Case Study – Roast Ltd

Executive summary

The report on Roast Ltd shows that the coffeemaker has potentiality in the market to grow as the UK market is thriving with profound players. Roast has financial soundness, though there are certain issues that need to be attained and with time, it will yield suitable outcomes. Its Bulgarian project has started yielding positive results and the Italian project is about to start soon. Thus Starbucks will be utterly benefitted if it acquires a growing company and able to exploit its targeted market, supply value chain, and marketing capabilities. Roast has huge potentiality in the market and acting as a subsidiary of Starbucks, it is poised to grow with leaps and bounds.

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PART 1: INDUSTRY REVIEW

- As per the statistics of the British Coffee Association, the Britons gulped around 95 million cuppa daily in 2018 (British Coffee Association, 2018).
- Currently, there are about 13,450 café and coffee shops in the UK employing 90,877 personnel.
- The leading coffee houses in the country are Costa Ltd, Starbucks Coffee (UK), Pret A Manger (Europe), and the Nero Group Ltd.
- In 2018, the coffee and tea processing segment in the UK generated a revenue worth £2.1 billion contributing £661 million to the UK GDP (Ibisworld, 2021).
- In 2018, the UK coffee houses sold 28,572 tons of roasted coffee for worth £210 million.
- The numbers show that coffee drinking is catching up with the fellow Britons but the impact of COVID has interrupted the industry growth substantially.
- Then there is the uncertainty of Brexit that shook the confidence of the businesses and consumers fairly (British Coffee Association, 2018). This is because VAT and import duty to be imposed on the coffee products raising its price.
- Sustainability is a raging issue as there are instances of poor employment laws and inefficiency in law enforcement to provide proper treatment to the coffee producers in the East African farms.

PART 2: BUSINESS PERFORMANCE ANALYSIS

This section explores the financial performance of the targeted company, Roast Ltd by going through its financial statement for two consecutive periods, 2017 and 2018. For this, the income statement, statement of financial position, and the cash flow statement of the targeted firm will be evaluated.

2.1 Statement of Profit or Loss

The income statement of Roast Ltd will be analysed by determining various profitability ratios to understand its business performance. There are several profitability elements like gross margin, operating margin, net margin, ROE, ROA, and ROCE will be determined.

Gross Margin

Gross margin = Gross profit / Sales revenue

Gross margin depicts the financial health of the business as it shows the level of profitability after deduction of the cost of sales from the organisational revenue (Warren & Jones, 2018). In this case, Roast Ltd had a gross margin of 25.57% in 2017 while it is 21.47% in 2018. It indicates a decline in gross margin in 2018 despite having a higher revenue worth £2.53 million against £2.02 million in 2017. But Roast experienced a higher cost of sales in the current year amounting £1.99 million whereas in the last year, it was £1.50 million. It is the incapability of the organisation to control the cost of sales that it could not retain the requisite profitability despite having a higher revenue than the last year (Brewer, 2017).

Operating margin

Operating margin is a crucial juncture for the business to understand the influence of operations in retaining profitability after expending the requisite business operations (Maynard, 2017). The operating margin for Roast stands as 5.01% in 2018 while in 2017, it was 2.52%. The ratio indicates that in the current year, the coffeemaker has been able to control the business operations quite tactfully to deliver a better outcome. Though there were no such huge differences in the operating expenses in both the years as in 2017, it was £466,000 while in 2018, it was £477,000 as the figure increased by £11,000. But in 2018, Roast managed to generate an operating income

of £60,000 presumably from its Bulgarian operations that gave the firm an edge in the current year to retain a better profitability.

