
Appendix 5

SWOT Analysis

Strengths	Weakness
• Well-recognized brand name in Europe • Strong cash support • Corporate social responsibility as to produce environmental friendly clothing	• Declining, low profit margin • Seasonality of the sales • Large inventories & deteriorating WCM • High manufacturing cost
Opportunities	**Threats**
• Prevalence of online and retail store shopping • China-a growing market for expansion • European customers' rising concerns about environment protection	• Low recovery of the European Market • Euro depreciation again Hong Kong Dollars • Competitor in China- Glamour

Appendix 6

Apparel Market Trends in 2013



Note 1: Scaling 0~3, HFIC is rated regarding the extent to which it has adapted to each market trend by incorporating pertinent strategies into its operations.

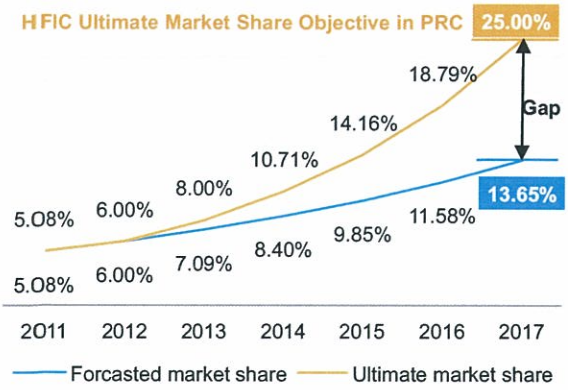
Rating	Description
0	No sign of this market trend has been observed
1	The trend has been publicly discussed by the management and incorporated into the company's overall corporate strategies
2	The trend has been further incorporated into the company's segmented business strategies
3	The trend has been integrated in the company's detailed implementation strategies and operations

Note 2: Six Apparel Market Trends in 2013

Market Trends	Description	HFIC Adaption Rating
Geographical	Asia market gains power as the new growth point	**2**
Distributional	Retail stores outweigh department stores in percentage of sales	**0**
Technological	Electronic/Social Media/Mobile-commerce is re-shaping retailing landscape	**1**
Product	Product diversification balances risk profile in a volatile market	**2**
Price	Mid-market is squeezed as consumers increasingly elastic to unit price changes	**1**
Supply Chain	Vertical integration gives retailers an edge in fiercer global competition	**1**

Appendix 7

HFIC PRC Market Share Gap Analysis



Appendix 8

HFIC Same Store Sales (SSS) 2011-2012

(Million HKD)	2011	2012
Europe Retail Sales	17,213	16,836
POS-retail	725	800
SSS	23.74	21.05
Adjusted POS-retail	650	700
Adjusted SSS	26.48	24.05
Percentage change in SSS		-9.18%

Appendix 7 Forecasted HFIC market share line (i.e. projected momentum line), is based on two assumptions: i) constant existing strategies and ii) constan reaction pattern to external events. The ultimate market share target is 25%, with sales function $y = S(1+x)^5$, where S is the total sales in 2012. PRC market size is estimated based on projected real-term growth rate from Economist Intelligence Unit. HFIC's strategic gap is thus the shortfall between the ultimate target and the current forecast.

Appendix 9

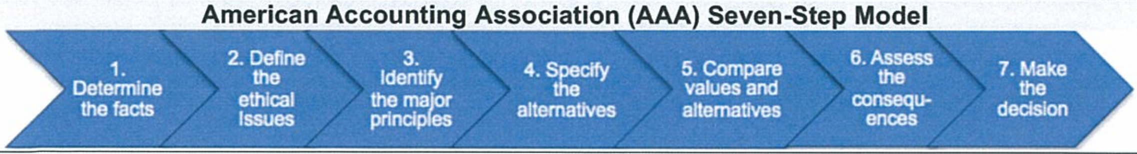
PRC Ultimate Sales Projection

(Million HKD)	2013	2014	2015	2016	2017
Turnover	1,469.00	3,025.34	4,785.54	6,607.90	8,424.42
Cost of goods sold	(749.19)	(1,542.92)	(2,440.63)	(3,370.03)	(4,296.45)
Gross profit	719.81	1,482.42	2,344.92	3,237.87	4,127.97
Operating costs	(592.55)	(1,220.33)	(1,930.34)	(2,665.42)	(3,398.15)
Operating profit	127.26	262.09	414.58	572.45	729.82
Taxation (30.5%)	(38.81)	(79.94)	(126.45)	(174.60)	(222.60)
Profit after taxation	88.45	182.15	288.13	397.85	507.22

Note: 1. Projected turnover is calculated based on the 25% market share target.
2. Gross margin is estimated as 49%.
3. Operating margin is estimated as 17.68%.

