Part (a) Calculate the estimated impact on DMG's budgeted EBIT and profitability margins in FY2019 if 60 000 of the 750ml bottles of DMG gin are sold through YuppieDrinks.com		Marks
Does DMG have sufficient production capacity?		
Annual production hours = 2 200		
= [2 200/8 x 300]/0,75 = 110 000 bottles less 40 000 budgeted = 70 000 available for YupD contract and free samples		2
	R	
Revenue (60 000 x R189)	11 340 000	1
Raw material costs (R39,80 x 60 000)	(2 388 000)	1
Other direct production costs (R27,86 x 60 000)	(1 671 600)	1
Indirect manufacturing overheads	(935 000)	0.5
Gross profit	6 345 400	
Advertising and promotional expenses	(500 000)	0.5
Sales commission (20% x 11 340 000)	(2 268 000)	1C
Distribution costs	(300 000)	0.5
YupD subscription costs (12 x R15 000)	(180 000)	1
Incremental EBIT	3 097 400	0.5P
Profitability margins – before		1
Gross profit margin	47,5%	
EBIT/revenue	7,1%	
Profitability margins – after		1C
Gross profit margin (increase by 5 percentage points)	52,5%	
EBIT/revenue (increase by 12 percentage points)	19,0%	
	Available and maximum	**11**
	Total for part (a)	**11**

Part (b)	Describe the key factors DMG needs to consider in pursuing the supply arrangement with YupD	Marks
1	**Production capacity**	
1.1	DMG's maximum production capacity is 110 000 bottles annually as calculated in part (a). Would the 10 000 bottles be adequate to provide for the free samples?	1
1.2	If DMG accepts the YupD offer, it will be operating at near maximum capacity – is this realistic? Would it not impact the quality of the final product? What will the impact be on repairs and maintenance?	1
1.3	DMG will not be able to take on any other (potentially more lucrative) offers if this contract is taken, as it will be at close to capacity – consider any relevant opportunity costs, for example the strategic expansion into Mauritius.	1
1.4	Does DMG have sufficient resources to fund the additional investment that will be required to increase production from 40 000 to 100 000 units including the increased working capital requirements, raw materials availability etc.	1
2	**Pricing**	
2.1	The current selling price of R199 per bottle is a wholesale price. DMG will be reducing its selling price per bottle from R199 to R189. The fact that YupD want to sell direct to the public at R189 will definitely create a problem with the current business model. Will other customers insist on lower prices too?	2
2.2	In the longer term, would existing customers switch to buying online, thereby cannibalising current revenue?	1
3	**Reliance on YupD**	
3.1	Consider the long-term sustainability of YupD, especially given stiff competition from other online websites such as Takealot (with an established brand name) and monthly wine clubs.	2
3.2	Consider the strategic fit of the gin with the rest of YupD's products. Although mention is made of 8 000 products, the website mainly focuses on 'kitchen' and 'homeware' – gin does not necessarily fit into this.	1
3.3	No mention is made of whether or not YupD also sells other gins – DMG should consider what exclusivity would cost them.	1

3.4	DMG will derive the majority of its profits from YupD (R3,097m versus R0,567m previously). There is a risk that DMG will become overly dependent on YupD and place it at risk should the contract be terminated. *Alt. Entering into the agreement with YupD provides DMG with the opportunity to significantly increase its profits.*	1
3.5	There is a reputational risk of being associated with YupD – if YupD's credibility is tarnished for whatever reason, DMG could be at risk. *Alt. DMG is a new and small company who could benefit from the reputation of YupD*	1
3.6	Risk relating to annual renegotiations of the selling price – unless there are certain set standards in the contract, YupD could raise or lower the selling prices at will and DMG will have no control over the process.	1
4	**Sales commission and subscription fees**	
4.1	YupD is insisting on a 20% sales commission, which is double that paid to the independent third party and there is an additional R15 000 monthly fee. *Alt. Paying a 20% sales commission, although it is double the existing sales commission, is worth it given the increase in profits that are expected to arise from the YupD agreement.*	1
4.2	Will DMG be under pressure to pay higher commissions to current and any future sales channels?	1
5	**Accuracy of forecasts**	
5.1	How reliable are the forecast revenues and costs with regard to the YupD initiative - the increase in EBIT margin is considerable (7.1% vs 19%) and could be a result of inaccurate forecasts? The quantitative factors could lead to incorrect decisions being made.	1C
5.2	Is the demand for 60 000 bottles realistic and supported by a feasibility study, especially given that the company was only founded in 2017; the current demand is only 40 000 bottles; and there is lots of competition in the market?	2
6	**Advertising budget**	
6.1	Why does YupD need R500 000 for advertising? It will be earning more than R2,2 million in commission – surely they should invest in their own advertising of DMG products? Alternatively: what guarantees are they giving that advertising and promotions will be done / what does the contract specify (e.g. two emails per week...?)	1
7	**Contractual and regulatory considerations**	
7.1	How much would it cost DMG if it wanted to extricate itself from the contract after a year (or two)? Any penalty payments?	1
7.2	To date, DMG has sold to wholesalers and retailers and now it will be selling directly to customers (potentially individuals): DMG should consider whether there are any laws it needs to comply with or licences it needs to obtain with regard to this change in the distribution system.	1
7.3	DMG need to explore the terms of the agreement in more detail. For example, who will receive the payment from customers? If its YupD, when will it be payable to DMG? If it is DMG, when will the sales commission be paid over to YupD?	1
8	**Strategic and risk considerations**	
8.1	The shift from B2B to retail is a large change in DMG's business strategy. For example, a more complex order fulfilment and returns process will be required; distribution of smaller volumes on a more frequent basis may change the distribution and courier costs; and It may change the amount of warehouse and storage space needed, and the attendant costs.	2
8.2	DMG will be required to carry all the inventory risk and given the significant increase in production levels, inventory levels are likely to increase significantly too thereby increasing inventory risk.	1
9	**Operating leverage**	
9.1	The agreement will have a low break-even point given the relatively small increase in fixed costs in comparison with existing fixed costs and the increase in contribution per bottle.	1
	Available	**27**
	Maximum	**17**
	Communication skills – appropriate style	*1*
	Total for part (b)	**18**

