

HKICPA Business Case Competition 2022

Universe Consulting & Advisory Ltd.

Overview

Universe Consulting & Advisory Ltd. (Universe) is one of the leading consulting and professional services firms in Hong Kong with more than 400 staff. Most key team members of Universe are members of the HKICPA. Universe provides a full range of advisory services for private and listed companies in Hong Kong.

Universe provides a comprehensive range of strategy consulting services, from corporate strategy development and mergers and acquisitions, to new market entry and organizational design. Universe is an industry-specific expert who offers professional advice, guidance, and practical solutions to corporates. Universe has experience of providing consulting service for several industries that are most popular in Hong Kong, such as real estate, retail, media & entertainment and healthcare.

Other than strategy consulting services, Universe also provides other professional services:

Accounting outsourcing and financial reporting advisory – these services include accounting services, advisory on financial reporting, business management reporting and strategic accounting solutions.

Tax – the tax experts of Universe provide advisory services on statutory tax compliance, advising on aspects of tax planning and management, such as advice on transfer pricing. When there is any enquiry from or dispute with the tax authorities, the tax experts provide valuable opinion.

Internal audit – the team helps corporate clients to resolve various potential risks encountered in their operations, through reviewing different elements of enterprise operation, such as internal management, sales planning, operational risk, product quality and operational environments. The internal audit team has years of practical experience serving different industries and recommends practical improvement measures.

Compliance advisory – the compliance service team comprises experienced lawyers and CPAs. They provide a full scope of certain compliance advisory services for their clients, such as compliance on listing rules, Securities and Futures Commission rules and environmental, social, and corporate governance reporting.



Your Action – HK Sub-degree

You are working as a team head of Healthcare advisory department in Universe Consulting & Advisory Ltd. This afternoon, you received below internal memo from your Managing Director.

Universe Consulting & Advisory Ltd.

Internal Memorandum

To: Ms. Connie Tsang, Head of Healthcare advisory department

From: Ms. Michelle Chan, Managing Director

Date: 1 September 2022

Subject: Business proposal for Galaxy Health International Limited

A week ago, Mr. Vincent Hui, the Chairman and CEO of Galaxy Health International Limited (Galaxy), approached us. I have briefly introduced the background of our firm. He requested us to provide a business proposal for consulting services for Galaxy.

Could you please prepare a business proposal for Galaxy?

In the proposal, we aim to:

- recommend a constructive corporate strategy option for Galaxy by using an appropriate strategy assessment and development model; and
- advise Vincent on the issues he should consider when making the decision whether to pull on with regards to “negotiating a contract to supply a patented Galaxy product in Luxembourg” as a responsible listed company with corporate social responsibilities, and from the view of corporate best practices.

You may refer to the relevant information of Galaxy sent to you separately.

Since we are providing a full scope of professional advisory services to our clients, in order to have a better chance of gaining this engagement, I would like to utilize our internal resources to add value to the business proposal. Please kindly work with our other departments (accounting outsourcing and financial reporting advisory, tax, internal audit and compliance advisory team) to make relevant suggestions to be included in the proposal.

Please only focus on drafting the contents for a 15-page business proposal with an executive summary of not more than three pages. I will assign my assistant to coordinate all the tender administration work later.

Tender Invitation from Galaxy Health International Limited

GALAXY HEALTH INTERNATIONAL LIMITED

4/F, No.56 GALAXY ROAD, KENNEDY TOWN, HONG KONG

Tender Invitation

Date: 1 September 2022

To: Universe Consulting & Advisory Limited

Dear Sir,

Re: Invitation for tender submission of provision of professional consulting services for Galaxy Health International Limited

We are writing on behalf of Galaxy Health International Limited (hereafter referred to as the Company) to invite you to submit a tender concerning provision of professional consulting services for the Company.

Services to be provided

The vendor is required to prepare a business proposal to recommend a corporate strategy option for the Company. In addition, the vendor is also welcomed to give additional comments and suggestions that identify additional matters the Company should address.

--- Please refer to the attached appendices for the Company's background and financial information.