Operating margin = Operating profit / Sales revenue

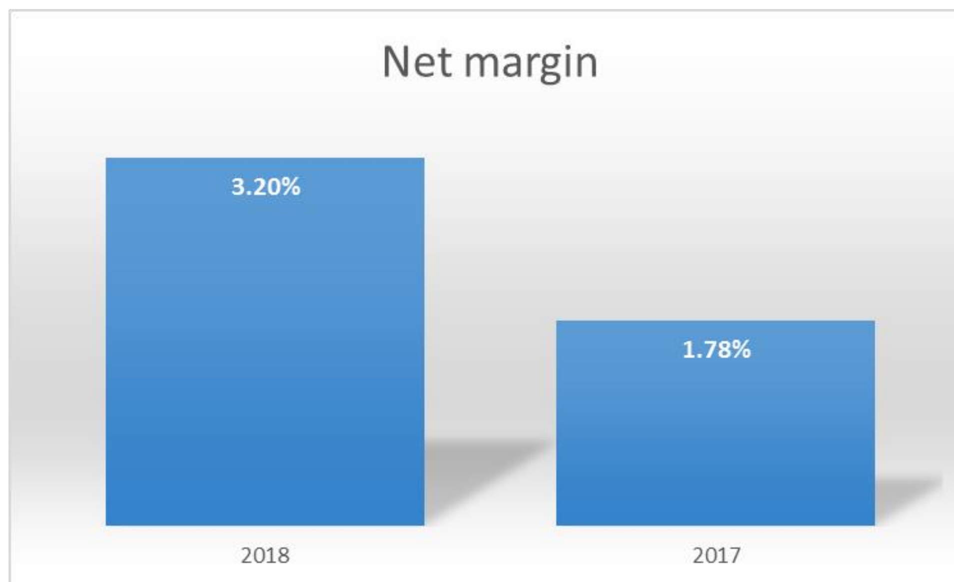
Pre-tax margin

Pre-tax margin = Pre-tax profit / Sales revenue

Pre-tax margin is the profitability level determining the profitability the firm is able to retain before considering the taxes and how much it incurs the finance costs (Wild, et al., 2018). The pre-tax

margin for Roast was 2.23% in 2017 which increased to 3.99% in 2018. This is despite the fact that in 2017, it incurred a finance cost of £6,000 which increased to £26,000 in 2018. So by retaining a higher figure in the current year, Roast establishes its operating efficiency to retain a higher profitability despite incurring a higher interest costs to run the business.

Net margin

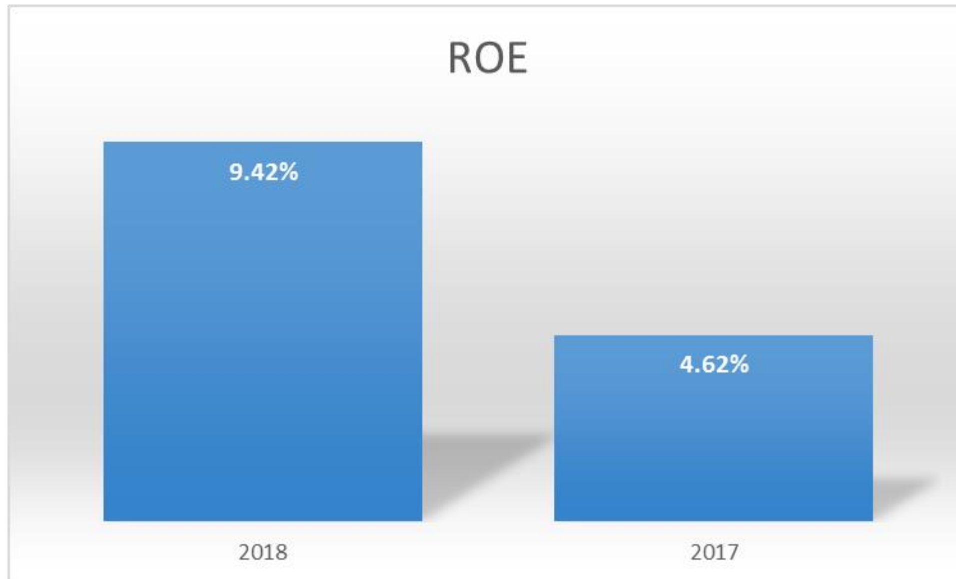


Net margin = Net profit / Sales revenue

Net margin shows the profitability that the firm can retain after expending all sorts of business expenses and costs and higher the figure, it is better for the company (Ameen, et al., 2018). In 2017, Roast earned a net margin of 1.78% which increased to 3.2% in 2018. The net margin in 2018 is a good indication that the business has been able to enhance its revenue despite experiencing an increase in its various costs raising the hopes of the investors.

