



LEVEL 7 ASSESSMENT SPECIFICATION

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Executive Summary

Traditional Chinese Medicine (TCM) originates in ancient China with a 5000-year history. Rooted in ancient Eastern philosophies such as Taoism, TCM focuses on a holistic view between humans and nature.

This case study is focus on the financial situation of Wai Yuen Tong, a famous Chinese medicine factory that founded in 1897, has a history of more than 100 years. Through comprehensive financial analysis of its current as well as the last 3 fiscal years business, IPO history, stock value, organization structure, sales performance etc. to compare with its major competitors, Tong Ren Tang and Pura Pharm (農本方). By using various financial and accounting computations/ ratio, to address the performance of companies. Such comprehensive analysis includes few different aspects and ultimately provides conclusion and recommendations from the operation point of view in order to show the profitability, liquidity, efficiency, solvency, stock market prospects for investors.

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1. Introduction

1.1 Company background

Wai Yuen Tong is a Traditional Chinese Medicine (TCM) manufacturer of venerable vintage that all Hongkongers are familiar with. The company was founded during the Qing dynasty, in the twenty-third year of the Guangxu reign period (1897), by a government official Li Changhou and several likeminded friends. It proved a fine remedy for ordinary folks at the time, and became very popular. Wai Yuen Tong relocated from Guangzhou to Hong Kong in 1952. In 1980, it was registered as a trademark and Wai Yuen Tong Medicine Company Limited was officially established.

In December 2000, Wang On Group Limited (stock code: 1222) acquired a 99.79% interest in Wai Yuen Tong for HK\$126 million. In March 2001, Town Health International Holdings Company Limited (stock code: 8138) acquired a 24% interest in Wai Yuen Tong from Wang On Group Limited for HK\$30 million. In the same year, Wai Yuen Tong invested close to HK\$100 million to build a 110,000-square-foot GMP Chinese pharmaceutical manufacturing facility in Kowloon Bay, the largest of its kind in Hong Kong. In the next year, Wai Yuen Tong Medicine Holdings Limited was listed in Hong Kong Stock Exchange (stock code: 897).

In 2003, Wai Yuen Tong began to enter the China market in the hope of building a nationwide network of TCM operations. Wai Yuen Tong started to develop the China market from Guangdong. Our retail network covers Shenzhen, Dongguan, Guangzhou and other cities neighbouring Hong Kong. In August 2004, the flagship store was opened in Nathan Road. Wai Yuen Tong moved into Wai Yuen Tong Medicine Building on Wang Kwong Road in Kowloon Bay. The 110,000-square-foot pharmaceutical manufacturing facility features a herb pre-

processing plant, manufacturing and packaging operations, QC laboratories and warehouses etc. Wai Yuen Tong opened its first retail outlet in Macau in September 2012 followed by their first concept store in 2015 located in Causeway Bay.

1.2 Business and performance overview

Principal activities of the Group comprise the production and sales of traditional Chinese and Western pharmaceutical products, health food and personal care products and property investment.

For the year ended 31 March 2018, the Group's revenue increased by approximately 14.5% to approximately HK\$845.8 million (2017: approximately HK\$738.4 million). The Group recorded a loss attributable to owners of the parent amounting to approximately HK\$115.6 million (2017: approximately HK\$93.3 million), representing an increase in loss attributable to owners of approximately 23.9% as compared with corresponding period of last year.

Chinese pharmaceutical and health food products are used to occupy the largest income of Wai Yuen Tong (chart 1.2.1). With the world's aging population and ardent demand for healthy living, the Group continued to promote and develop a series of traditional Chinese medicine ("TCM") healthcare products for common diseases of urban people.

Table 1.2 Segments revenue of 2014-2018, Wai Yuen Tong

Segments revenue of 2014 - 2018									
'000	Chinese pharmaceutical and health products	%	Western pharmaceutical and health products	%	Property Investment	%	Others	%	Total
2018	700,329	82.8%	135,888	16.1%	16,405	1.9%	-6,841	-0.8%	845,781
2017	578,294	78.3%	149,859	20.3%	17,223	2.3%	-6,936	-0.9%	738,440
2016	649,275	78.7%	163,423	19.8%	20,562	2.5%	-7,929	-1.0%	825,331
2015	677,401	81.5%	141,253	17.0%	20,099	2.4%	-7,665	-0.9%	831,088
2014	701,620	79.5%	152,042	17.2%	17,987	2.0%	10,456	1.2%	882,105

Source: Wai Yuen Tong financial report 2014-2018

For western pharmaceutical and health food products, the turnover for the current year decreased by approximately 9.3% to approximately HK\$135.9 million compared to last year. During the year, full impairment provision of HK\$7.6 million of the goodwill relating to the Western Pharmaceutical Business was made.

For property investment, at the end of 2018, the Group owned 12 properties which are all retail properties. Some of these properties were leased out for commercial purpose whereas some were used as our retail shops. During the year, the net fair value gain on investment properties of the Group amounted to HK\$23.4 million. Despite the upward adjustment in the valuation of the properties as compared to last year, the Group considers that the investment property portfolio can provide stability to the operating cost of retail shops and strengthen the Group's income base in the long run.

