

Zodiac Fashion Company Limited



Table of Contents

| | |
|--|----|
| 1. Executive Summary..... | 2 |
| 2. Financial Analysis | 3 |
| 3. Internal Strategic Analysis..... | 5 |
| 4. External Environmental Analysis..... | 6 |
| 5. Incident of Acquisition of Ron Fashion Shares By Eric Kam | 8 |
| 6. Recommendation on Business Strategies | 10 |
| 7. Implementation Plan..... | 12 |
| 8. Financial Projections..... | 12 |
| 9. Services Provided By CPAC | 14 |
| 10. Conclusion..... | 15 |

1. Executive Summary

In this proposal, we have used financial ratios and SWOT analysis to evaluate the performance of Zodiac Fashion Company Limited (ZFC) in 2020, and identify the problems it faces.

The financial ratios unveil that its loss is mainly attributable to the impact of COVID-19 pandemic on sales and ineffective control on cost of sales, staff costs and aging accounts.

The SWOT analysis indicates that ZFC faces the problems of heavy dependency on Asian manufacturing suppliers, under-utilization of Just-In-Time Systems, downward trend of sales for kids' fashion, absence of mission statement, increasing raw material and labour costs, depreciation of euro, insufficient exploration of e-shop capacity, sluggish demand in Spain and Italy, and awareness of environment protection.

We have given the corresponding business strategies in the recommendation part to help ZFC to manage these problems.

In the recent incident, Eric Kam has involved in insider dealing on Ron Fashion Limited and breached the related sections of Cap. 571 Securities & Futures Ordinance and Cap. 662 Company Ordinance. He also breached Principles 1, 5 and 6 in "A Guide on Directors' Duties" issued by the Companies Registry. Peter Zhou is a whistle blower but he trespassed Eric's personal information. He is suspected to have committed s.9 of Cap. 210 Theft Ordinance. This case needs to be reported to Hong Kong Stock Exchange, and Securities and Futures Commission for investigation. In addition, ZFC needs to immediately suspend the posts of Eric and Peter until the announcement of legal decisions.

In the last part of this proposal, we have designed an implementation plan for the strategies and presented the financial projections for the coming three years which indicate that ZFC performance would be gradually improved from loss \$87m in 2021 to eventually enjoy profit after taxation \$936m in 2022 and \$2,363m in 2023.

2. Financial Analysis

We have conducted ratio analysis to illustrate the profitability, efficiency, liquidity, and investment & risk of ZFC. Elaboration is as follows:

| 2.1 Profitability | | | | |
|----------------------------|--|---------|--------|------------|
| Ratio | Formula | 2020 | 2019 | Difference |
| Gross Profit Ratio | $\frac{\text{Gross Profit}}{\text{Sales}}$ | 49.00% | 53.48% | -4.48% |
| Net Profit Ratio | $\frac{\text{Net Profit before Tax}}{\text{Sales}}$ | -31.28% | 18.89% | -50.17% |
| Operating Margin | $\frac{\text{Operating Profit}}{\text{Sales}}$ | -31.67% | 18.64% | -50.31% |
| Return on Capital Employed | $\frac{\text{Net Profit before Tax}}{\text{Net Capital Employed}}$ | -60.76% | 57.65% | -118.41% |

The result shows that all ratios are in negative percentage and ZFC profitability decreased from 2019 to 2020. The decrease is attributable to substantial decrease in turnover due to negative impact of COVID-19 pandemic, and high percentage of cost of goods sold and staff costs due to ineffective control.

| 2.2 Efficiency Ratio | | | |
|---------------------------------------|--|----------|-----------|
| Ratio | Formula | 2020 | 2019 |
| Accounts Receivable Collection period | $\frac{\text{Closing Accounts Receivable} \times 365}{\text{Credit Sales}}$ | 140 days | 56.7 days |
| Inventory Turnover Period | $\frac{\text{Closing Inventory} \times 365}{\text{Cost of Goods Sold}}$ | 140 days | 64 days |
| Uncollectable debts Ratio | $\frac{\text{Bad Debts} + \text{Increase in Allowance}}{\text{Credit Sales (from wholesales)}}$ | 5.74% | - |
| | $\frac{\text{Bad Debts} + \text{Increase in Allowance} + \text{Overdue}}{\text{Credit Sales (from wholesales)}}$ | 12.64% | - |