Appendix 10

American Accounting Association (AAA) Seven-Step Model



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11 Peer companies' annual reports. 2007-2013.

Key Database: Bloomberg, Wind, Reuters, Factiva, Hoovers, Passport, Economist Intelligence Unit, ISI emerging markets, Business source complete.

1. Introduction

High Fashion International Company Limited (HFIC), a HK-based company listed in 2007, specializes in high-fashion, ready-made, and medium-to-top ranked garment retail market. It provides affordable, stylish and reliable clothing products for both female and male customers aged from 3 to 40 year-old internationally. Currently major problems facing it are inefficient asset management, increasing production and operation cost, and deteriorating profitability. This 5-year proposal aims to bring HFIC's current net income to HK$ 7,928 million, bring EBITDA/Sales to 20.34%.

2. External Analysis

2.1 Industry Analysis

The global fragmented apparel industry (forecasted CAGRs 4.0% in 2012-2017)[1]is in **moderate level of rivalry**. Comparatively European and Asian will grow with CAGRs of 1.3% and 5.8%[2]. **Supplier power is low** since majority of manufacturers are labor-intensive SMEs. Low barriers to entry, low capital requirement, low switching cost and low level of product differentiation contributes to **high threats from new entrants**. Increasing direct sales to individuals makes **buyers' power moderate**.

2.2 Manufacturing (Upstream) Analysis

Though production costs have risen greatly during 2011-2011[3], world cotton price decreases enormously in 2013 and will continue to decline slightly in next decade[4]. Prices of raw materials differ across geographical origins [5] but small-sized manufacturers are unable to optimize raw materials procurement. Compared with

[1] From Companies and Markets. Com
[2] From "Market Industry Profile: Global Apparel Report February 2013" by MarketLine.com
[3] From NYMEX CME Group
[4] From "OECD-FAO Agricultural Outlook for 2013-2022" by oecd.org
[5] For example, cotton price on 27th Sep 2013 in China HKD12.1397/lbs, in U.S HKD 7.0915/lbs from. Bremer Index

China, labor cost for garment production is lower in southern and south-eastern Asian countries[6] along with tariff preference, making **strategic sourcing**[7] more important.

2.3 Market (Downstream) Analysis

Largest market values as Europe obtains, its growth remains feeble under slow economic recovery, while Asian markets, especially **PRC (CAGRs of 23%[9])** becomes the growth engine. Expansion in PRC is more likely to realize HFIC's financial goals, and mitigate the effect of Euro depreciation. However, Chinese market is very competitive with many local players in lower-tier cities and increasing number of foreign players in higher-tier cities.

Macro-economic Indicators In year 2012		
	PRC[8]	Europe
GDP growth rate	7.2%	0.6%
Consumer spending	+11.4902%	-0.99%
Consumer confidence	97.2%	-14.9%

3. Internal Analysis

3.1 Financial Analysis

	HFIC		Average[10]	Difference (2012)
	2012	2011	(2012)	(HFIC v.s. Average)
Short-term Solvency				
Quick ratio	1.68	1.54	1.45	15.85%
Long-term Solvency				
Total debt ratio	0.41	0.31	0.31	31.63%
Profitability Measures				
Profit margin	7.26%	15.13%	8.95%	-18.84%
Return on asset (ROA)	13.31%	32.72%	15.59%	-14.61%
Operation Efficiency				
Current liability coverage	0.03	N/A	0.58	-95.18%
Long-term liability coverage	0.06	N/A	1.81	-96.62%
Capital Asset Ratio	0.14	N/A	1.84	-92.39%
Asset Management				
Net working capital turnover	4.44	5.56	4.18	6.23%
Days' sales in inventory	70.00	64.09	73.83	**-5.19%**

[6] Hourly wage of India HKD5.0401, Bangladesh HKS1.6283, China HKD7.2122

[7] **Strategic Sourcing** is an institutional procurement process, conducted by 3rd party sourcing agent, such as Li & Fung, APL Logistics, that continuously improves and re-evaluates the purchasing activities of a client company.

[8] From National Bureau of Statistic of China and European Commission

[9] From fibre2fashio.com News Desk, October 19, 2012.