The Group targeted better cost efficiency through further optimisation of its retail sales network and distribution channels. The Group had enhanced the distribution channel by partnering with a strong distributor in the fourth quarter of 2018 which will focus on distributing the Group's products to the key accounts in Hong Kong. The Group is also well aware of the importance of networks nowadays and therefore has intensified its efforts to explore other sales channels, major customers, distributors and overseas regions to expand and enrich its sales channels. Increased investment will be also made in the development of online shopping platform.

1.3 Business industry overview

Traditional Chinese Medicine (TCM) in China enjoyed more rapid growth than other segments of the pharmaceutical industry in the past years. Driven by an increasingly aging population, rising GDP per capita, expanding medical insurance programs and urbanization, we believe it will continue to expand rapidly. The industry will also benefit from favourable government policies for the Chinese medicine industry, and we expect it to be globally competitive over the long term. For Chinese patent/finished medicines, companies face a tougher operating environment due to slower organic growth amid tough competition. For modern Chinese medicines, favourable policies are leading to the emergence of new companies.

Through the observations of universal principles within nature, TCM inquiries from a macro level into the microcosm of human physiology and the mutual relationships between our body's internal workings and the external environment. Its highest goal is to master the fundamental principles that govern the human body in order to maintain health, and prevent and treat diseases. Under this view, TCM, as an integral part of Chinese culture, has been warmly welcomed and plays a critical role in Hong Kong's healthcare system.

1.4 Company structure

As of 31 March 2018, the Group had a total of 721 employees, of which 544 were based in Hong Kong and 177 employees were based in mainland China. The proportion of male to female employees was 33:67. Majority of employees were aged between 31 and 50, accounting for 57%. In terms of professional profile, management staff accounted for 5% of employees. The Board currently comprises four executive Directors and four independent non-executive Directors (the "INEDs").

2. Financial analysis

According to the financial performance of Wai Yuen Tong in the past three years, the net profit has turned from profit to loss, debt has also risen, and EBIT has decreased.

Table 2 Financial analysis of 2016-2018, Wai Yuen Tong, Tong Ren Tang, Pura Pharm

(Company Name)	Wai Yuen Tong			Tong Ren Tang	Pura Pharm
(HK\$'000) (Yr)	2018	2017	2016	2018	2018
NET CURRENT ASSETS	638,596	650,524	507,766	2,605,533	131,499
Total Assets	3,656,461	3,573,251	3,237,452	3,171,085	1,333,103
Retained earnings	2,541,853	2,639,140	2,319,327	1,966,838	378,438
EBIT	(95,961)	(79,804)	43,920	720,917	48,410
Stock value (HKD)*1	0.32	0.39	0.90	12.32	2.10
Number of Stock (thousand shares)	1,265,143	1,265,143	316,286	837,100	247,718
Total Liabilities	1,096,436	915,528	907,896	146,858	770,884
Sales	845,781	738,440	825,331	1,513,873	745,503

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

2.1 Bankruptcy index **Z-score** analysis

The purpose of the Z Score Model is to measure a company's financial health and to predict the probability that a company will collapse within the years. It is proven to be very accurate to forecast bankruptcy in a wide variety of contexts and markets.

Based on the calculation formula $1.2A + 1.4B + 3.3C + 0.6D + 0.999E$ to calculate the forecast of bankruptcy possibility. Result which above 3 means bankruptcy is not likely happen. Between 1.8 to 3 means bankruptcy cannot be predicted in grey area. Finally if the result is below 1.8, it means bankruptcy is likely to be happened. (Alexandrov et al., 2006)

Table 2.1 Z-score of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

(Company Name)	Wai Yuen Tong			Tong Ren Tang	Pura Pharm
	2018	2017	2016	2018	2018
A	0.17	0.18	0.16	0.82	0.10
B	0.70	0.74	0.72	0.62	0.28
C	(0.03)	(0.02)	0.01	0.23	0.04
D	0.37	0.54	0.31	70.22	0.67
E	0.23	0.21	0.25	0.48	0.56
Z Score	1.55	1.71	1.68	45.22	1.60

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

2.2 Financial structure

Table 2.2 Liability ratio of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Fixed Asset to Long term Liability Ratio	0.41	0.39	0.39	0.40	0.11	0.39	0.30
Current Liability to Net Asset Ratio	0.17	0.08	0.14	0.13	0.06	1.07	0.42
Current Liability to Stock Ratio	2.32	1.25	2.07	1.88	0.63	2.55	1.69

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

➤ Fixed asset to long term liability ratio

The fixed-assets- to long-term-liabilities ratio is a way of measuring the solvency of a company. A company's long-term debts are often secured with fixed assets, which is why creditors are interested in this ratio. A smaller number is better, with a low number indicating the debts can be covered by fixed assets. Refer to the table 2.2, the average ratio of 3 companies is 0.3 while Wai Yuen Tong is 0.4. This numbers reflect that Wai Yuen Tong has the highest ratio of fixed assets to liability among three companies, which means, the risk is also higher relatively for investors.