The accounts receivables collection period increased from 56.7 days in 2019 to 140 days in 2020 owing to the wholesales stores not settling due payment on time. Tighten credit control should be imposed on them. The inventory turnover period increased from 64 days in 2019 to 140 days in 2020 owing to drastic decrease in sales, and this unsold inventory would become outdated fashions in coming seasons. The uncollectable to debt ratio is 5.74% which seems to be marginally acceptable. However, there is a window dressing effect on the financial statements that \$490m overdue is still included in the accounts receivable. If it had written off, the ratio would have become 12.64% and hence unacceptably high.

| 2.3 Liquidity | | | | |
|----------------------|---|--------|---------|------------|
| Ratio | Formula | 2020 | 2019 | Difference |
| Current Ratio | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ | 1.58:1 | 2.33:1 | -0.75 |
| Quick Ratio | $\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$ | 0.94:1 | 1.727:1 | -0.79 |

The current ratio in 2020 is 1.58 which is less than 2 while quick ratio is 0.94 which is less than 1, indicating warning signal of incapable of settling current liabilities when due.

| 2.4 Investment and Risk | | | | |
|--------------------------------|--|----------|----------|------------|
| Ratio | Formula | 2020 | 2019 | Difference |
| Earnings Per Share (EPS) | $\frac{\text{Loss/Net Profit after Tax}}{\text{No. of Ordinary Shares}}$ | -HK\$4.5 | HK\$4.64 | -HK\$9.14 |
| Return on Equity (ROE) | $\frac{\text{Loss/Net Profit after Tax}}{\text{Shareholders' Equity}}$ | -84.84% | 47.34% | -132.18% |
| Gearing Ratio | $\frac{\text{Debt Capital}}{\text{Net Capital Employed}}$ | 26.97% | 2.44% | +24.53% |

Both EPS and ROE in 2020 are negative due to loss in the year. The gearing ratio increased from 2.44% to 26.97%, which is attributable to financing from long term bank loan \$2,375m (\$1,900+\$475) in 2020 to cover the cash outflow for operating expenses.

3. Internal Strategic Analysis

3.1 Strengths

(1) Good Reputation

Zodiac Fashion Company Limited (ZFC) was established over 100 years. This brand is well known with high-quality, affordable, and fashionable products. Besides, ZFC has reputation and positive image for high ethical standard as substantiated by international awards. This strength will continue in the future and be positive to ZFC turnover.

(2) Talented Fashion Designers

ZFC has a large in-house team of experienced and productive designers with international reputation who can design more than 15,000 new fashions in a year. Their design products are welcome by customers worldwide and make significant contribution to ZFC turnover. This team should be retained in forthcoming years.

(3) World-wide Distribution Network

The company has a world-wide distribution network, including 800 retail stores and 7,000 wholesale stores something in Europe, Mainland of China (the Mainland), Hong Kong of China (Hong Kong), Japan etc. This network lets customers reach ZFC products easily.

3.2 Weaknesses

(1) Dependency on Manufacturing Suppliers

ZFC production processes rely heavily on external manufacturers because over 95% of the ZFC manufacturing is outsourced. The outsourcing is unfavorable to cost and quality control, and timely response to rapid change in market. It takes a long response time to additional or urgent order, and would result in loss of sales. Due to the increase in outsourcing cost, the cost of goods sold increases as well.

(2) Under-utilization of Just-in-Time System

The company tried out just-in-time system of purchasing and production to avoid excessive unsold inventory. However, the development of the system is immature and it

takes time for staff to use the system. As the manufacturers respond to the order from JIT slowly, shipment would reach stores close to the end of season, and hence loss of sales arises.

(3) Declining Trend of Kids' Fashion

As shown in the production line analysis, the sales kid's fashion accounts for \$2,796m in 2020. But its trend decreased from 22% of sales in 2018 to 18% in 2020. Something has to be done to reverse this change, e.g. cooperation with animation studios which have patent right of cartoon characters.