[10] Average is calculated from 5 homogeneous companies: Giordano, Uniqlo, H&M, GAP, and Ann Taylor

Days' receivable outstanding	32.07	27.78	16.43	95.23%
Cash conversion cycle	16.32	9.56	15.88	59.10%

HFIC performs well in profitability and solvency, but cash flow and working capital should be further improved. In details: 1) HFIC's **inventory** level is only 5.19% better than average, which should have had a significant improvement from just-in-time (JIT) system; 2) **Receivable** is high and irrecoverable bad debt increases, which leads to longer cash conversion cycle and higher cash conversion risk; 3) Too high **cash dividend** (60%), financed by bank loans, exerts pressure on capital purchase needs.

3.2 Qualitative Analysis

HFIC's **strong** design team, international outsourcing capacities and global reputation of quality and social responsibility enable it to provide most-updated, diversified and reliable products. It also enjoys strong bargaining power over small-sized manufacturers. However, lack of characterized brand image may obstruct it from differentiated. Unsatisfactory JIT system performance and **weak** control of outsourcing manufactures hinder its growth. It may need to finance new projects from banks due to inefficient working capital management. **Opportunities** facing HFIC include expansion in China, in online sales, and the fashion trend of widely-accepted denim products at a global growing demand of 5%[11]. Meanwhile, HFIC needs to cope with **threats** of rising cost, intensifying competition in fast-fashion and currency risk.

4. Strategies Evaluation and Recommendations

4.1 Financial Strategy

HFIC's is recommended to improve asset management by: 1) Reducing dividend payout ratio from 60% to 40% so as to allocate net operating cash flow for new

[11] FARMINGTON, Conn., Dec. 6, 2012, RNewswire-iReach

projects' initial investments and financing; 2) Cutting wholesale stores to reduce receivables risk and to increase net working capital efficiency; 3) Improving Supply Chain Management (SCM) further to increase inventory turnover speed.

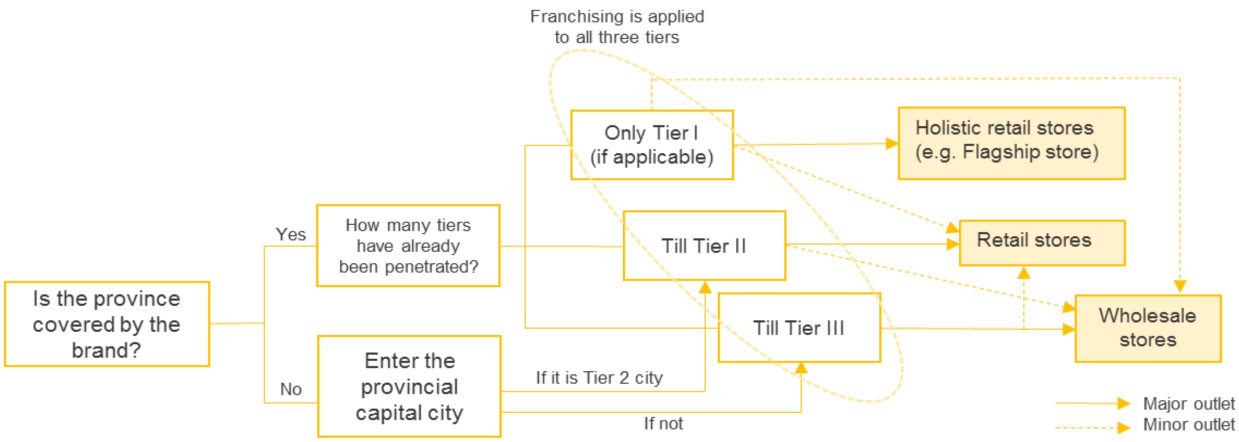
4.2 Growth by Strategic Expansion

4.2.1 *Aggressive Expansion in PRC*

It is recommended that HFIC should expand in China aggressively, while maintains its previous strategies and stable growth in Europe till further market recovery.

4.2.1.1Penetration in different city tiers in China

HFIC should open stores of different types and sizes accordingly to exploit different tier-level markets. A **decision model** of the penetration strategy is suggested below.



According to the features of three tiers, retail stores and franchising stores could be opened based on the evaluations below.

		Retail store	Franchising store
Advantages		● High gross profit & low receivables ● Enhance customer experience	● Low cost ● Rapid growth of market share
Disadvantages		● Heavy investment	● Higher receivables
Recommendations	Tier 1	Mainly large holistic stores (e.g., flagship stores)	
	Tier 2	Mainly medium-size retail stores	All three tiers applied
	Tier 3	Small stores with limited product category	

4.2.1.2 Entry Mode: Form a joint venture with major competitor

HFIC, as the absolutely controlling shareholder, could form a joint-venture subsidiary in China with Glamour. If successful, the plan allows HFIC to increase market share rapidly by utilization of Glamour’s existing distribution channels. The agreement is mutually beneficial to Glamour in its development in market of medium-ranked products of higher profit margin, supported by HFIC’s product design and JIT system.