➤ Current liability to net asset ratio

This ratio can further show the liability condition of the company based on its current liability to its net asset figures. The number is lower, the risk is lower. The average ratio of Wai Yuen Tong of 2016-2018 is 0.13

compared to the average ratio of 3 companies. The ratio of Wai Yuen Tong in 2017 was 0.08 but increased to 0.17 in 2018 because of the interest-bearing bank borrowings have been increased from HKD 62,290 million to HKD 264,790 million (increased 325%) but it is still at a reasonable level among the industry and should not cause Wai Yuen Tong to a serious financial problem.

➤ Current liability to stock ratio

As same as the ratio of the above two figures, the lower the number is, the better steadiness is. Refer to the figures shown on table 2.2, due to the increase of interest-bearing bank borrowings in 2018, the current liability to stock ratio of Wai Yuen Tong grew from 1.25 in 2017 to 2.32. Although there is more than 85% increment, its average ratio of the past three years is still acceptable, it is about 11% higher than the industry average ratio.

After an overall review of the financial structure through the above figures, Wai Yuen Tong is underperform among the industry while Tong Ren Tang is the one who perform the best with outstanding financial performance.

2.3 Short-term solvency and liquidity ability

Table 2.3 paying debts ability of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Current Ratio (%)	250%	406%	258%	305%	1713%	129%	715%
Quick Ratio (%)	207%	326%	210%	248%	1553%	89%	630%
Stock Credit Index	(2.49)	(2.83)	(2.28)	(2.53)	(9.10)	0.28	(3.79)
Cash Ratio (%)	99%	152%	64%	105%	516%	27%	216%
Total Debt Ratio (%)	30%	26%	28%	28%	5%	54%	29%
Debt / Equity Ratio (%)	26%	26%	25%	26%	0%	13%	13%
Long Term Debt Ratio	0.21	0.21	0.20	0.20	0.00	0.11	0.10
Total Debt / Fixed Asset Ratio	0.84	0.70	0.79	0.78	0.50	2.86	1.38
Time interest cover ratio	(5.07)	(4.82)	2.96	(2.31)	23138.69	2.99	7713.12

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

➤ Current ratio and quick ratio

An indication of a company's ability to meet short-term debt obligations; the higher the ratio, the more liquid the company is. If the current assets of a company are more than twice the current liabilities, then that company is generally considered to have good short-term financial strength. If current liabilities exceed current assets, then the company may have problems meeting its short-term obligations. Thus, it is a very important indication of a company.

In this case, due to the outstanding performance of Tong Ren Tang (average current ratio of 2016 – 2018 is 1713%, total assets is HKD 3,171,085 million and total liabilities is HKD 146,858 million), the average ratio of industry have been pulled up a lot (715% & 630% respectively for current ratio and quick ratio). Commonly acceptable current ratio is about 200% which is a comfortable financial position for most enterprises. So therefore, the ratio of Wai Yuen Tong is still sufficient for its operation.

➤ Stock credit index

Refer to the table 2.3, we can see the average ratio of Wai Yuen Tong is - 2.53, which means there is sufficient current assets and with no problem on repaying current liabilities.

➤ Cash ratio

A cash ratio is expressed as a numeral, greater or less than 100%. Upon calculating the ratio, if the result is equal to 100%, the company has exactly the same amount of current liabilities as it does cash and cash equivalents pay off those debts. The average ratio of Wai Yuen Tong is reluctantly passed the bottom line. In fact its ratio in 2017 was 152%, however, the current liabilities have been increased a double in 2018 so affected to all its figures.

➤ Total debt ratio

If the ratio is less than 50%, most of the company's assets are financed through equity. If the ratio is greater than 50%, most of the company's assets are financed through debt. A bigger ratio shows that a considerable portion of debt is funded by assets. In other words, the company has more liabilities than assets. A high ratio also indicates that a company may be putting itself at a risk of default on its loans if interest rates were to rise suddenly. A low debt ratio indicates conservative financing with an opportunity to borrow in the future at no significant risk. In this case, the average ratio of Wai Yuen Tong compared to the industry ratio, it is acceptable.

➤ Debt/ Equity ratio

The ratio is used to evaluate a company's financial leverage. The D/E ratio is an important metric used in corporate finance. It is a measure of the degree to which a company is financing its operations through debt versus wholly-owned funds. Higher leverage ratios tend to indicate a company or stock with higher risk to shareholders. Simply stated, this is a ratio of the total long term debt and equity capital in the business. Average of industry ration is 13% which means Wai Yuen Tong's ratio is higher than average but still within an acceptable range.

➤ Long term debts ratio

The long-term debt-to-total-assets ratio is a measurement representing the percentage of a corporation's assets financed with long-term debt, which encompasses loans or other debt obligations lasting more than one year. This ratio provides a general measure of the long-term financial position of a company, including its ability to meet its financial obligations for outstanding loans. If a business has a high long-term debt-to-assets ratio, it suggests the business has a relatively high degree of risk, and

eventually, it may not be able to repay its debts. For Wai Yuen Tong, its borrowings from bank are much higher than other two companies but its ratio is still acceptable.