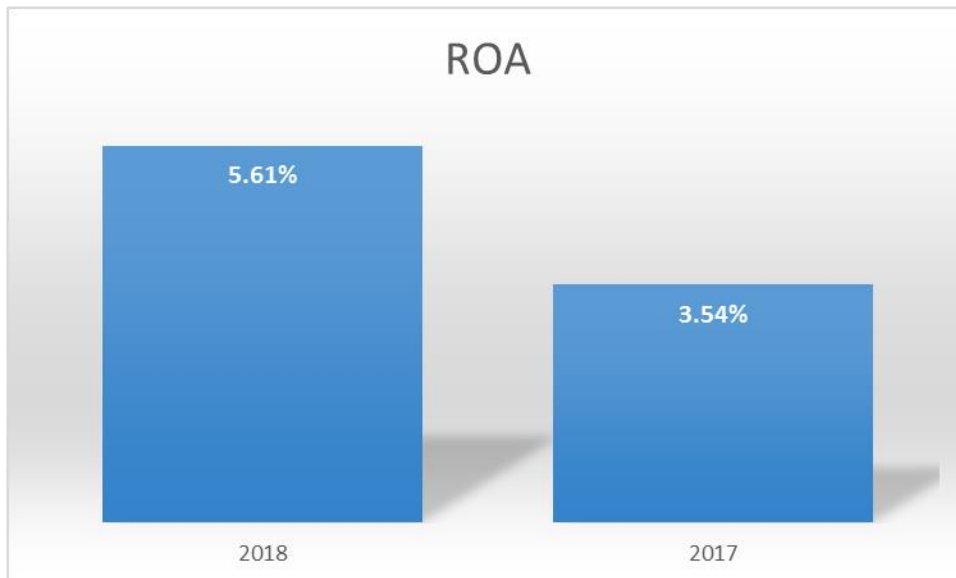
Return on equity

Return on equity (ROE) determines the organisational capability to deliver a better return to the investors based on their respective investment (Granlund & Lukka, 2017). In 2018, the ROE of Roast has been derived as 9.42% whereas in the last year it was 4.62%. It is assumed that higher the ROE, it is better for the corporation to deliver a better return to satisfy the investors. The phenomenon will encourage them to invest more in the business for a better return (Lins, et al., 2017).



Return on equity = Net profit / Total equity

Return on assets

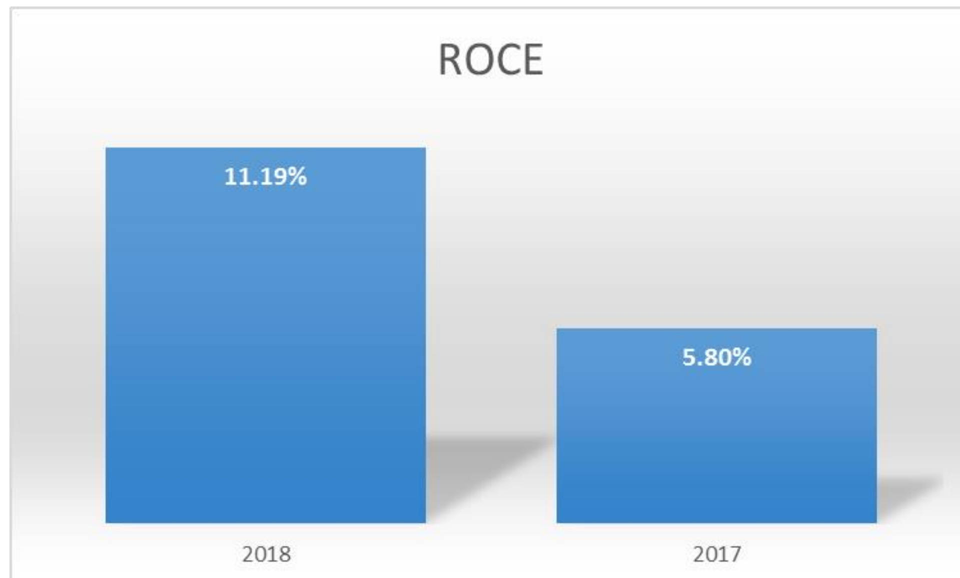


Return on assets = Net profit / Total assets

Through return on assets (ROA), the organisational efficiency is determined how the assets are exploited to generate a suitable return (Shapiro & Hanouna, 2019). 2018 experienced a higher ROA with 5.61% against 3.54% in 2017. It is assumed that if the mangers in the firm is able to exploit the resources efficiently, it can yield a better profitability and higher the figure, it is better for Roast (Lukason & Camacho-Miñano, 2019).

