

Business and Financial Analysis on Public Enterprises

- Case Study of MTR Corporation Limited

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Agenda

- Objectives of the Case Competition
- BAFS syllabus
- Applying Case Questions in teaching BAFS
- Q&As



Objectives

- Aims to enhance students' ability in using accounting information for business development and their generic skills, such as *research, analysis, team-building, communication, critical thinking, creativity and problem-solving* as required by today's business world.
- To provide students with fundamental accounting and business management knowledge and skills, and *to develop their positive values and attitudes.*



BAFS Syllabus

Compulsory (40%)

- Business Environment
- Introduction to Management
- Introduction to Accounting
- Basics of Personal Financial

Elective Module (60%)

- Accounting

- *Financial Accounting*
- *Cost Accounting*

- Business Management

- *Financial Management*
- *Human Resources Mgt*
- *Marketing Management*



Relevance of BAFS Syllabus

Compulsory (40%)

- Business Environment
- Introduction to Management
- Introduction to Accounting
- Basics of Personal Financial

Elective Module (60%)

- Accounting — {
 - *Financial Accounting*
 - *Cost Accounting*
- Business Management — {
 - *Financial Management*
 - *Human Resources Mgt*
 - *Marketing Management*



Case question

Milton Friedman was the well-respected 1976 Nobel Prize Winner in economics. In the 1960s, when the world economy was in a slump, he wrote an article saying that: “The sole responsibility of business is to increase its profits.”

REQUIRED

Should directors only consider maximizing shareholders’ profits to be their sole operating goal? Can they neglect the needs of other stakeholders, e.g. employees and customers?

Relevant to *Business Environment - Business Ethics and Social Responsibility*



Social Responsibility

- Responsibility of businesses is not “solely” on profit.
- Emphasize on the means rather than just achieving the goal.
- Growth of companies involves a complex relationships among the company and the owners of property, labour and other stakeholders.
- All stakeholders will benefit with a sustainable environment.
- Should consider the needs of all stakeholders before decision-making.



Case question

The MTR was one of the winners of the Best Corporate Governance Disclosure Awards 2007. The award has been organized by the Hong Kong Institute of CPAs since 2000. As well as preparing its statutory reports, the MTR has also published a sustainability report for the past eight financial years.

REQUIRED

- (i) *What is the meaning of **sustainable development**?
Why is it important to the MTR's success?*

Relevant to *Business Environment - Business Ethics and Social Responsibility*



Sustainable development

- Keeping the consumption of renewable natural resources within the limits of their replenishment.
(The United Kingdom's Sustainable Development Strategy)
- Aims to meet human needs while preserving the environment so that these needs can be met in present and in indefinite future.
- Ties together concern for the carrying capacity of natural systems with the social challenges facing humanity.
- Four dimensions: social, economic, environmental & institutional.



Sustainable development (*cont'd*)

- Important to the success of the MTR.
- *MTR's Sustainability Report* shows how MTR is using its resources and demonstrates its continual improvement.
- “The art of sustainability is about crafting the tools and steering the aspirations of both a business and its stakeholders,” *MTR's Sustainability Development Manager, Dr Glenn Frommer said.*
- To excite a personal awareness among staff, engender a sense of the MTR Corporation within the community and collectively steward the organization for the benefit of the greater society.



Case question

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REQUIRED

- (i) *What is the meaning of sustainable development?
Why is it important to the MTR's success?*
- (ii) *It is not compulsory for a company to prepare a sustainability report. Assume you are one of the stakeholders of the MTR. Are you happy to see a **sustainability report** prepared? Explain your reasons.*

Relevant to *Business Environment - Business Ethics and Social Responsibility*



Advantages for preparation of Sustainability Report

- Increase transparency
 - ➔ opens to criticism but also sets an example of a sustainable business;
- Provide benchmarks for investors;
- Sustain its ratings on the internationally recognized indices such as DJSI ➔ attract more long-term SRI investors;
- To educate the company's employees and general public;
- Promote corporate image and goodwill.



Disadvantages for preparation of Sustainability Report

- Cost incurred to prepare the report
- Will stakeholders really spend time on studying the details?



Case Question

The MTR's two main operating areas are railway operations and property development. Some investors classify MTR as a public utility company (with a constant dividend) while others classify it as a property development company.

REQUIRED

Which of the classifications is correct? Why? Please explain your reason with reference to the financial data of MTR Corp.