(4) No Mission Statements

ZFC does not have a formal mission statement to uphold its corporate policies. It should write up a mission statement. With such statement, it is expected that ZFC would gain extra sales from young customers who support protection for environment and wild animals.

4. External Environmental Analysis

4.1 Opportunities

(1) Younger Generation in Existing Market

Youngsters nowadays have high consuming power¹ and would like to pursuit trendy, colourful and youthful products to show their personal styles. To foster the increasing sales trend of ZF Libra, ZFC should shift the weighting of sales mix of ZF Libra to youngster market. These products should be characterized with colours and cross-over attributes in order to meet the preference of young generation.

(2) Existing Network in the Mainland of China

There are some stores in the Mainland accounting for less than 10% of sales. With 1.4 billion people², China provides the largest consumer market for entrepreneurs in the

¹ http://www.fona.com/wp-content/uploads/2019/02/0219-FONA-Teens-Purchase-Power_v2.pdf

² https://en.m.wikipedia.org/wiki/Demographics_of_China

world. Furthermore, China has been successful to control COVID-19 pandemic, its economy will soon totally recover³. Upon full resilience, a market with high consuming power, ample opportunities and bright prospect is found there for ZFC full exploration.

(3) e-Shop System Adopting Latest Technologies

With the convenient online technology well adopted by consumers under COVID-19 pandemic, online shopping mode becomes much popular. ZFC should incorporate the technologies of Artificial Intelligence (A), Block Chain (B), Cloud Storage (C), and Data Analytics (D) with the functions of e-shop. These “ABCD” can analyze the consuming habits of customers and recommend appropriate seasonal products to them for patronage. These e-shops should cover all countries where ZFC products are being sold.

(4) Stringent Protection Policy

Government and customers are raising awareness on the protection of the environment and wildlife in these few years. ZFC turnover will be in benefit of the introduction of the formal mission statement as it gives positive image to consumers.

4.2 Threats

(1) The Impact of Coronavirus Disease 2019

Under COVID-19 pandemic, many cities in the world are locked down and the retail stores over there have closed as well. The lockdown has adverse impact on retail sector, including ZFC sales. It is expected that demand from Italy and Spain are still weak in 2021.

(2) Increasing Manufacturing Costs

The manufacturing cost increases owing to the increase in wages and the prices of raw materials in suppliers. Cotton prices rose in a range of 15% to 25% while wages rose by over 10% during the year. These costs are expected to keep on increasing in the future that would further reduce ZFC profit.

³ <https://documents1.worldbank.org/curated/en/764051625169940524/pdf/China-Economic-Update-Beyond-the-Recovery-Charting-a-Green-and-Inclusive-Growth-Path.pdf>

(3) Depreciation of Euros

According to past records, euros has been depreciating against HK dollars. The rate of Euro to HKD depreciated from \$9.80 in 2018 to \$9.12 in 2021⁴. Most of ZFC income is received in euros, the depreciation would drag down the turnover figures after translation to HK dollars.

(4) Major Competitor in the Mainland of China

The main competitor in the Mainland of China market is Platinum Fashions Limited. It owns 25% share in the market. It is developing a new brand line that focuses more on quality and fashion and be competitive to ZFC products.

5. Incident of Acquisition of Ron Fashion Shares by Eric Kam

In 2018 Eric Kam, the operation director, bought shares in Ron Fashion Limited (Ron) through the company owned by his mother-in-law and made large personal profit before he recommended ZFC board of directors for purchase of Ron shares.

5.1 Analysis on Breaching of Statutory Laws

Being director of ZFC, Eric Kam breached his duties owed to ZFC under s.536 of Cap. 662 Company Ordinance as he failed to disclose material interest in the transaction with Ron.

As ZFC is a listed company, Hong Kong Listing Rules and Cap. 571 Securities & Futures Ordinance are also applicable to this case. Eric breached the duty to avoid insider dealing on Ron. Eric's act on insider dealing falls into the definition in ss.271(1)(b)(d)(f) and ss.291(2)(4)(6) of Cap.571 which state that insider dealing occurs when persons (Eric) making or contemplating making takeover offer deal, counsel others (his mother in law) to deal or discloses information to others in relation to the target company's securities (Ron).