Return on capital employed

Return on capital employed (ROCE) determines the organisational profitability and efficiency simultaneously. ROCE is an important determinant when the analysts try to figure out the capital efficiency in generating a suitable profitability (Cooper, et al., 2017). Roast managed to derive a ROCE of 5.80% in 2017 and 11.19% in 2018 showcasing the increasing capability of the firm to generate a suitable profitability.



Return on capital employed = Operating profit / Capital employed

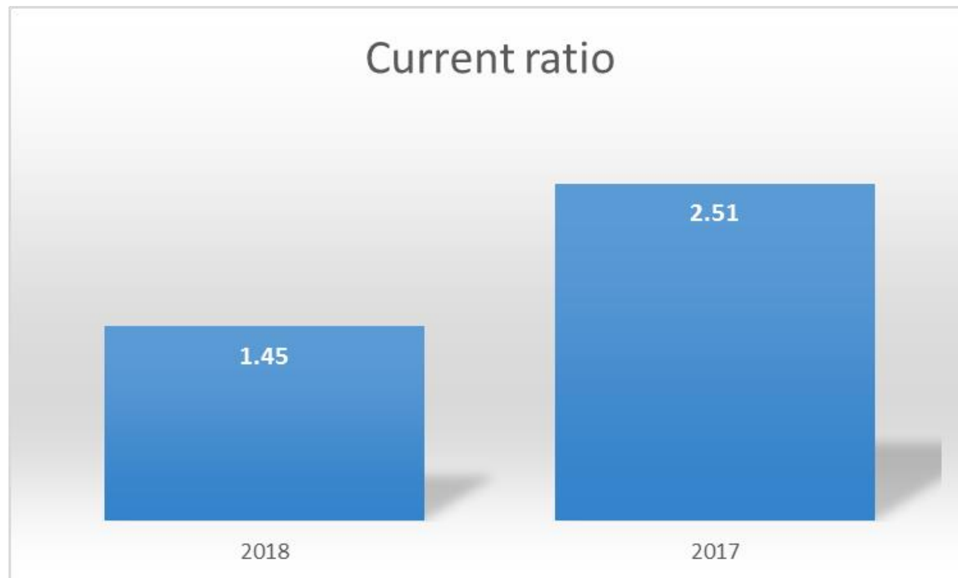
2.2 Statement of Financial Position

In this section, the balance sheet of Roast Ltd will be evaluated for the two consecutive years, 2018 and 2017. It will help to understand the financial position of the coffeemaker in terms of liquidity, solvency, efficiency, and leverage.

Current ratio

Current ratio determines the liquidity aspect of the business. It is to see how well the firm is prepared to meet the business obligations that may rise within a short period, say within a year (Kim, et al., 2018). Roast earned a current ratio of 1.45 in 2018 while in 2017 it was 2.51 showing a decline in the liquidity level. It is noted that Roast still holds a current ratio of 1.45 and the figure

is not dismal to ensure protection from sorts of bankruptcy risks. It is better to exploit the resources rather than keeping it idle to meet unforeseen events (Lukason & Camacho-Miñano, 2019). So Roast has undertaken a good decision in marginalising its liquidity and the same will be adequate to preserve the desired organisational liquidity.