Relevant to *Financial Analysis of Financial Management*



Financial Analysis

	Railway Operations and Related Activities		Property Developments	
	2007	2006	2007	2006
Return on assets (%)	2.85% (\$3,839 / \$134,561)	3.03% (\$3,156 / \$104,173)	47.41% (\$8,304 / \$17,517)	43.77% (\$5,817 / \$13,291)
Assets / Total assets (%)	86.43% (\$134,561 / \$155,668)	86.51% (\$104,173 / \$120,421)	11.25% (\$17,517 / \$155,668)	11.04% (\$13,291 / \$120,421)

- No conclusion from the above analysis
- Need more information before we decided

Financial Analysis (cont'd)

According to Note 17 “Segmental Information” in the Annual Report (p.158):

	Railway Operations and Related Activities		Property Developments	
	2007	2006	2007	2006
Operating profit	\$million	\$million	\$million	\$million
	3,839	\$3,156	8,304	5,817
Weighting	32%	35%	68%	65%

- Property developments accounted for > 60% of the operating profit.
- MTR should be classified as a **property development company**.



Case Question

You are required to prepare an annual report survey by reading the MTR's annual report for the year ended 31 December 2007 and compiling a ***Ratio Analysis Report*** with reference to a comparable local listed company as given.

Relevant to Basic Ratio Analysis



Ratio Analysis Report

Profitability

Ratio	MTR	A comparable local listed company	Interpretation and limitations
Net profit margin	>	29%	Efficiency of cost control and marketing policy
ROCE	<	12.5%	Efficiency of overall management efficiency



Ratio Analysis Report (cont'd)

Liquidity and Debt Management

	MTR	A comparable local listed company	Interpretation and limitations
Current ratio	<	1.8:1	Liquidity position
Interest Cover	<	12 times	Ability to make further loan
Total debt to equity	>	28.4%	Check whether the amount of borrowing is within the safe margin



Ratio Analysis Report (cont'd)

Asset Management

Ratio	MTR	A comparable local listed company	Interpretation and limitations
Debtors ratio (days)	<	75 days	Efficiency of credit control
Fixed assets turnover	=	0.08	Efficiency of fixed assets management



Ratio Analysis Report (cont'd)

Investment Appraisal

	MTR	A comparable local listed company	Interpretation and limitations
Earnings per share	>	\$2.59	The profitability in terms of ordinary shares holding
PE ratio (based on the market price on 30 Sept 2008)	>	3.26 times	The market confidence towards the future development of the company
Dividend cover	=	6 times	The trend of future dividends

Remarks: Gross profit margin: 55.3%



Case Question

You are required to prepare an annual report survey by reading the MTR's annual report for the year ended 31 December 2007 and compiling a ***Ratio Analysis Report*** with reference to a comparable local listed company as given.

You are also required to compile a ***SWOT Analysis Report*** based on your ratio interpretation and the significant events presented in the directors' reports.

Relevant to *Business Management*



SWOT Analysis Report

Area of concern	Descriptions
Strengths	Monopolistic power and good brand
Weaknesses	Bureaucratic organization and excess assets
Opportunities	New markets and new products
Threats	Economic downturn and competition



Case Question

The merger between the MTR and the Kowloon-Canton Railway Corporation was completed on 2 December 2007. Synergy is often given as the prime reason for a merger to be implemented.

REQUIRED

- (i) *What is the meaning of synergy?*
- (ii) *What are the synergy effects of the merger?*

Relevant to *Financial Management*



Synergy effects

- Synergy means “cooperation” and “working together”.
- Interaction of discrete agencies so that the total effect is greater than the sum of the individual effects.
- In business, it means a result from different individuals, departments, or companies working together that result in greater productivity.



The Synergy effects of the Rail-Merger

- Manage the businesses of MTR and KCRC in an integrated manner.
- Both cost and revenue will synergize in a number of areas:
 - I) *Property Business*
 - II) *Transaction structure*
 - III) *Stakeholders*



I) Benefits to the Property Business

- Key success ingredients: Rail-and-property model.
- Economic benefits of the Property Package:
 - *Increased land bank*
 - *Increase recurrent income from the investment property portfolio management businesses.*
 - *Act as development agent for West Rail property developments.*



II. Benefits of Rail Merger Transaction Structure

- Acquire the rights to operate KCRC System and related assets.
- Cash flow, earnings enhancement and financing flexibility.
- The annual variable payment structure offers protection against future adverse changes in patronage and fares of the KCRC System.
- Payment structure (an up-front payment and annual fixed and variable payments)
 - MTR is not required to pay a large upfront amount.



II. Benefits of Rail Merger Transaction Structure (*cont'd*)

- A significant portion of the transaction consideration (i.e. The Fixed and Variable Annual Payments) can be funded through the yearly operating revenue
-> enhances cash flow and earning during initial years.
- Increases recurrent profitability and enhances the long term sustainability.
- Provide a platform for the sustainable development of HK's public transportation services.



III. Benefits to stakeholders

Labour Cost Savings

- A bigger pool of experienced employees is available for business requirements.
- An overall staffing synergy of 650-700 in number
-> direct cost savings.

Increased Employment Opportunities

- > 1,300 vacancies will be created in the first three years.