Submission of tender

Please submit the duly completed and signed form of tender and declaration form (both forms are standard forms that can be downloaded from our website) in a sealed envelope marked conspicuously "Confidential – Tender document for preparation of business proposal for Galaxy Health International Limited." and send to the tender box at our registered office at 4/F, No.56 Galaxy Road, Kennedy Town, Hong Kong before 17 October 2022. Late submission will not be considered.

Please note that it is the responsibility of the tenderer to study the specification and requirements before submitting the tender.

Yours faithfully,

For and on behalf of Galaxy Health International Limited

Vincent

Vincent Hui
Chairman and CEO

Appendix 1: Prospective client information – Galaxy Health International Limited

Background

Galaxy Health International Limited (Galaxy) is a pharmaceutical company listed on the Hong Kong Stock Exchange (HKEx). The Company was established over 20 years by Vincent Hui and Carlton Tong, both of them previously started their careers with a major international pharmaceutical firm. Since then, Galaxy has grown successfully and achieved a stock exchange listing five years ago.

Galaxy's products are sold mainly in Hong Kong and four of the world's five biggest geographical markets for pharmaceutical products: Japan, USA, Germany and France (the fifth market is the People's Republic of China). There are also some sales to Indonesia, Australia, and emerging markets. According to the market, Galaxy's products are sold in several currencies: Hong Kong dollars, US dollars, euros, Australian dollars and Japanese yen.

The products made and sold by Galaxy are divided into two broad product groups:

- I. Patented products: products that have been developed in-house by the Research and Development (R&D) department and are protected by patents for a definite period.
- II. Generic products: products that are not protected by patents and are made and sold by competing pharmaceutical companies worldwide.

The Board of directors

Vincent Hui is the Chairman and CEO of Galaxy, and Carlton Tong is the Executive Director responsible for R&D. The other executive directors are:

- Damon Tam, the Director of Operations.
- Ella Hui, the Chief Financial Officer. Ella is the daughter of Vincent Hui and HKICPA member.

In addition to the four executive directors, there are three independent non-executive directors.

Vincent Hui owns 30% of the shares in Galaxy. Carlton Tong owns 5%. The other executive directors own some shares but are not significant shareholders.

Company vision and mission

Galaxy launched a new corporate image which is tied to its significant investment in the sales and marketing division in 2021. Additionally, in early 2022 Galaxy introduced its updated brand, vision and mission to the market.

Our vision

We are transforming lives through easy access to innovative, high-quality, cost-effective healthcare solutions.

Our mission

Our mission is to become a world leader in providing high-quality, cost-effective healthcare solutions. We aim to increase our supply of generic and patented products in key market areas while maintaining our commitment to scientific excellence and responsible drug development and delivery.

Our values

- Integrity: To be fair, honest and responsible in our dealings with stakeholders and the global community
- Excellence: To continually strive for innovation, quality and scientific leadership in the development of new products
- Transparent: To ensure production, pricing, and sales practices are sustainable, ethical, and open to public scrutiny

Product development

Successful development of new drugs and medicines calls for well-trained and well-educated scientists. Galaxy has been very fortunate in its ability to attract suitable graduates returning to Hong Kong after studying at leading universities in France, the UK and the USA.

Galaxy has a good record of developing new drugs successfully. Even so, about 50% of new product ideas do not get as far as clinical trials, and 30% fail clinical trials. As a result, only about 20% of new product developments eventually reach the market.

When new products are launched commercially, their success is not guaranteed. Some new products are enormously successful and generate significant sales and profits, whereas some new products do not attract sufficient customer demand and are withdrawn from the market after only a short time.

Production and sales

Galaxy has two production centres, one in Hong Kong and one in the USA. Each produces both patented products and generic products. Direct materials account for about 70% of the cost of production and direct labour for about 10%. One major problem faced by all pharmaceutical companies is the shortage of direct material supplies. Most direct costs are settled either in Hong Kong dollars or US dollars.

Galaxy employs a large sales force, with sales offices in its main markets. Sales to mainland China and emerging markets are the responsibility of the sales team based in Hong Kong. Customers comprise government organizations which are responsible for procuring medical supplies, major independent hospitals and private clinics, as well as companies operating drug stores and pharmacies. The customer profile varies among Galaxy's different geographical markets.