Current ratio = Current assets / Current liabilities

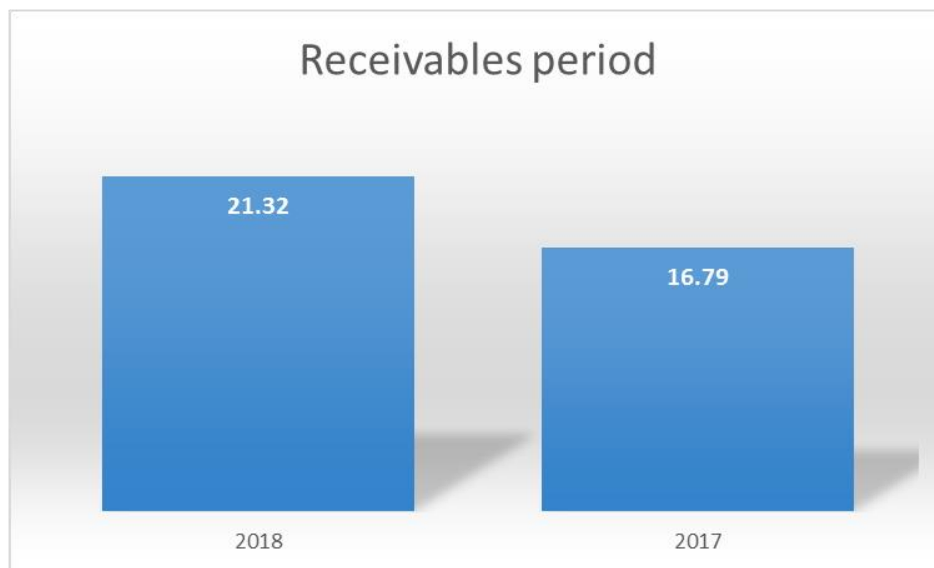
Inventory turnover

Inventory turnover = Cost of sales / Inventory

Inventory turnover depicts the frequency of the ordering and replacement of the inventories for the particular period (Potter, et al., 2019). Roast got an inventory turnover of 6.66 in 2018 while it was a whopping 12.54 in 2017. A higher inventory turnover is generally expected but the lower inventory may indicate that Roast has stored adequate inventory to address its higher demand in the market (Granlund & Lukka, 2017). Roast possessed inventories worth £120,000 in 2017 which tripled to £299,000 in 2018. The phenomenon led to a greater sales and possess the capacity to address the growing demands in the market.

Receivables period

Receivables collection period determines the number of days the firm takes to collect its dues from the market and lower the figure, it is better for the firm (Brewer, 2017). Roast managed to get a receivables collection period of 21.32 days in 2018 whereas in 2017, it was 16.79 days. It shows that the coffeemaker is giving a relaxation to its debtors in the current year but it will be better if it tries to negotiate with the customers to accelerate the payment. Roast can offer certain discounts for the targeted creditors so that they pay off quickly and uphold its collection efficiency (Cooper, et al., 2017).

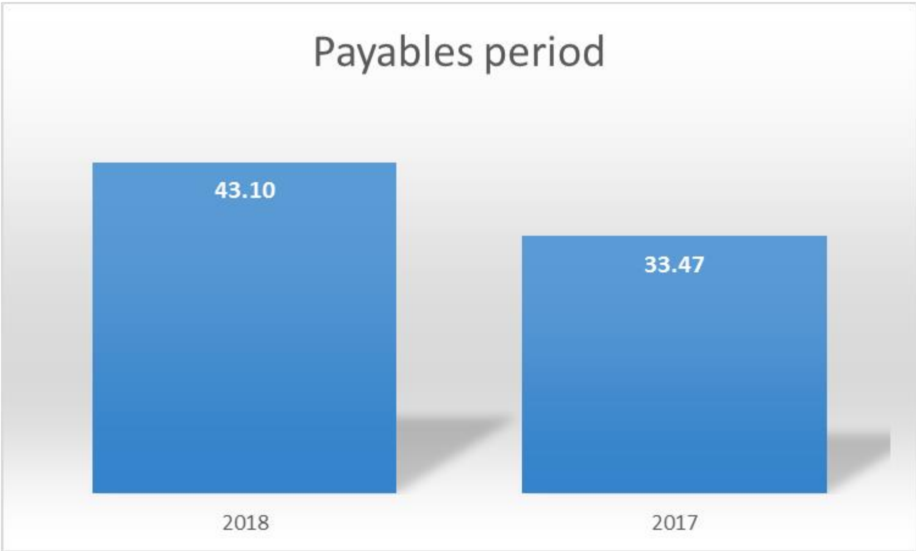


Receivables period = (Receivables / Credit sales) x 365 days

Payables period

Payables period determine how long the firm takes to pay off its suppliers and creditors in the market and longer the period, it is considered better for the firm (Wild, et al., 2018). The graph

shows that in 2017, Roast had a payables period of 33.47 days but in 2018, it attained a higher figure at 43.10 days. The businesses across considers a delay in paying off the suppliers is better as the payments can be utilised for better usage for the time being (Lins, et al., 2017). This will insist the suppliers and creditors to offer trade discounts to the firm and a scope to save from the payables account.