	HFIC	Glamour
Contribution	● Provide new product design (without sacrifice IPR) ● Advanced JIT system	●Distribution channels ● Local markets first-hand information
Benefit	● Glamour's distribution channels ● Greater market share ● Better brand awareness	● Gains more profit in medium-ranked market ● Advanced management experience

4.2.1.3 Maintain the current pricing strategy

Price-sensitive as Chinese customers are, HFIC should not position itself as a “cheap brand”, especially under rising production cost pressure. HFIC should maintain its reputation, image and pricing strategy to be differentiated from local brands by enhancing customer experience (e.g. store decoration, training), design and quality.

Gross profit ration comparison: Selected foreign & domestic brands

Type	Foreign brands				Local brands		
Company	**HFIC**	Ann Taylor	Giordano	H&M	Baoxiniao	Metersbonwe	Semir
Gross profit %	**49.00%**	54.82%	58.72%	59.50%	41.10%	43.90%	30.37%

4.2.2 New Product Range Development

HFIC should consolidate its product-mix by clarifying existing brands’ images, and launch denim products as the new product range, given the positive **NPV of HK$ 1127.51 million**. Advertising expense should increase accordingly.

HFIC Product Mix	**Existing market**			
	25-35 year-old mature ladies	30-40 year-old mature men	18-25 year-old young adults	3-10 year-old kids
Market penetration & Consolidated brad image	Women’s fashion:	Men’s fashion:	HF Star:	Kids’ fashion:
	Smart, fashionable inspirational, elegant	Relaxed, mature, terse, reliable	Affordable, stylish high-street, trendy colorful, young	Cute, comfortable, safe, fashionable.
Product Range Development	Denim: Casual, fit, comfortable, easy-going, classic, all-purpose, durable.			

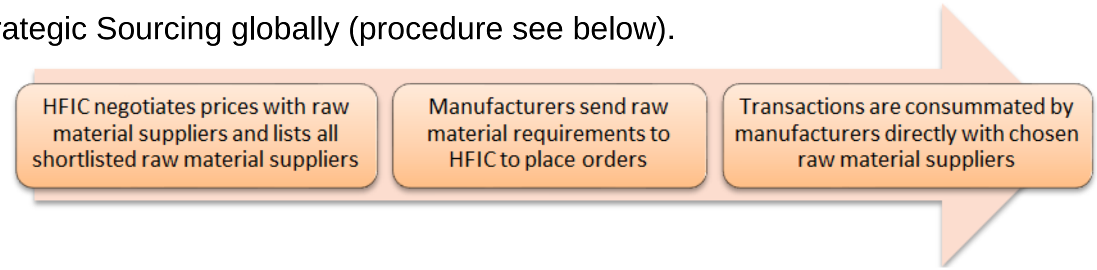
4.2.3 Distribution Channel

It is recommended that HFIC should organize its distribution channel strategically by 1) properly **reducing the percentage of wholesales** to the degree that Account Receivable/Total Sales to 5% in 5 years based on evaluation on the credibility of each wholesale store; 2) utilizing the **online platform** for promotion, such as discounted sales of past-seasoned products; 3)widening the distribution channels, considering opening **licensed franchising stores and e-shops** in more cities in PRC, while keeping the channels in Europe as usual.

4.3 Cost Reduction by Operation Consolidation

4.3.1 Raw Materials Acquisition and Production Optimization

While continuing its past policy of contracting production with large number of small-sized manufactures to spread the risk of supply shortage and insolvency, HFIC should **transfer more production** from China to southern and south-eastern Asia. Moreover, to help SMEs optimize materials acquisition at lowest cost, HFIC may **cooperate with an apparel sourcing agent**, such as Li & Fung, for centralized Strategic Sourcing globally (procedure see below).