Financial highlights in 2020 and 2021

The performance of Galaxy in 2020 and 2021 has been disappointing. A summary of financial results is given in Appendices 2 and 3. In addition, there has been a slow-down in the development of the Company's product portfolio.

In 2020, during the pandemic, the production lines experienced lockdown. In addition, Galaxy had difficulties with production due to its limited capacity. Galaxy was operating near full capacity. As a result, it was unable to increase sales as much as it might otherwise have expected. Galaxy has been pursuing a policy since 2020 of increasing production capacity by adopting certain production streamline exercises, and there has been new investment in production facilities. Other than that, there was more spending on R&D for the products that reduce the adverse effect on health after recovering from COVID-19. Still, increased capacity and benefits from R&D have not yet been achieved.

In 2021, two of Galaxy's high-performing patented products reached the end of patent protection: other generic product manufacturers have already begun to produce and sell similar products, and the market price of both products have fallen substantially. In response to greater competition in the market and the need to focus more on selling and marketing, Galaxy recruited and trained more sales and marketing staff in 2021. The poor performance in 2021 has urged the Board to search for ways of reducing costs, and some redundancies have been carried out throughout Galaxy. However, expenses on R&D increased more than twice of that in 2020 since the management expected COVID-19 to be a prolonged disease. The need for the products to care for the adverse effect will be huge for many years. Therefore, these products will become Galaxy's primary product strategy in the coming five years. Galaxy expects the first relevant COVID-19 patented product to be launched in 2022, while several COVID-19 patented products have already been selling in the market since late 2021.

Treasury policies

Ella Hui, the new Chief Financial Officer, who is also the daughter of the Chief Executive Officer (CEO), has supported the policy of borrowing from banks to finance business development rather than using Galaxy's large cash deposits. She believes that Galaxy's liquidity and gearing levels are not a threat to its financial position and that Galaxy's financial situation will strengthen in the future when its business recovers and sales increase.

All Galaxy's borrowings are from banks and are denominated in Hong Kong dollars or US dollars: the loans are primarily secured against assets of Galaxy. There are unsecured overdraft facilities in all of Galaxy's trading currencies.

90% of Galaxy's bank balances are held in Hong Kong dollars or US dollars, with some deposits in Australia dollars, euros and Japanese yen. These deposits are held in Hong Kong and are managed centrally by the headquarter. Ella has an internal policy that every sale's proceeds denominated in currencies other than Hong Kong dollars are required to convert to Hong Kong dollars at the receipt date. Operating units keep minimal deposits for their daily uses only.

Galaxy's floating rate bank borrowings carry interests at Hong Kong Interbank offered rate (HIBOR) plus 2% to 2.5%. Galaxy has not entered any hedging contracts as Ella thinks she can manage the interest rate risk by closely monitoring the interest rate exposure.

Vincent is concerned about the increase in borrowings by Galaxy during 2021 and the fall in the amount of Galaxy's bank balances. Vincent is worried that unless the cash flow situation improves, Galaxy may face a liquidity crisis some time in the not-too-distant future. Therefore, he would like the company to increase its cash balances and he believes surplus cash can be invested in short-term investments. The returns from these provides a valuable addition to Galaxy's annual profits.

Dividend policy

When Galaxy was first listed on the HKEx, it announced its intention that annual dividends would be maintained or increased each year. As a result, dividends in 2021 HK\$1,125,000,000 (2020: HK\$1,075,000,000) were more than the retained profits for the year. Although there were disappointing financial results for the year, the Board finally decided to increase the dividend slightly for 2021 to boost Galaxy's share price as the Board considered that the P/E ratio of Galaxy is lower than those of comparable market pharmaceutical companies.

Some Board members argued that dividend payments were too high, preventing Galaxy from retaining cash and reinvesting in the business.

Negotiating a contract to supply a patented Galaxy product

Although Galaxy introduced its updated brand, vision and mission to the market, there are concerns about the sales and marketing division that the Board of directors and management of Galaxy are not incorporating the new vision and values into company decisions and that Galaxy is not yet 'living by their values'.