Payables period = (Payables / Credit purchases) x 365 days

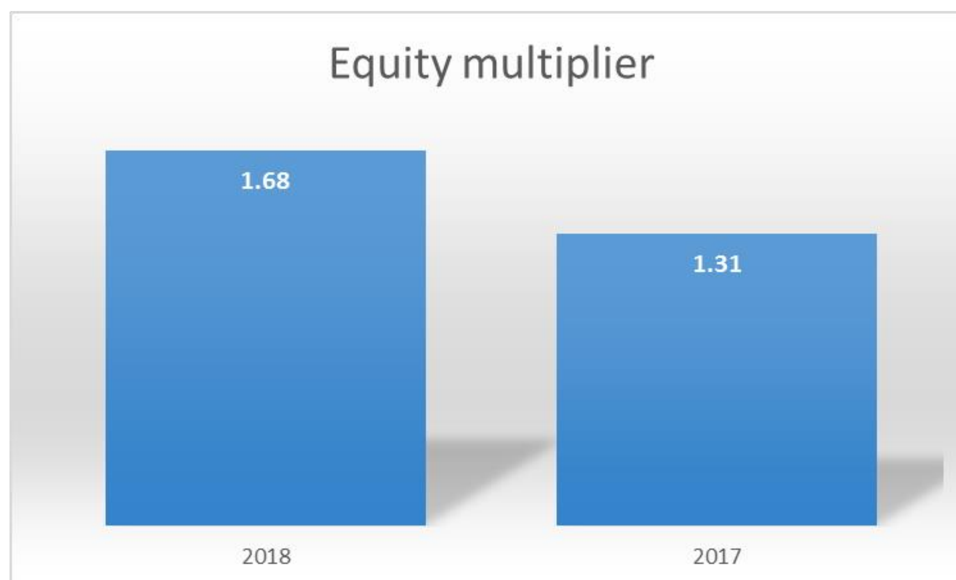
Debt/equity ratio

Debt/equity ratio = Total debts / Total equities

Debt/equity ratio indicates the proportion of debts that the organisation holds in comparison to its equity holdings (Shapiro & Hanouna, 2019). Roast got a debt/equity ratio of 0.68 in 2018 and 0.31 in 2017. A lower debt/equity ratio is desirable as higher the debts, it raises the business risk. In this case, the debt/equity ratio has been raised in 2018 may be to address the growing needs of the business. It is always desirable for the firm to maintain a suitable capital structure rather than focusing too much either on debts or equities (Cooper, et al., 2017).

Equity multiplier

Equity multiplier can be perceived as a risk indicator to the organisation measuring the proportion of assets that has been financed using the organisational equities rather than debts (Lins, et al., 2017). Roast has a comparatively lower equity multiplier with 1.31 in 2017 which slightly increased to 1.68 in 2018. A lower figure indicates that the organisation do not have much dependence on debts which is a good indicator (Kim, et al., 2018). It is because higher dependence on debts will take away the decision making power of the business which will be shifted to the debtors looking for their interest rather than organisational interest.



Equity multiplier = Total assets / Total equity

2.3 Statement of Cash Flows

Analysis

The cash flow statement generally depicts the summary of the cash and cash equivalents for the organisation for the scheduled period. Herein, the cash flow statement for 2018 of Roast Ltd is presented showing the operating profit worth £127,000. It is followed by a series of adjustments concerning cash flows from operating activities, investing activities, and financing activities.

Cash flow from operating activities show that Roast has been able to generate cash resources worth £22,000 from its business operations. This has been achieved after having an adjustment of £32,000 for depreciation alongside subsequent adjustments for inventories, receivables, and payables. Notable transactions are the interests and taxes paid showing respective amount of £26,000 and £20,000. So from the analysts' perception, cash flow activities from business operations is crucial as it shows how much the organisation incurs as finance costs against the loans generated (Maynard, 2017). Similarly, it shows the amount of tax to be paid for the purpose. From the statement, it is clear that Roast has not paid any dividend to its shareholders in the current year arriving at a negative balance of £24,000.

