Unseen case material

In 2022, the CAPL successfully launched a new premium brand of essential oil. CAPL now considering plans put forward by the Marketing Manager to launch the full range of essential oils in France, priced in euro (EUR).

The launch is planned for 1st January 2023.

It is well known within the industry that it can be very difficult for a foreign company to break into the French market for essential oil because there is significant loyalty towards local French brands and imported Swiss and Belgian brands. Initial market research based on free tasting sessions has met with an encouraging response but there is still some uncertainty over the success of the launch. However, the greatest danger to the success of brand in France is considered to be the risk that another company might launch a similar range of products in the same market.

Financial data for the project

To date, Rs. 0.5 million has been spent on initial market research for the products in the French market. If the project is approved, an additional Rs. 2.0 million will be required for detailed market research and packaging design. The cost of the launch itself includes an expensive radio and television advertising campaign in France and is expected to be of the order of Rs. 1.0 million. Both of these costs are tax deductible.

In addition, EUR 1.0 million will be spent on a distribution centre in France. All of these one-off costs are payable on 1st January 2023.

Estimates of net operating cash flows for the project vary considerably according to assumptions made regarding consumer and competitor reaction to the launch of the brand in France.

Forecast cash flow figures for the sales revenue and associated costs for the project for the year ending 31st December 2023 have been estimated based on two possible outcomes, known as Scenario A and Scenario B.

The forecasts are:

Forecast operating cash flow figures for the year ending 31 December 2023

Scenario A:

Sales revenue EUR 3 million

Costs EUR 0.5 million plus Rs. 2.0 million

Scenario B:

Sales revenue EUR 1 million

Costs EUR 0.5 million plus Rs. 1.5 million

All operating cash flows shown above are expected to grow by 5% per annum in subsequent years for the duration of the project.

It can be assumed that if Scenario A occurs in 2023, it will also occur in all subsequent years. The same is true for Scenario B. It is estimated that there is a 70% probability of occurrence of Scenario A and a 30% probability of Scenario B.

Other relevant financial information:

- The CAPL evaluates projects of this nature at a risk-adjusted after-tax discount rate of 15% over a four year period.
- The proposed new distribution centre to be built in France is expected to have a residual value of EUR 0.6 million after four years.
- Corporate income tax is charged at 35% on taxable profits and is paid at the end of the year in which the taxable profit arises. Tax depreciation allowances are available on all capital expenditure associated with the project at a rate of 100%.

Balancing charges will arise on any residual value. There are sufficient profits elsewhere in the group to be able to take advantage of these tax benefits or any taxable losses that occur.

- Operating cash flows should be assumed to arise at the end of the year to which they relate.
- The exchange rate is expected to be Rs. 250 = EUR 1 on 1st January 2023 and Rs. are expected to strengthen against the euro by 2% a year in each of the next four years.
- The project could be abandoned on 1st January 2024 and the distribution centre sold for an estimated EUR 0.9 million. If the project were abandoned on 1st January 2024, no further cash inflows or outflows would arise from then onwards and there would be no penalties for pulling out of the market.

Required

Assume that you are the Management Accountant of the CAPL and have been asked to write a Report addressed to the Board of the CAPL that will assist it in deciding whether or not to proceed with the proposed product launch. In your report you are required to:

(a) Ignoring the abandonment option:

(i) **Calculate** the NPV for the project as at 1st January 2023 for Scenarios A and B individually as well as the overall total expected NPV. **(13 marks)**

(ii) **Calculate** the payback period for the project for each of Scenario's A and B. **(4 marks)**

(iii) **Interpret** your results from (1)(i) and (1)(ii). **(6 marks)**

(b) **Evaluate** whether or not the project should be abandoned on 1 January 2024 if Scenario B occurs. **(8 marks)**

(c) Discuss potential risks of the product launch in France and suggest how these could be managed. **(12 marks)**

(d) **Recommend**, with reasons, whether or not to proceed with the proposed product launch on 1st January 2023. **(4 marks)**

Additional marks available for structure and presentation: **(3 marks)**

(Total = 50 marks)