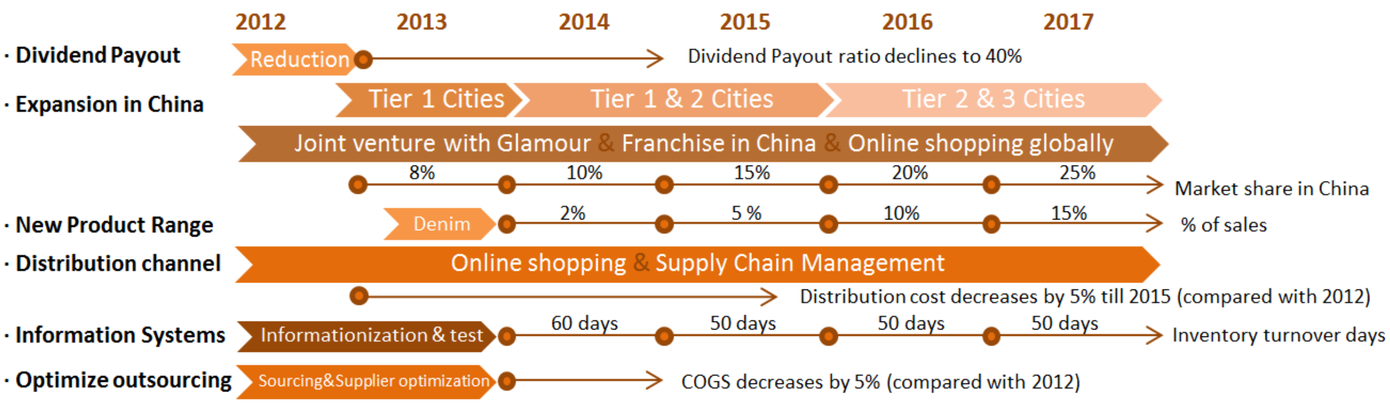
4.3.2 Integration of Supply Chain for JIT efficiency

To better fulfill wholesale customers' short lead-time orders and cope with timing pressure imposed by fast-fashion, HFIC should consolidate its company structure and IT systems[12] (use which provided by SAP as examples) respectively to increase efficiency in supply chain.

[12] Total **estimated investment** in intangible asset HKD 9.13 million, in PPE HKD 4.6 million, proposed by SAP.

Company Structure	<u>Manufacturing</u>: Establish small-sized **procurement offices** near outsourcing destinations, to ensure production quality and manage efficient purchase of finished goods
	<u>Distribution</u>: Assign "**regional centralized warehouse**" as distribution center to sales-dense location, to implement centralized inventory management and allocation for covered stores within the region
	<u>Sales</u>: Set up **China sales division** for regional management
IT	<u>Manufacturing</u>: **Manufacturing Resource Planning (MRP) System** to manage supplier relationship, and ensure manufacturing orders be placed just-in-time.
	<u>Distribution</u>: **Allocating Run (ARun) System** to collaborate relevant departments to feed right volume of inventory (efficiency improved 25%)
	Sales: **Wholesale Store Relationship Management (CRM) System** to place and execute short lead-time orders from wholesaler

5. Implementation Plan and Feasibility Study



The implementation plan above is technically feasible, given reciprocity in joint venture, innovative designers and mature IT applications. Financial feasibility is shown examined in the table of free cash flow below

	2012	2013	2014	2015	2016	2017
Beginning Balance of Cash	4,461	2,795	1,996	3,722	4,201	3,946
Cash Collections	2,718	4,119	5,737	6,267	7,669	9,703
Total cash available	7,179	6,914	7,733	9,988	11,870	13,649
Less: Cash Payments	(4,384)	(4,918)	(4,012)	(5,787)	(7,924)	(10,651)
Ending Cash Balance	2,795	1,996	3,722	4,201	3,946	2,998
Cash Reserve	4,236	4,913	5,333	6,529	7,608	9,095
Risk of Liquidity	(1,441)	(2,917)	(1,612)	(2,327)	(3,662)	(6,097)
Financing from the bank	2,375	1,900	1,900	1,900	1,900	1,900
Ending cash balance after financing	934	1,358	4,563	5,748	6,313	5,778

Risks[13] of the proposal includes that 1) declining dividend payout ratio may cause stock price to drop temporarily; 2) blacklisting some wholesalers may incur much bad debt expense; 3) outsourcing in less developed countries might undermine CSR and reputation; 4) staff may get unaccustomed to new IT systems provided by SAP.

6. Ethical Issue

Chris Lee, the COO, had bought substantial shares of Elite at low price before HFIC's acquisition, from which he made large personal profit at the cost of company's benefit. Mr Chan needs to consult Mary Leung and identify the seriousness of this issue, while Mr Jiang should be excluded due to his close relationship with Chris. The decision-making process should be complied with the following two principles.

• **Objectivity:** Mr. Chan, the chairman, shall make judgement based on unbiased advice and ethical norms, not on friendship with Chris Lee.