Cash flow from investing activities is important as it depicts how much cash resources has been expended as investment. The cash flow statement shows that in 2018, Roast purchased fixed assets worth £358,000 which is a long-term investment undertaken to raise the operational efficiency (Warren & Jones, 2018).

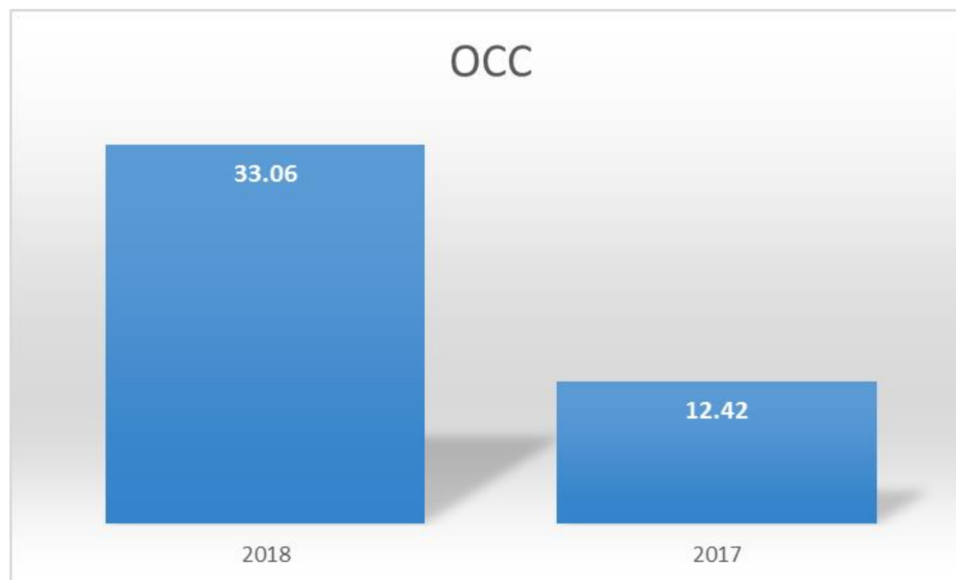
Lastly, there is the cash flow from financing activities showing that Roast has raised a long-term loan in the current year amounting to £175,000. This particular amount will enable Roast to carry out its upcoming project in Italy amidst substantial fanfare. This brings the current decrease of cash resources for £207,000 with a negative cash balance of £73,000. This is due to the fact that the cash resources has been used extensively to run the business operations of Roast to better its outcome.

Dividend policy of Roast Ltd

From the cash flow statement, it is clear that Roast has not declared any dividends in 2018. Dividends are generally issued considering the fact that a portion of profitability will be distributed among the shareholders as rewards for their investment (Potter, et al., 2019). In 2018, Roast did

not declared any dividends while in 2017, dividends worth £30,000 were distributed among the shareholders. It is assumed that Roast has withhold the dividends despite earning a higher revenue in the current year. It is because it is too engaged with the upcoming Italian project and save every worth as much as possible to deliver better returns to the investors in future (Ameen, et al., 2018). So the decision of Roast to avoid the dividend payment in the current year cannot be considered a bad idea in the current context.

Operating cash cycle



Operating cash cycle = Inventory days + Receivable days – Payable days

Operating cash cycle (OCC) is also known as the working capital cycle or the cash conversion cycle. It determines the gap of days between payment of the suppliers and receipt from cash sales and having a lower number of days is desirable (Shapiro & Hanouna, 2019). But in this case, Roast has an OCC of 12.42 days in 2017 against 33.06 days in 2018. It shows that the figure in the last year was better but in recent times, there are gaps in its payment to suppliers and receipt from customers has widened in comparison to the last year (Brewer, 2017). Roast need to accelerate its collection mechanism which is suffering in the current phase.

Part 3: Investment appraisal

In this segment, a proper investment appraisal will be carried out as Roast Ltd is planning to expand its business operations to the Italian shores. This segment has two broad sections such as management forecast on the business activities of Roast alongside the investment appraisal of the upcoming Italian project. Another segment is to suggest two alternative ways of finance that can be utilised for the coffeemaker to pursue the investment project in Italy.