For customers

- Fare reduction
- Better integration of rail network in HK



Case Question

From page 58 of the Annual Report 2007, we are told that the MTR has a massive expansion plan in both local and international markets. Proposed projects include Tseung Kwan O South, South Island Line (East) and projects overseas. The company will need to raise further capital to finance the business.

Supposed that on 1 January 2008 the MTR's directors intended to raise a further \$4 billion in addition to the \$10 billion syndicated local facility signed in October 2007 mentioned on page 79. It is believed that operating profit will, thus, increase by \$320 million per year for the foreseeable future. There are three possible methods of raising the \$4 billion:

- a. *a rights issue of ordinary shares at \$4.50 each*
- b. *issuing new 4% preference shares with a nominal value of \$1 at \$5.20 each*
- c. *issuing 5% debentures with \$100 nominal value at \$90*

REQUIRED

Suggest **why the MTR chose the syndicated loan option** instead of the other forms of finance available in raising the \$10 billion. **In raising the additional \$4 billion, please suggest the most appropriate option and why.**

Relevant to *Financial Management* - Source of Financing



Possible reasons for choosing syndicated loan

- More chance of success
- Can offer hefty sum
- Better term and other acceptable reasons



The most appropriate method of raising \$4 billion

a: Right issue

	\$m	\$m
Dr Bank	4,500	
Cr Ordinary Share Capital		1,000
Cr Share Premium		3,500

As there will be more number of ordinary shares, the earnings per share will probably drop.

b: Issue of preference share

	\$m	\$m
Dr Bank	4,500	
Cr Preference Share Capital		1,500
Cr Share Premium		3,000

As there will be no change in the number of ordinary shares, the earnings per share will not change.



The most appropriate method of raising \$4 billion (cont'd)

c. Issue of debentures

	\$m	\$m
Dr Bank	4500	
Cr Debenture discount	500	
Cr Debentures		5000

As there will be heavy burdens of debenture interest, the earnings per share will probably drop.

Suggested Method

Issue of preference shares - the cost of financing with the least change of earnings per share.



Case Question

On page 147 of the Annual Report 2007, we are told that the MTR's business development expenses relate mainly to studies on business opportunities in mainland China and Europe, in line with the company's business strategy.

REQUIRED:

Discuss the significance of the MTR's development expenses and the implications of its ups and downs to MTR's operating prospects.

Relevant to *Financial Accounting*



The significance of the MTR's development expenses

- Equip the firm to cope with ever increasing competition
- Enable the firm to improve the quality of services
- Improve the capacity for making innovation
- Facilitate better resources utilization



Case Question

MTR may have benefited from the integration of two railway networks and secured a higher market share in franchised public transport. However, current problems include reorganization of the company's structure, rearrangement of resources and further challenges in this period of global economic hardship. You therefore need to draft the Business Policy Blue Print for MTR, with reference to the following areas, as a guide for its sustained growth.

	Proposed Business Policy
Product	
Marketing	
Financial	
Human Resources Management	

Relevant to *Business Management (Financial Management, HRM and Marketing Management)*



Case Question

Along with expansion, decentralization of the MTR seems to be inevitable if management efficiency is not to be adversely affected. One danger of decentralization is that managers may use their decision-making freedom to make decisions that are not in the best interests of the overall company (these are so-called dysfunctional decisions). To redress this problem, senior managers generally introduce performance measurement systems to ensure – among other things – that decisions made by junior managers are in the best interests of the MTR as a whole.

REQUIRED

(i) Profit before tax in the MTR's income statements is a leading performance indicator. What **other performance measurement indicators** would you suggest?

Relevant to *Business Management (Capital Investment Appraisal, Working Capital Management, Development of a Quality Workforce, Marketing Research)*



Performance Indicators

i) Competitiveness

- Comparison with other forms of transport:
 - percentage of seats/capacity occupied
 - average service delay at peak times
 - Market share

ii) Quality of service

- Mystery shoppers
- Number of weekly customers
- Number of complementary letters & complaints letters



Performance Indicators (cont'd)

iii) Innovation / flexibility

- Expertise of staff and their ability to perform multi-skill activities
- New service package e.g. special package to Disneyland.

iv) Resource utilization

- No. of employees per customer served
- % of seats occupied at peak and non-peak times
- Idle time and annual operation hours with no customers



Case Question

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REQUIRED

- (i) Profit before tax in the MTR's income statements is a leading performance indicator. What other performance measurement indicators would you suggest?
- (ii) What particular performance measurement indicators would you add in view of the assumed social responsibilities of a franchised public transport operator?**

Relevant to *Business Management (Capital Investment Appraisal, Working Capital Management, Development of a Quality Workforce, Marketing Research)*



Areas of Interest

- How does the company deal with suppliers?
- How does the company treat employees?
- How does the company work with local community?
- How does the company response to environment concern?



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Q & A Session



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