⁴ <https://www.hkd24.hk/%E6%AD%90%E5%85%83/2018-09-21>

In addition, Eric breached Principles 1 (no good faith), 5 (conflict of interest), and 6 (transaction without ZFC approval) in “A Guide on Directors’ Duties” issued by the Companies Registry.

5.2 Recommendations

- (1) Based on prima facie, Eric is suspected to have committed offence under s.291 of Cap.571, James Ding should advise Herman Tam to report this case to Hong Kong Stock Exchange, and Securities and Futures Commission for investigation. Eric’s post of operations director should be suspended immediately. His post resumption will depend on the legal decision after investigation.
- (2) Though Peter Zhou is a whistle blower, he trespassed Eric’s personal information. Peter is suspected to have committed s.9 of Cap. 210 Theft Ordinance. The Hong Kong Stock Exchange and Securities and Futures Commission would refer Peter’s case to Prosecution Division of the Department of Justice. Prosecution on Peter’s act would depend on the judgement of the Prosecution Division in consideration of Peter’s good intention, negligence, malicious mind etc. If convicted, he will suffer from punishment. However, if Eric is held not guilty, Peter will be liable for Eric’s claim under law of tort. Therefore, Peter’s post of deputy operations director should also be suspended immediately. His post resumption will depend on the legal decision after investigation.
- (3) Ella Poon is neither a legal expert nor a compliance officer. She is not in a position to give advice to Herman and should keep silent in this matter.
- (4) The disclosure of Eric’s insider dealing to public during the investigation process will have negative impact on the price of ZFC shares and unit price of Pluto Investment fund. Therefore, Herman, James and Ella should not act on this information to make transactions on the shares and unit fund. Otherwise, they would also have breached ss.270(1)(a), ss.291(1)(a), ss.270(1)(d),ss.291(3), ss.270(1)(e), and ss.291(5) of Cap.571.

6. Recommendation on Business Strategies

6.1 Write-up of a Mission Statement

ZFC should write up a mission statement which can capture corporate policies. It is recommended that the motto of this mission statement is “An ethical and sustainable business cherishing talents and environment conservation and providing trendy products for customers with high value.” It is expected that the mission statement can increase 10% sales ($\$15,525\text{m} \times 10\% = \$1,553\text{m}$).

6.2 Support to Non-profit Organizations

ZFC should make donations to environmental conservation and protection organizations such as World Animals Protection (WAP)⁵. This action can further improve the corporate image and raise customer confidence to its products.

6.3 Cooperation with Animation Studios

ZFC kids' fashion should be co-branded with animation studios for production of clothes which are featured with cartoon characters such as Marvel Superhero of Disney, Line Friends and Kakao Friends from Korea. This cooperation can effectively to boost the sales volume and help market penetration. It is expected that the cooperation can increase 30% of kids' fashion sales ($\$2,796\text{m} \times 30\% = \838m).

6.4 Implementation of Online Advertising

The low cost online advertising can engage different groups of customers easily in their daily life. ZFC can upload promotion video onto and hold live shows in social media, e.g. Twitch rather than publish magazines. This can increase 8% expected sales ($\$15,525\text{m} \times 8\% = \$1,242\text{m}$).

6.5 Expansion of market share and manufacturing in the Mainland of China

ZFC should expand market share in the Mainland to achieve additional 10% of sales there. The expected increase in sales is $\$1,553\text{m}$ ($\$15,525\text{m} \times 10\%$). ZFC should also

⁵ <https://www.worldanimalprotection.org/>

expand its production facilities in the Mainland to replace those in Asia. The quality of Mainland labour is high. Though their wage is increasing, it can be set off by increasing their productivity through proper training. By this means, the cost of production is stable.

6.6 Affordable Price for High Quality Clothes in the Mainland Market

ZFC should strengthen its edges on production of high-quality clothes at affordable price in order to drive out Platinum Fashion from this segment in long run.