3.1a Management Forecast

The UK coffee industry is growing and so does the business of Roast Ltd. The management forecasts reveal that with passage of time, the firm will be able to garner positive cash flows a sharp contrast from the current year's figure (Bekaert & Hodrick, 2017). The ratio analysis extracted from the financial statements of the organisation reveal that the organisational efficiency is declining in various aspects. For instance, it is not able to collect its dues from the market efficiently. But the Roast management is positive about the fact that things are turning for the better and since the firm is undergoing an overhaul, there are certain gaps. A reconstruction phase is undergoing as the firm is coming up with its Italian project and trying to save costs to survive in the dynamic market.

3.1b Investment Appraisal Techniques

Payback Period

Payback period stands for the approximate time undertaken by the project to recover the investment cost and sooner the break-even point is achieved, the project seems feasible (Warren & Jones, 2018). The Bulgarian project of Roast shows that it has a payback period of 4 years and it has been achieved before the 5-years term.

Advantages and disadvantages –

The advantage of payback period lies in the fact that it is simplistic to derive, draws a quick solution, and useful in uncertain times (Brewer, 2017). But payback period is too simplistic to derive ignoring the concept of time value of money, and ignores the profitability aspect.

Accounting Rate of Return

Accounting rate of return (ARR) shows the proportion rate of return anticipated on the business investment as compared to the initial capital cost (Ameen, et al., 2018). Roast achieved an ARR of 18% from its Bulgarian project drawing an encouraging picture.

Advantages and disadvantages –

ARR considers the total profitability over the economic life of the project satisfying the owner's interest to earn a suitable return. It is useful to determine the current performance of the business but it is not as effective as other profitability determinants like ROCE (Maynard, 2017). ARR ignores the time value of money and cannot extract the fair rate of return.

Net Present Value

Net present value (NPV) is an essential metric to understand the investment profitability in the upcoming future considering the cash flows (Wild, et al., 2018). The Bulgarian project of Roast earned a NPV of £110,000 showing its viability to undertake such a project.

Advantages and disadvantages –

NPV is the most crucial determinant of capital budgeting and only the project with a positive NPV will be accepted (Bekaert & Hodrick, 2017). So it is quite effective for an efficient business decision and considers the time value of money but there is ambiguity as a suitable cost of capital cannot be derived suitably.

3.2 Source of Finance

Roast Ltd to pursue the Italian project requires fund worth £400,000. It has applied for a bank loan but the bank manager does not seem to approve the loan pointing out certain discrepancies with the organisation. So the firm is thinking about alternative source of finance like venture capital or issuing equity shares.

Venture capital

It is a kind of private equity financing that is provided to firms like Roast having higher potential for growth in the market (Cooper, et al., 2017). Venture capitalists support the business for a long

term and can be in form of well-off investors, investment banking firms, or any acclaimed financial institutions.

Advantages and disadvantages –

Venture capitalists are trustworthy as they not only provide the requisite capital but will also guide Roast to chart out an effective roadmap to attain success in the Italian market (Granlund & Lukka, 2017). The venture capitalists are well-connected in the industry which can be rightly utilised by the business to grow its operations in the thriving Italian diaspora.

Contrarily, venture capitalists can be expensive to the business as it attracts higher fees for its guidance and networking in the market. The ownership gets diluted as they tend to extract a higher profitability to satisfy their quest that may lead to undervaluation of the firm (Potter, et al., 2019).

Equity capital

Equity capital serves as a long term capital to the firm and raised by issuing shares of the company in the market. Equity capital plays a significant role in contributing capital to the company and a crucial component of the organisational capital structure (Lins, et al., 2017).

Advantages and disadvantages –

Equity capital does not need to be repaid or interest to be paid as the equity holders become owners of the company. Since the capital is for a long term, it can be used to pursue the various business activities as it is not scheduled to be repaid unless liquidation of the company (Bekaert & Hodrick, 2017).

Equity capital dilutes the ownership and control aspect as the shareholders number increases and tries to influence the business decision that may not be favourable at times (Kim, et al., 2018). Though it is a preferable mode of finance, it is quite expensive and time consuming to rise equity capital.

Going by the evaluation, it is highly recommended that venture capitalists ought to be adopted as it will provide capital and guidance to the business for its rightful growth.

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