Andy Smit is Galaxy's leading sales representative for the Western European market. He is currently negotiating a contract to supply a patented Galaxy product to the national health authority of Luxembourg, which has its own strict ethical procurement policies. All suppliers must follow the Global Reporting Initiative triple bottom line reporting procedures. This incorporates economic performance, environmental performance and social performance and must be both quantitative and qualitative. Galaxy makes a one-page corporate social responsibility (CSR) disclosure in its annual report. It is qualitative, but not quantitative. Vincent Hui thinks that CSR is "a waste of time and money". He recognises that Galaxy must follow the law in each jurisdiction and international medical and research and development guidelines but Galaxy would not do any more than the minimum requirements.

Ella Hui reported to Vincent that a few practices in Galaxy would deviate from the best practices. Below are some examples (but not an exhaustive list) of those practices:

- Corporate governance – Vincent Hui is both the Chairman of the Board and the CEO. This contravenes the best corporate governance requirements.



- Employee rights and welfare standards – Galaxy has been cutting cost on safety checks at its Hong Kong production facility. It has also been very slow in implementing the new minimum wage rules in Hong Kong.
- Clinical trials – To cut costs, Galaxy has stopped auditing the treatment of its patients in clinical trials. There are standards in place, but they have not been audited (internally or externally) for two years.
- Anti-corruption – Galaxy has not adopted any code of anti-corruption. Two production managers were found guilty of bribery previously.
- Price setting – The patented medicines are set at a very high price. Most patients cannot afford them and the medicines are being defined as “products for the rich”.
- Customers’ complaints – There is no designated department or personnel to handle customers’ complaints. Only written complaints are accepted by Galaxy, but it usually takes over one year to produce a response. The reply is prepared by an administrative clerk without any approval or review by the management.

Considering all the above, Vincent decided to pull out of the Luxembourg negotiation. The reason for pulling out was not explained to Andy. However, a rumour has been spread that Galaxy may be pulling out of the market as it does not want to address the underlying CSR best practice as required.

Appendix 2: Summary of financial results for Galaxy

Income statement for the year ended 31 December:

	2021	2020
	HK\$'000	HK\$'000
Revenue	6,579,120	8,567,889
Cost of sales	<u>(1,848,330)</u>	<u>(2,065,241)</u>
Gross profit	4,730,790	6,502,648
Distribution costs	(114,665)	(132,854)
R&D expense	(1,247,666)	(1,298,640)
Selling and general admin expenses	(2,065,801)	(2,651,490)
Other operating expenses	<u>(210,598)</u>	<u>(255,498)</u>
Operating profit	1,092,060	2,164,166
Net financial expense	<u>(98,621)</u>	<u>(154,756)</u>
Profit before tax	993,439	2,009,410
Taxation	<u>(145,224)</u>	<u>(382,468)</u>
Net income	<u><u>848,215</u></u>	<u><u>1,626,942</u></u>

The below expenses for the year above are included:

Amortisation and impairment of intangible non-current assets: HK\$443,840,000
(2020: HK\$250,846,000)

Depreciation of property, plant and equipment: HK\$572,645,000 (2020: HK\$586,975,000)

Appendix 2: Summary of financial results for Galaxy (Cont'd)

Statement of financial position as at 31 December:

	2021	2020
	HK\$'000	HK\$'000
<i>Non-current assets</i>		
Property, plant and equipment	3,657,201	3,364,905
Intangible assets	<u>4,186,430</u>	<u>1,756,889</u>
	<u><u>7,843,631</u></u>	<u><u>5,121,794</u></u>
<i>Current assets</i>		
Inventories	680,504	659,185
Trade and bills receivables	2,051,891	1,968,210
Other current assets	134,223	182,675
Bank balances and cash	<u>1,051,659</u>	<u>2,102,861</u>
	<u><u>3,918,277</u></u>	<u><u>4,912,931</u></u>
<i>Current liabilities</i>		
Trade payables	402,551	373,660
Other payables	299,521	284,162
Provisions	463,746	493,258
Tax liabilities	147,561	370,658
Bank borrowing	<u>825,463</u>	<u>556,820</u>
	<u><u>2,138,842</u></u>	<u><u>2,078,558</u></u>
Net current assets	<u>1,779,435</u>	<u>2,834,373</u>
Total assets less current liabilities	<u><u>9,623,066</u></u>	<u><u>7,956,167</u></u>
<i>Non-current liabilities</i>		
Borrowings	6,245,881	4,674,600
Provisions	857,669	680,093
Other non-current liabilities	<u>898,105</u>	<u>769,504</u>
	<u><u>8,001,655</u></u>	<u><u>6,124,197</u></u>
Total assets less total liabilities	<u><u>1,621,411</u></u>	<u><u>1,831,970</u></u>
<i>Capital and reserves</i>		
Share capital	500,000	500,000
Reserves	<u>1,121,411</u>	<u>1,331,970</u>
	<u><u>1,621,411</u></u>	<u><u>1,831,970</u></u>
Number of shares	2,500,000,000	2,500,000,000