• **Integrity**: Mr. Chan should not be associated with any information that contains a misleading statement to avoid conflict of interests.

Three alternatives facing Mr. Chan are evaluated as follows.

Alternatives	Advantages	Disadvantages
• Warn Chris privately • No disclosure or punishment	• Avoid to frustrate shareholders • Keep an experienced manager	• Violating objectivity & integrity
• Disqualify Chris as CEO candidate • No further disclosure	• Complied with objectivity • Ethical issue being addressed	• Not complied with integrity • Shareholders are ignored
• **Report the issue to Board of directors & auditing committee directly**	• Complied with objectivity & integrity • Draw the future ethical line	• Negative impact on shareholders' confidence • lose an experienced manager

After weighting pros and cons, we suggest a direct report to Board of Directors and auditing committee. Stock price and corporate image may be negatively impacted in short run, but it is more important to maintain the ethical code and discipline of HFIC.

[13]Financial impacts of reasonable risks have been **integrated** into the **free cash flow projection**.

参考3

1. INTRODUCTION

1.1 Market Overview

In 2012, the market size of Asia-Pacific (APAC) in the beauty and personal care industry has grown by 5.2%[1]. Owing to the rising income and awareness of personal appearance among Chinese consumers, the PRC is of the highest growth potential[2]. Brisk demand over Beauty and Facial (B&F) treatment and rise of medical beauty are observed[3]. In addition, there is a rising need of qualified manpower[4]. Another two new trends worth mentioning are value chain consolidation and mobile penetration[5].

1.2 Current Situation

Currently, 83% of Tango's revenue originates from Hong Kong, while Singapore and PRC market account for 13% and 4% respectively.

STRENGTHS
- High reputation in services and equipment
- Wide range of services and products
- Strong cash position
- Promising dividend payout

WEAKNESSES
- High staff turnover
- High operating cost
- Imbalanced board composition
- High leverage ratio

OPPORTUNITIES
- Growing PRC beauty and healthcare market
- Rapid growth in online retailing
- Brisk demand of beauty & facial service
- Technology development on medical beauty

THREATS
- Continuing global economic downturn
- Risk of medical beauty
- Competition with other multinational brands

Fig. 1 SWOT Analysis

In view of the growing PRC market and brisk demand of qualified manpower (Fig. 1), Tango is considering 3 major strategies. With our strong cash position (Section 3.1), these strategies are believed to be effective and feasible.

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2. TANGO'S VISION AND FUTURE DEVELOPMENT

2.1 Our Vision

Tango strives to be Asia's leading health and beauty player. We rest on the skills of our employees to provide quality customer service and maximize shareholder value.

2.2 Future Strategy

2.2.1 Our Business - MOST Strategy

Mainland China Expansion

In light of China's growth potential, Tango will (i) refurbish our flagship store in Shanghai as a one-stop beauty center offering latest health and beauty service and products, (ii) integrate Traditional Chinese Medicine (TCM) to our service, (iii) extend reach to lower tier cities through Tmall.com and social websites, and (iv) in the long term, franchise our Slimming and Fitness (S&F) centers, to build brand awareness and boost sales in the PRC.

Optimization of Beauty & Facial division in Hong Kong

In view of the brisk demand for B&F treatments, Tango will (i) open more beauty clinics to achieve performance optimization and (ii) implement Tango Academy (Section 2.2.2) to improve employee productivity and efficiency.

Supply chain management

To effectively manage flow of goods, Tango will (i) initiate sole agency relationships with existing suppliers and The Shahnaz Husain Group, a leading herb supplier in India, and (ii) distribute products in on and offline stores (i.e. Tmall and outlets).

Tango's sustainable business growth

Considering the rise of medical beauty, Tango leverages its R&D expertise on medical beauty industry to further a growth in the coming decade.

2.2.2 Our Customer – Tango Club Membership Scheme

To gain insight into existing and potential customers behavior, Tango Club along with iTango will be launched to strengthen our brand loyalty and to acquire big data.

Tango Club: A mixed membership model with TangoPoints Payment System (TPPS), where customers can add or deduct value (i.e. TangoPoints) to membership cards and enjoy services across service lines and regions. With the increasing number of high-end customers who often travel from the PRC to Hong Kong[6] and wish to enjoy health and beauty services, the S&F centers will be kept to grow revenue from this segment. Loyal customers will be rewarded with hard and soft exclusive benefits, which found to be persuasive among Asian consumers[7]

iTango: A mobile app that allows Tango Club members to share their experiences, review on Tango's products and services, and access to Tango's membership system for reviewing TangoPoints balance, schedules and bookings.