➤ Total debts/ fixed assets ratio

The total debt to total assets ratio shows the degree to which a company has used debt to finance its assets. The calculation considers all of the company's debt, not just loans and bonds payable, and considers all assets, including intangibles. A ratio greater than 1 shows that a considerable portion of the debt is funded by assets. In other words, the company has more liabilities than assets. A high ratio also indicates that a company may be putting itself at risk of defaulting on its loans if interest rates were to rise suddenly. A ratio below 1 translates to the fact that a greater portion of a company's assets is funded by equity. The industry average is above 1 due to the financial situation of Pura Pharm, its fixed assets are less than HKD 300,000 million while total liabilities is more than HKD770,000 million. Wai Yuen Tong although has about HKD 1,100,000 million total liabilities but it also has about HKD 1,300,000 million fixed assets to support.

➤ Time interest cover ratio

The times interest cover ratio is used to see how well a firm can pay the interest on outstanding debt. Also called the interest coverage ratio, this ratio is used by creditors and prospective lenders to assess the risk of lending capital to a firm. A higher coverage ratio is better, although the ideal ratio may vary by industry. The lower the ratio, the more the company is burdened by debt expense. When a company's interest coverage ratio is only 1.5 or lower, its ability to meet interest expenses may be questionable. Wai Yuen Tong is going downward since 2017 and

its average ratio of the past three years is -2.31 which is unacceptable with high risk for investors

In view of the above ratio analysis of Wai Yuen Tong as well as the industry average, the overall solvency and liquidity is still within the safety zone. As at the last accounting period in 2018, Wai Yuen Tong has about total assets of HKD 3,656.5 million which was financed by about HKD 425.4 million of current liabilities, HKD 671.1 million non-current liabilities and shareholders' equity about HKD 2,560 million.

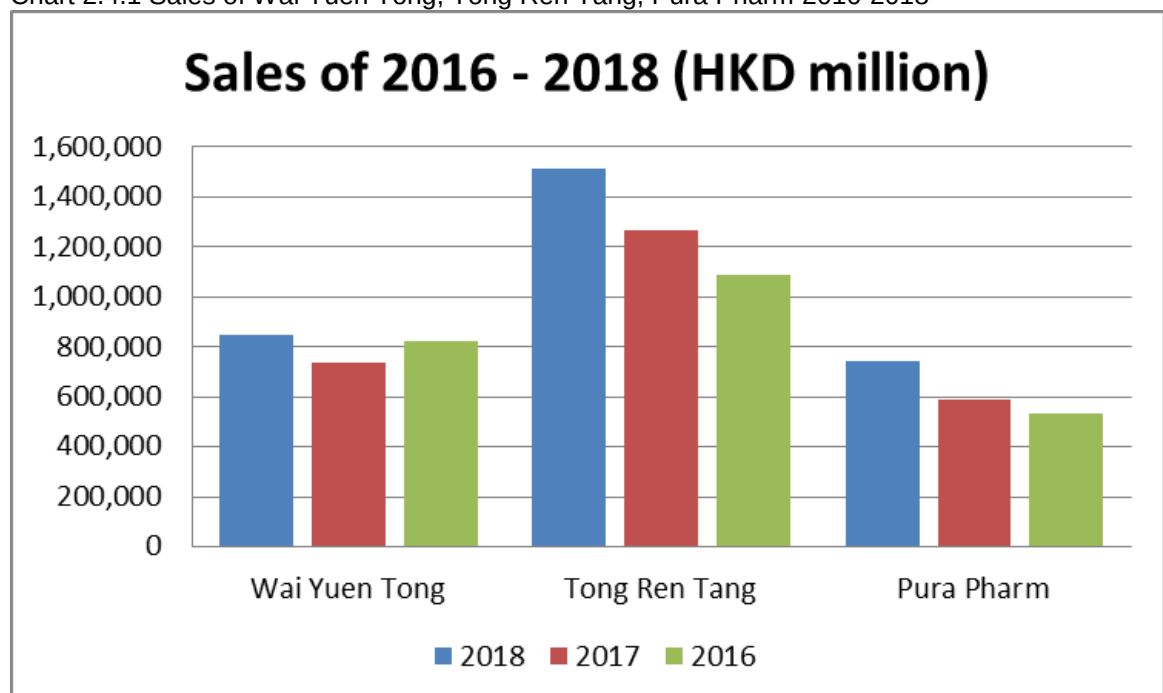
Wai Yuen Tong so far still maintained a healthy liquidity position with current ratio at 2.5. However, according to its financial history in the past 2 years, there may be a possibility of going downhill.