6.7 Hosting of Training Courses on Raising Productivity and Using JIT System

ZFC should organize training course on using JIT system for its staff. It is expected that the training on JIT system can avoid 5% of loss of sales ($\$15,525m \times 5\% = \$776m$). ZFC should also organize training course on raising productivity for workers in the Mainland and its staff. The expected increase in productivity is 20%. After setting off the 10% increase in wage, the net increase in productivity is 10%, or reduce cost of goods sold to 40.9 % of sales. Also, staff cost can be reduced to 15.9% of sales. Once these training course become mature, they will be introduced to workers in Asia.

6.8 Use of Forward Contracts and Futures Contracts for Hedging

ZFC should sell its euros from sales by short forward contract at forward price. This could avoid loss of euro deprecation. The expected increase in translated revenue is 3% ($\$15,525m \times 3\% = \$466m$). ZFC should also buy raw materials by long futures contract at futures price. This could hedge the raw material costs percentage as same as that 2019.

6.9 Upgrade of e-Shop System

It is expected that the upgraded e-shop with incorporation of Artificial Intelligence (A), Block Chain (B), Cloud Store (C), and Data Analytics (D) can increase 15% of sales ($\$15,525 \times 15\% = \$2,329m$).

6.10 Stringent Credit Policies on Credit Sales from Wholesales Stores

Stringent credit policies should be imposed on wholesales stores. ZFC should use cash discount to encourage prompt payment and restricts payment term to 31-60 days only. This could reduce bad debt and impairment in 2021.

7. Implementation Plan

| STRATEGIES | Month | 2023 HK\$M | 2022 HK\$M | 2021 HK\$M |
|----------------------------------|-------|---------------|---------------|---------------|
| Donation | Jan | 2 | 2 | 2 |
| Expansion in the Mainland | Jan | 30 | 90 | 100 |
| High quality product development | Jan | 2 | - | - |
| Cooperation with studios | Feb | 8 | 8 | 8 |
| Online advertising | Mar | - | 2 | 2 |
| e-shop upgrade | Mar | - | 2 | 2 |
| Training on JIT | Apr | - | 3 | 3 |
| Training on productivity | Apr | - | 3 | 3 |
| Total cost | | 42 | 110 | 120 |

| | Base HK\$M | Increase % | HK\$M | HK\$M |
|--------------------------|------------|------------|-------|---------------|
| Turnover in 2020 | | | | 15,525 |
| Implementation | | | | |
| Mission statement | 15,525 | 10.00% | 1,553 | |
| Cooperation with studios | 2,796 | 30.00% | 838 | |
| JIT avoid loss of sales | 15,525 | 5.00% | 776 | |
| Mainland market | 15,525 | 10.00% | 1,553 | |
| Online advertising | 15,525 | 8.00% | 1,242 | |
| e-shop upgrade | 15,525 | 15.00% | 2,329 | |
| Hedge of euros | 15,525 | 3.00% | 466 | |
| | | | | 8,757 |
| Turnover in 2021* | | | | 24,282 |

8. Financial Projections

- Note:**
- (1) Reduce to 40.9% of Sales by training.
 - (2) Reduced to 15.9% of Sales by training.
 - (3) Same as % of Sales in 2019.

- (4) Same as 2019
(5) Same as 2020
(6) Reduce to 16% by transfer pricing
(7) Turnovers of 2022 and 2021 increase by 20% recovery per year.
(8) Costs of 2022 and 2021 increase by 15% inflation per year.