2.2.3 Our Employees – Tango Academy

In view of the rising need of qualified manpower, Tango Academy will be introduced for potential talents development and employee retention, which comprises:

1. Sponsorship arrangement for recruiting potential talents: Tango offers ITEC training programs in collaboration with HKBHA at our head office. Upon program completion, participants will be offered a two-year employment contract. Half of the program fees will be reimbursed as scholarship subsequent to acceptance of offer.

2. Incentive scheme for retaining current employees: The scheme comprises both non-monetary rewards (i.e. freely enjoy Tango's services, on-the-job training and career advising) and monetary motivations (i.e. stock option compensation)

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3. FINANCIAL ANALYSIS

3.1. Operational and Financial Analysis

1. Employee Benefit Expenses Control

In 2013, Tango recorded a sale growth of 4.9%. However, 51.3% of sales were used to cover employee benefit expenses. With relative measures (Section 2.2.3), we aim to boost labour productivity to 55% to meet the industry average[8] (Fig.2: R1).

2. A Signal to Beauty & Facial Expansion

The overwhelming demand on B&F services indicates the 4.7% increase of deferred revenue over 2013. It helps secure our future revenue but at the same time, revealing the need to enhance our service capacity. By expanding our local B&F services by 6%, Tango will generate an additional 8.5% of sales revenue and introduce more customers. Moreover, decrease in deferred revenue over sales will improve Tango's financial leverage. (Fig.2: R2)

3. Strong Cash Position

Tango held $410M cash reserve in 2013, mainly generated from the deferred revenue. Our strong cash position fundamentally supports our future development plans. To enhance liquidity in the long term, cash reserve is to be kept at 56.25% of the total assets while quick ratio to be improved 1.18 in ten years. (Fig.2: R3)

	Tango (2013)	Industry Average (2013)
R1. Return on Labour	17.13%	55.20%
R2. Debt-to-Equity Ratio	2.61	0.45
R3. Quick Ratio	0.97	1.94

Fig. 2 Ratio Analysis (Abstract)

[8] Comparing a list of HKEx listed company of the same industry (0157.HK,0919.HK,1830.HK,1161.HK,8200.HK), weighted by their market capitalization (2013), cited from Thomson Reuters

3.2. Cash Flow Forecast[9]

Tango Health and Beauty Limited Cash Flow Statement Forecast (HK$ million)	2013A	2014E	2015E	2016E	2017E	2018E
Operating Cash Flow	123	67.01	138.43	125.48	245.06	313.86
Investing Cash Flow	(39)	(40.62)	(48.35)	(58.19)	(69.17)	(81.75)
Financing Cash Flow	(64)	(39.53)	(56.20)	(37.92)	(71.95)	(82.29)
Net increase in cash	**20**	**(13.14)**	**33.87**	**29.37**	**103.94**	**149.82**

Fig. 3 Cash Flow Statement Forecast 2014 – 2018 (Abstract)

To support our development project, the expected cash outflow in 2014 and 2016 are relatively higher. In 2017, a substantial increase in net cash flow is expected due to our newly established flagship store and franchise in the year. (Fig.3)

Free Cash Flow Analysis (HK$ Million)	2014E	2015E	2016E	2017E	2018E
Sale Revenue (MOST Strategy)	0.00	77.95	81.32	147.06	167.86
Less: Operation Cost (Tango Academy & TangoPoint)	19.10	91.27	114.66	172.47	179.95
Less CapEx (Net)	0.125	1.56	4.68	4.68	4.68
Less: Net increase in non-cash WC	-6.5	-6.5	-6.5	-6.5	-6.5
Free Cash Flow	**(12.72)**	**(8.38)**	**(31.52)**	**(23.59)**	**(10.27)**

	2019E	2020E	2021E	2022E	2023E
Sale Revenue (MOST Strategy)	188.19	216.28	248.81	286.62	330.70
Less: Operation Cost (Tango Academy & TangoPoint)	184.47	189.17	194.07	199.19	204.55
Less CapEx (Net)	4.68	4.68	4.68	4.68	4.68
Less: Net increase in non-cash WC	-6.5	-6.5	-6.5	-6.5	-6.5
Free Cash Flow	**5.55**	**28.93**	**56.56**	**89.25**	**127.98**