2.4 Operational review

Revenue

Compared to Tong Ren Tang and Pura Pharm, the sales trend of Wai Yuen Tong is relatively unstable (Chart 2.4.1 & Table 2.4.2)

Chart 2.4.1 Sales of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018



Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

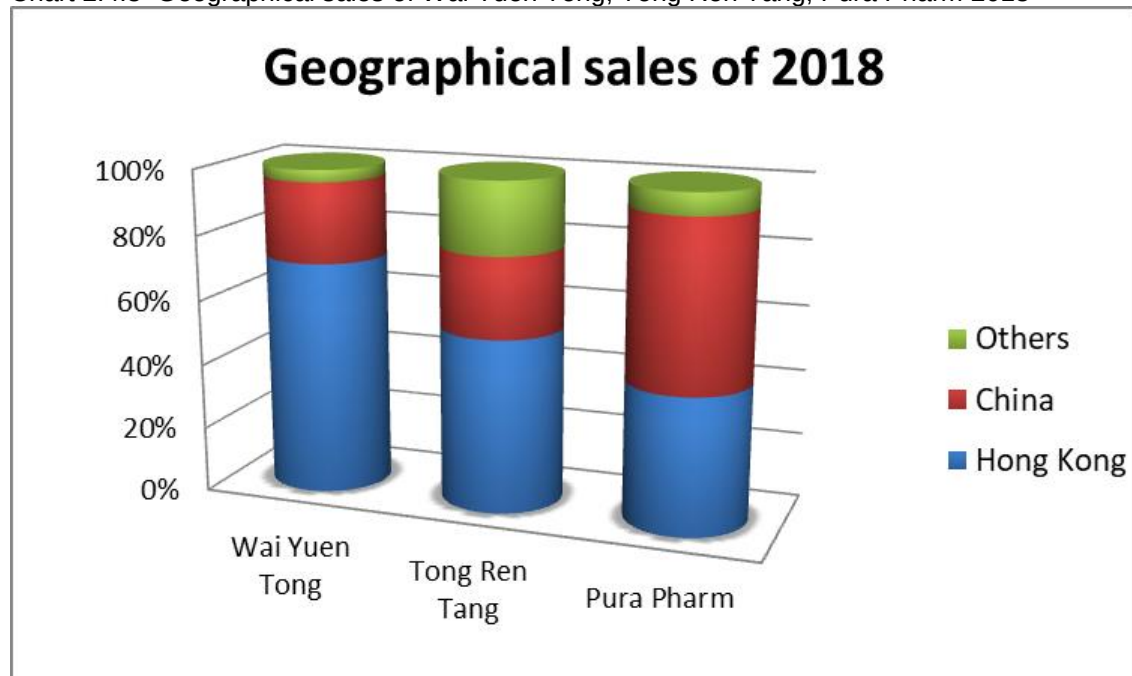
Table 2.4.2 Sales of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

Revenue of 2016-2018			
HKD million	Wai Yuen Tong	Tong Ren Tang	Pura Pharm
2018	845,781	1,513,873	745,503
2017	738,440	1,265,994	591,566
2016	825,331	1,084,280	535,986

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

If we are talking about the sales by segment (table 2.4.3), over 70% of sales of Wai Yuen Tong was came from Hong Kong followed by about 25% from Mainland China. For Pura Pharm, it is opposite to Wai Yuen Tong and Tong Ren Tang, its major revenue was came China which more than 50% of its total sales. For Tong Ren Tang, its business is not only cover Hong Kong, Mainland China and Macau but also in Australia, Canada, Singapore, New Zealand and United States.

Chart 2.4.3 Geographical sales of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2018



Source: 2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

Operating expenses

Refer to the operating expenses data from financial statement of 2016 – 2018 in three companies, it shows the average of total operating expenses including administrative cost, rental and depreciation is 32.48% of its revenue.

Revenue is the most important element of a company operation with no doubt, but expenditure management is also very important. According to Table 2.4.4, the total operating expenses of 2018 of Wai Yuen Tong has been increased by 6% from 2016 although there was a slight decrease of 1.9% from 2017. Compared to its sales growth in the same years (2016 to 2018), it was only about 2.5%. Obviously the proportion is insufficient to its operation.

Table 2.4.4 Operating expenses of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Administrative cost	22.25%	23.35%	18.24%	21.28%	9.99%	30.94%	20.74%
Rental cost	13.58%	17.94%	15.22%	15.58%	5.80%	5.27%	8.88%
Depreciation	5.53%	1.96%	1.78%	3.09%	1.83%	3.67%	2.86%
Total:	41.36%	43.25%	35.24%	39.95%	17.61%	39.88%	32.48%

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

Operating ability

Through the following ratios (Table 2.4.5) to let us further understand the operating ability of three companies.

Table 2.4.5 Operating expenses of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Total Assets turnover	23.13%	20.67%	25.49%	23.10%	46.55%	54.65%	41.43%
Average collection period	45.30	43.49	57.03	48.61	46.85	150.62	82.03
Days' sales in inventory	133.19	144.84	124.12	134.05	225.42	373.81	244.42
Payment period	43.76	52.13	62.56	52.82	48.03	176.25	92.37

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

➤ Total assets turnover

The total asset turnover ratio compares the sales of a company to its asset base. Ideally, a company with a high total asset turnover ratio can operate with fewer assets than a less efficient competitor, and so requires less debt and equity to operate. Wai Yuen Tong maintained 20% to 25% in the past three years while the industry average is 41%.