Budget Statement of Comprehensive Income for the year ended 31 December

| | 2023 | 2022 | 2021 | Note |
|------------------------------------|---------------------|-------------------|--------------------|-------------|
| | HK\$M | HK\$M | HK\$M | |
| Turnover (7) | 34,966 | 29,138 | 24,282 | * |
| Cost of goods sold | (13,134) | (11,421) | (9,931) | (1) |
| Gross profit | <u>21,832</u> | <u>17,717</u> | <u>14,351</u> | |
| Staff costs (8) | (5,106) | (4,440) | (3,861) | (2) |
| Distribution costs | (2,377) | (2,067) | (1,797) | (3) |
| Advertising cost | (1,394) | (1,212) | (1,054) | (3) |
| Deprec. and amort. | (5,873) | (5,107) | (4,441) | (4) |
| Other operating costs | (4,288) | (3,728) | (3,242) | (3) |
| Implementation costs | (42) | (110) | (120) | |
| Operating profit | <u>2,752</u> | <u>1,053</u> | <u>(164)</u> | |
| Interest income | 89 | 89 | 89 | (5) |
| Finance costs | (28) | (28) | (28) | (5) |
| Profit before taxation | <u>2,813</u> | <u>1,114</u> | <u>(103)</u> | |
| Taxation (16%) | (450) | (178) | 16 | (6) |
| Profit after taxation | <u><u>2,363</u></u> | <u><u>936</u></u> | <u><u>(87)</u></u> | |
| No. of O/S: | 1,100 | 1,100 | 1,100 | |
| Dividends proposed | 2,000 | 900 | - | |
| Dividend per share, in HK\$ | 1.82 | 0.82 | - | |
| EPS (basic), in HK\$ | 2.15 | 0.85 | (0.08) | |

9. Services Provided By CPAC

The Divisions of CPA & Co. (CPAC) can provide the following types of services for ZFC to improve its performance.

9.1 Audit and Assurance

This Division can give ZFC further advice on the dealing committed by Eric Kam. The dealing may cause subsequent event (HKAS10) and contingent liabilities (HKAS37) to be disclosed in ZFC financial report in 2021. Also, the Division can advise ZFC on how to raise fund from issuance of new ordinary shares to settle its long-term bank loan (\$1,900m) earlier. The early settlement can improve its long-term financial sustainability.

9.2 Consulting

This Division can provide training to improve the productivity of ZFC workers in the Mainland and its staff. Such increase can set off the effect on increased wages. Once the training becomes mature, it can be delivered via online (e.g. MS Teams, Zoom) to worker in Asia. Once their productivity is improved, the manufacturers can meet additional order in short time. The Division also can make ZFC e-shop system more user friendly and reachable in order to increase online sales particularly in Italy and Spain.

9.3 Tax

This Division can give tax advice to minimize ZFC effective global tax rate to 16% when it expands market share and manufacturing in the Mainland. Also, the Division can give advice on transfer pricing which determines the selling price in one tax regime and purchasing price in another tax regime within ZFC structure for tax minimization.

9.4 Advisory

This Division can give advice on the market operations to long/short futures/forward contracts so as to hedge the raw material prices and euros movement. The Division can also give advice on the probable outcomes of legal decisions from relevant courts (e.g. District Court, Magistrates' Courts) on the dealing, which may affect ZFC reputation and contingent claims from shareholders who suffer from loss on share price.

10. Conclusion

ZFC has advantages of international reputation, professional design team and extensive worldwide distribution channels. However, ZFC financial performance was hammered by COVID-19 in 2020, resulting in unsatisfactory financial ratios in all aspects.

In order to improve ZFC performance in coming year, ZFC needs to increase turnover by exploration of market in the Mainland, cooperation with animation studios, hedging with euro price, donation to environmental protection organizations, introduction of mission statement, launching of online advertising, upgrade of e-shop system etc.

ZFC also needs to control costs by provision of training on utilization of JIT System and productivity enhancement for its staff, hedging with raw materials, transfer pricing, and tighten credit policy.

The insider dealing case has to be reported to Hong Kong Stock Exchange and Securities and Futures Commission for investigation. In addition, ZFC needs to immediately suspend the posts of Eric and Peter until the announcement of legal decisions. The immediate suspension would stop the case deteriorating further.

It is advised that further discussion between Herman Tam of ZFC and Michael Yip of CPAC should be conducted as CPAC has all the expertise for the implementation of the above business strategies.

By this means, it is expected that ZFC can improve performance from loss \$4,952m in 2020 to loss \$87m in 2021, and profit after taxation \$936m in 2022 and \$2,363m in 2023. In addition, ZFC shareholders will enjoy \$0.82 and \$1.82 dividend per share in 2022 and 2023 respectively.

- End of Proposal -