Fig. 4 Free Cash Flow Analysis 2014 – 2023

Due to the robust market demand and mobility of high-end customers across HK and PRC, the project will provide positive free cash flow starting from the 6th year (Fig.4). With the current business growth, profit after tax will increase to $117M in 2018 (a CAGR of 21.0%), sustaining the dividend payment to our shareholders. (Fig.5)

Tango Health and Beauty Limited Income Statement Forecast (HK$ million)	2013A	2014E	2015E	2016E	2017E	2018E
Turnover	637	661.67	765.25	875.06	1,054.33	1,260.03
Operating Costs	582	615.01	699.04	830.35	950.34	1,117.55
EBITDA	**81**	**74.33**	**95.54**	**76.47**	**139.14**	**181.99**
Profit after taxation	45	39.57	55.62	37.73	86.03	116.95
Dividends	**54**	**32.45**	**45.61**	**30.94**	**54.00**	**56.85**

Fig. 5 Income Statement Forecast 2014 – 2018 (Abstract)

[9] Financial modeling based on implicit assumption method, with the support of economical data and statistics, please refer to the final report for details.

4. CORPORATE GOVERNANCE

4.1 The Board of Directors

An Extraordinary General Meeting will be held with regard to David Chan's withdrawal and changes of Board composition. To achieve a balanced composition of Directors, either existing non-executive directors (with a minimum of three[10]) or new members will be invited to be executive directors.

4.2 Financial Risk Management – Currency Exposure

With our PRC expansion and continuous appreciation of RMB against HKD[11], Tango will increase cash in RMB. However, given the slow recovery of Europe economy[12] and ongoing depreciation of Euros[13], Euros account will not be opened in short term.

4.3 Accountability and Audit

1. Dividend payout policy: Dividend payout ratio will be readjusted to 81.59% in the short term (industry average, Section 3) to retain cash for future development and to ensure sustainable return for our shareholders.

2. Bad debts write-off policy: According to the prudence concept[14], allowance for doubtful accounts should be established to avoid overstating assets. Accounts receivable aging method will be used for bad debt estimation and help identify late-paying customers. With TPPS, amount of receivables will be reduced as value can be directly deduced from customers' membership card.

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5. EVALUATION ON EXTERNAL ADVISOR'S PROPOSAL

5.1 Overview

In view of the possibility of legal disputes with new investor and ethical issue arise from replacing purchased package, as well as the conflict of interests led by the bonus plan for the senior management, the external advisor's proposal will not be accepted. Suggestions regarding the future development of SlimFit are provided.

5.2 Legal Perspective

With the elements of offer and acceptance[15] in our consumer contracts, it is a Breach of Contract of replacing the purchased package at SlimFit with the blood transfusion therapy from Magic Spa.

5.3 Ethical Perspective

There are two ethical issues come upon the shutdown of SlimFit:

1. Client Safety

Clients' health should be of the utmost concern. Since the therapy's safety is unproven (i.e. a human trial on blood transfusion triggered septic shock on a patient) and there is previous case revealing death of woman after receiving this treatment[16], this therapy should only be carried out with adequate researches and until all trials are passed. Employees' prospects should also be considered as any therapist who performed a questionable therapy will face disciplinary action from the Medical Council and criminal charges.[17]

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[17] South China Morning Post (2012, Oct 11). *Blood therapy doctors could face manslaughter charges.* Retrieved from http://search.proquest.com.lib.ezproxy.ust.hk/docview/1095605955/5476286FE9D749EBPQ/2?accountid=29018

2. Conflict of Interest: Bias occurs since senior management will receive bonus when the original budget (i.e. no refund) is met. The objectivity principle (HKICPA Code of ethics)[18] should always be upheld to avoid any conflict of interest or undue influence of others to override professional or business judgment.

5.4 Suggestions regarding SlimFit

In view of the potential refund and its adverse impact on our corporate image, shutting down the S&F is not recommended. Suggestions are as follows:

1. Sale of division: Membership of Tango's customers will be bundled with the sale of division to other fitness centers. Members can continue to enjoy fitness services. However, seeking an appropriate buyer require time and involve additional costs.

2. Continuation with research and development: The decline of sales may be attributed to the change in consumer tastes. Further research on the trend of fitness industry can help adjust the current strategies and equipment in attracting more customers. However, R&D involves a high cost whereas outcome is uncertain.

3. Establishment of franchise network in PRC (recommended): With the annual growth rate of 15.9% in the Fitness Clubs industry[19], granting franchise in Mainland China can help increase Tango's profit and expand market growth more quickly (Section 2.2.1. (iv)).

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