➤ Average collection period

The average collection period is the amount of time it takes for a business to receive payments owed by its clients in terms of accounts receivable. Companies calculate the average collection period to make sure they have enough cash on hand to meet their financial obligations. The average collection period of Wai Yuen Tong is about 48days which close to Tong Ren Tang, Pura Pharm takes more than 150days in average that means a triple of another two companies.

➤ Days' sales in inventory

The financial ratio days' sales in inventory tells you the number of days it took a company to sell its inventory during a recent year. This is an important to creditors and investors for three main reasons. It measures value, liquidity, and cash flows. Both investors and creditors want to know how valuable a company's inventory is. In this case, Wai Yuen Tong performed the best among three companies with shortest inventory turnover days.

➤ Payment period

Average payment period means the average period taken by the company in making payments to its creditors and usually can reveal insight about a company's cash flow and creditworthiness. Payment period days of Wai Yuen Tong keep reducing from 2016 to 2018 that reflected they took shorter time to settle the payment with its vendors/ suppliers.

2.5 Profitability analysis

The figures (Table 2.5.1) of this part can easily show investors the profitability of three companies by using the past three years data then forecast the future trend accordingly.

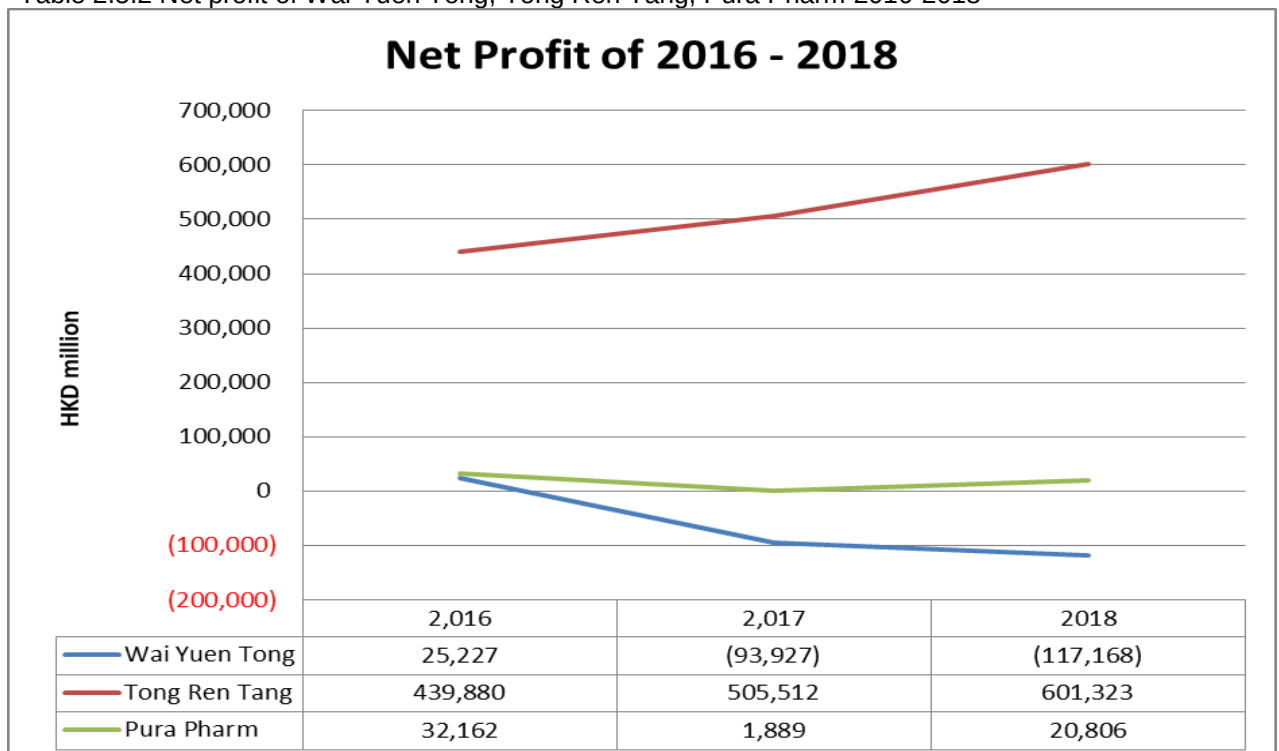
Table 2.5.1 Profitability analysis of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Net profit	(117,168.00)	(93,927.00)	25,227.00	(61,956.00)	515,571.67	18,285.67	157,300.44
Net profit growth	-24.74%	-472.33%	-79.13%	-192.07%	17.10%	306.77%	43.94%
Gross profit margin	40.65%	42.08%	44.86%	42.53%	72.32%	64.34%	59.73%
Net profit margin	-13.85%	-12.72%	3.06%	-7.84%	40.07%	3.04%	11.76%
Total asset turnover	23.13%	20.67%	25.49%	23.10%	46.55%	54.65%	41.43%
Leverage ratio	1.43	1.34	1.39	1.39	1.05	2.21	1.55
Return on equity after tax	-4.58%	-3.53%	1.08%	-2.34%	19.67%	3.71%	7.01%

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

➤ Net profit

Table 2.5.2 Net profit of Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018



Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

Refer to Table 2.5.2, there was a significant drop of net profit for Wai Yuen Tong in 2016-2017 (-472.3%) and then followed by another drop of 25% in last year. Also, the board of directors does not recommend the payment of any dividend in the past three years. It is definitely an alert for investors based on its unsatisfactory financial performance.