Appendix 3: Analysis of sales and gross profit by product group

Analysis of sales and gross profit by product group

	<i>Patented products</i>	<i>Generic products</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000
2021			
Revenue	4,322,245	2,256,875	6,579,120
Cost of sales	<u>(983,373)</u>	<u>(864,957)</u>	<u>(1,848,330)</u>
Gross profit	<u>3,338,872</u>	<u>1,391,918</u>	<u>4,730,790</u>
2020			
Revenue	6,370,343	2,197,546	8,567,889
Cost of sales	<u>(1,318,266)</u>	<u>(746,975)</u>	<u>(2,065,241)</u>
Gross profit	<u>5,052,077</u>	<u>1,450,571</u>	<u>6,502,648</u>

Appendix 4: Other financial information

Financial liabilities at 31 December 2021

	<i>Less than 1 year</i>	<i>1 – 2 years</i>	<i>2 – 5 years</i>	<i>More than 5 years</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Borrowings	825,463	3,824,000	1,452,000	969,881	7,071,344
Interest payable on borrowings	48,600	–	–	–	48,600
Trade payables	402,551	–	–	–	402,551
Other payables	<u>250,921</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>250,921</u>
Total	<u>1,527,535</u>	<u>3,824,000</u>	<u>1,452,000</u>	<u>969,881</u>	<u>7,773,416</u>

Financial liabilities at 31 December 2020

	<i>Less than 1 year</i>	<i>1 – 2 years</i>	<i>2 – 5 years</i>	<i>More than 5 years</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Borrowings	556,820	3,103,645	846,954	724,001	5,231,420
Interest payable on borrowings	43,613	–	–	–	43,613
Trade payables	373,660	–	–	–	373,660
Other payables	<u>240,549</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>240,549</u>
Total	<u>1,214,642</u>	<u>3,103,645</u>	<u>846,954</u>	<u>724,001</u>	<u>5,889,242</u>

Analysis of borrowings, split between fixed rate and floating rate

Date	Fixed rate	Floating rate
31 December:		
2021	75%	25%
2020	70%	30%
2019	67%	33%

Appendix 5: Analysis of provisions

Analysis of provisions at 31 December

	2021 HK\$'000	2020 HK\$'000
Severance	215,648	254,663
Environmental costs	68,756	24,556
Employee benefits	166,845	184,875
Patent litigation	96,854	112,004
Contractual disputes, claims and other provisions	<u>773,312</u>	<u>597,253</u>
	<u>1,321,415</u>	<u>1,173,351</u>

Provisions for environmental costs consist of provisions for investigation, remedy and maintenance activities in excess of normal ongoing R&D expenditure.

About 35% (2020:42%) of provisions are due within the next 12 months.

Provisions for non-recoverable trade and bills receivable at 31 December

	2021 HK\$'000	2020 HK\$'000
Trade receivables	1,901,899	2,104,856
Bills receivable	<u>334,650</u>	<u>366,012</u>
	2,236,549	2,470,868
Less provision for impairment	<u>(184,658)</u>	<u>(502,658)</u>
	<u>2,051,891</u>	<u>1,968,210</u>
Individually impaired receivables for which provision has been made	345,068	802,456
Expected recoverable amount	<u>(160,410)</u>	<u>(299,798)</u>
Impairment provision made	<u>184,658</u>	<u>502,658</u>