➤ Net profit growth

The growth rates of Wai Yuen Tong in the past three years were all negative. Their sales have been increased 15% in 2018 but at the same time the expense cost was also increased. The management of Wai Yuen Tong needs to review and consider about cost saving as one of the solution.

On another side, Tong Ren Tang remained a steady growth of approximate 17% year to year.

➤ Gross profit margin

Gross profit margin is a profitability ratio that calculates the percentage of sales that exceed the cost of goods sold. A higher gross profit margin indicates efficient processes in a company. A lower ratio indicates your processes may not be as efficient as they could be. Average of industry's gross profit margin is 60% while Wai Yuen Tong 's average is 43%, it is lower than average but acceptable.

➤ Net profit margin

The net profit margin is a profitability measurement. It represents the percentage of profit from business operations after deduction of all the expenses. Due to the increment of operating expenses in the past two years in Wai Yuen Tong, we can see the net profit margins in 2018 and 2017 were negative while the industry average is 12%. And again, Tong

Ren Tang performed the best with outstanding net profit margin ratio among three companies.

➤ Leverage ratio

It measures the amount of a firm's assets that are financed by its shareholders by comparing total assets with total shareholder's equity. This ratio also shows the level of debt financing is used to acquire assets and maintain operations. Industry average ratio in the past three years is 1.55 and Wai Yuen Tong is 1.39, this means that its debt levels are very low.

➤ Return on Equity (after tax) ROE

Return on equity measures how effectively management is using a company's assets to create profits. In general, ROE is 15% can be considered as an acceptable ratio and if less than 10% as poor. Only Tong Ren Tang has 19.67% among three companies, average ratio is 7% since both low ratio of Wai Yuen Tong and Pura Pharm. For Wai Yuen Tong, it is even a negative ratio which is absolutely unacceptable.

In consideration of all the data analysed through the above profitability analysis, Wai Yuen Tong obviously has to improve in different aspects including its profit margin by further control of company expenses.

2.6 Growth capacity analysis

Table 2.6.1 Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(CompanyName)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Retained earning ratio	(21.69)	(28.10)	91.94	14.05	4.86	73.85	30.92
Self-sustainable growth ratio	99.29%	99.30%	99.56%	99.38%	95.65%	66.00%	87.01%

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

Wai Yuen Tong had high retained earnings ratio in 2016 but then dropped to -28.1 and climbed up a bit to -22% but still being negative. Regarding to the self-sustainable growth rate, the average of three companies is 87% while Wai Yuen Tong's average ratio is 99% which is still very competitive.

2.7 Stock market analysis

Table 2.7.1 Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
Earning per share	(0.09)	(0.07)	0.08	(0.03)	0.62	0.08	0.22
Price-earning ratio	(3.46)	(5.25)	11.28	0.86	18.23	150.02	56.37
Dividend yield (%)	0.00%	0.00%	0.00%	0.00%	31.31%	4.71%	12.01%

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

Making a comparison of the PE ratio within an industry group can be helpful, though in unexpected ways. Although it seems like a stock that costs more relative to its EPS when compared to peers might be “overvalued,” the opposite tends to be the rule. Investors are willing to pay more for a stock, regardless of its historical EPS, if it is expected to grow or outperform its peers. In terms of the stock market analysis, the result of Wai Yuen Tong is poor. It has negative ratio of EPS and also no dividend has been distributed in the past three years. Investors might definitely not consider to buy its share based on the figures.

3. Corporate governance

The Board of Wai Yuen Tong currently comprises four Executive Directors and four Independent Non-Executive Directors including their Chairman and Managing Director, Mr. Tang Ching Ho. The Board has established various committees including executive committee (the “Executive Committee”), audit

committee (the “Audit Committee”), remuneration committee (the “Remuneration Committee”) and nomination committee (the “Nomination Committee”), each of which has the specific written terms of reference that will be reviewed and updated. Wai Yuen Tong uses Ernst & Young as its external auditor and paid HKD 4,349 million in the last accounting period. The Group has established risk management procedures to address and handle the all significant risks associate with the businesses of the Group. The Board would perform an annual or periodical review on any significant change of the business environment and establish procedures to response the risks result from the significant change of business environment. The management would identify the risks associate with the businesses of the Group by considering both internal and external factors and events which include political, economic, technology, environmental, social and staff in order to follow the best practices instructed by HKEX.

Table 3.1 Wai Yuen Tong, Tong Ren Tang, Pura Pharm 2016-2018

(Company Name)	Wai Yuen Tong				Tong Ren Tang	Pura Pharm	
	2018	2017	2016	2016-18Average	2016-18Average	2016-18Average	3 companies average of 2016-18
ROA after tax	-3.20%	-2.63%	0.78%	-1.68%	18.65%	1.82%	6.26%
ROE after tax	-4.58%	-3.53%	1.08%	-2.34%	19.67%	3.71%	7.01%

Source: 2016-2018 financial report of Wai Yuen Tong, Tong Ren Tang, Pura Pharm

According to Table 3.1, both ROA and ROE of Wai Yuen Tong are much behind the industry average and the industry average is already much lower than normal investors expected.

4. Investment project investment

Wai Yuen Tong is considering an investment of land in New Territories cost HKD 135,000 million with estimated life of six years then at the end it is estimated can be sold for HKD 100,000 million.

Below is the estimation of cash flows:

HKD million			
Year	Net operating cash flow	Depreciation	Operating profit
1	14,000	20,833	(6,833)
2	25,000	20,833	4,167
3	35,000	20,833	14,167
4	36,000	20,833	15,167
5	30,000	20,833	9,167
6	25,000	20,833	4,167
Total	165,000	124,998	40,002

Thus,

Total profit for the project will be approximated HKD 40,000 million

Average annual profit is HKD 6,667 million

Average annual return is 9.2%

HKD million		
Year	Cash flow	Cumulative cash flow
0	(135,000)	(135,000)
1	14,000	(121,000)
2	25,000	(96,000)
3	35,000	(61,000)
4	36,000	(25,000)
5	30,000	5,000
6	35,000	40,000

Operating cash flow of HKD 25,000 + residual value of the investment HKD 10,000 (year 6).

Payback period will be 4 years 10 months ($12\text{months} \times 25,000/30,000 = 10$ months)

HKD million			
Year	Cash flow	Discount 12%	Present value
0	(135,000)	1.00	(135,000)
1	14,000	0.89	12,502
2	25,000	0.80	19,925
3	35,000	0.71	24,920
4	36,000	0.64	22,896
5	30,000	0.57	17,010
6	35,000	0.51	17,745
NPV			(20,002)

*Company cost of capital is 12%

HKD million					
Year	Cash flow	Discount 12%	PV	Discount 4%	PV
0	(135,000)	1.00	(135,000)	1.00	(135,000)
1	14,000	0.89	12,502	0.96	13,468
2	25,000	0.80	19,925	0.93	23,125
3	35,000	0.71	24,920	0.89	31,115
4	36,000	0.64	22,896	0.86	30,780
5	30,000	0.57	17,010	0.82	24,660
6	35,000	0.51	17,745	0.79	27,650
NPV			(20,002)		15,798

Try to use a lower cost of capital (4%) to enhance the chance of positive NPV, a positive HKD 15,798 is calculated.

Based on the above new calculation, IRR of this investment is 7.53%, which means below the cost of capital.

Investment appraisal result

According to all the above analysis and calculations, it is not suggested to invest this project, because:

- Payback time is too long. Full payback period is estimated to occur 80% into the project period.
- 9.2% ARR is lower than the cost of capital 12%.
- NPV is negative.
- The IRR takes into account the extra cost of waiting and thus should give a lower return than the ARR.

5. Financing and working capital management

External financing comes in two different forms: debt or equity. Debt financing includes bank loans, promissory notes and credit card purchases, while equity financing occurs when the business sells off shares of its ownership to outside sources.

Bank Loans

One of the primary sources of external financing for small businesses is bank loans. The company submits a loan application to a bank, savings and loan or other financial institution. The application includes the purpose of the loan, the amount requested and information on the company's credit history. The bank analyzes the data, approves or declines the loan application and determines the interest rate on the loan. If the company fails to repay the principal and interest within the prescribed time period, the bank can claim any collateral the company provided to secure the loan

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Bond Issues

Instead of applying for a bank loan, small companies can also issue bonds for debt financing. For companies involved in industrial development, the Industrial Development Revenue Bond (IDRB) program works with local government agencies to pay for large industrial projects. Companies that receive IDRB approval are allowed to issue bonds and make them available to private investors. The company must repay the principal and interest on the bond to the local development agency, which disburses the proceeds to the investors.

Angel Investors

Companies that would prefer to avoid the liabilities that come with debt financing can obtain additional capital by equity financing. One source of equity financing is the so-called "angel investor." These investors contribute to improving the equipment capital, marketing strategies and industry knowledge base in exchange for small portions of equity of the target company. In return, angel investors look for companies with high potential and above-average rates of return on investment (ROI).

Venture Capital

Another popular form of equity financing is venture capital. Venture capitalists find companies with promising growth potential and offer to invest in exchange for a substantial share of the ownership. Venture capital firms have access to the money and expertise many growing firms need to reach their full potential. Since venture capital firms bring both capital and expertise to the business, they also often place their industry experts in control of their target firms.

Working capital represents the net current assets available for day-to-day operating activities. It is defined as current assets less current liabilities and, in exam questions, the components are usually inventory and trade receivables, trade payables and bank overdraft.

Many businesses that appear profitable are forced to cease trading due to an inability to meet short-term obligations when they fall due. Successful management of working capital is essential to remaining in business.

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