Part (c) Critically discuss the recommendation made by MedSize to retain Matty from both his perspective and that of DMG		Marks
1	**Matty Williams's perspective**	
1.1	What does a three-year service agreement mean? Does it mean that the agreement terminates after three years and the parties need to renegotiate a new contract? It may be better for Matty to have an employment contract that continues until he resigns or is legally terminated by DMG.	2
1.2	What are Matty's future plans? He might not want to be locked in for three more years, e.g. if his health is failing or he is close to retirement. *Alt. The three year agreement will provide him with additional job security*	1
1.3	The three-year restraint of trade proposal would potentially be unacceptable to Matty – Matty receives no compensation for effectively agreeing not to work for three years at a competitor. There should be some form of compensation.	2
1.4	Matty could, however, view that receiving share options is adequate compensation for the restraint of trade should he intend staying on for at least three years.	1
1.5	The income tax considerations for Matty associated with the share option needs to be considered. The section 8C gain will be taxed upon vesting of the shares.	2P
1.6	The opportunity to own 10% of DMG could be enticing, but shares in a private company are generally illiquid. It is difficult to sell these due to pre-emptive provisions.	2
1.7	Matty should consider what the shares might be worth in three years' time (especially given the company's proprietary status). Potential dilution of shareholding if share options given to others	1
1.8	Having production targets as a KPI could be counter-productive for all parties. It is likely that Matty will not have control over production volumes as this is likely to be driven by sales demand. Matty should consider suggesting alternative KPI's such as product quality, awards, new products, customer recruitment etc. Production targets should rather be driven by customer demand and realistic market share. If there is limited demand for the product, then manufacturing operations would need to be scaled back.	2
1.9	Current budgeted production for FY2019 is 40 000 bottles (i.e. 120 000 bottles over the three years) before considering the YupD and the miniature bottle opportunities. Is the 200 000 target realistic?	2
1.10	Has the miniature bottle opportunity and / or Mauritius expansion been factored into the production KPI?	1
1.11	As an alternative to the propsed agreement, Matty could explore the possibility of him patenting the recipe and thereby earn royalties on the use of the patent.	1
2	**DMG perspective**	
2.1	While a three-year service agreement may suit DMG, if Matty is critical to the business then an ongoing contract would be preferable.	1
2.2	A three-year restraint would protect DMG in the event of Matty leaving the employ of the company, however the restraint of trade only applies to South Africa and Matty could go to another country such as Mauritius.	1
2.3	The enforceability of restraint of trade agreements is a complex area of law and DMG should therefore ensure that they seek legal advice when drawing up this agreement.	1
2.4	Production volumes may not be the most appropriate KPI. Surely, the KPIs should focus on what Matty can control and contribute, and aim to maximise earnings for both parties. Targets could possibly be extended to include other non-financial measures such production efficiency, meeting costing benchmarks, market share, customer satisfaction, awards, etc.); alignment with strategy (such as a number of flavour variants, innovations)	2
2.5	Product quality should also be key and therefore incorporating the KPI relating to product quality as suggested will protect DMG.	1
2.6	Matty may feel more attached to DMG if he has share options. He may behave more like an 'owner' given the potential sharing in future dividends and sale of shares, which would be to the benefit to DMG. This will assist with ensuring goal congruency between Matty and DMG.	2
2.7	DMG needs to have a succession plan in place in any event.	1
2.8	Share options are not tax deductible for DMG, whereas payments for restraints and bonuses would be.	1
2.9	Share options would dilute existing shareholders' interests.	1
2.10	Matty's skills are essential to DMG's success – the company should almost be willing to pay Matty whatever he asks.	1

2.11	The employment contract / restraint of trade should incorporate additional specifications such that the unique gin recipe belongs to DMG and that Matty is prohibited from using it after his contract with DMG expires and that Matty is prohibited from using DMG's customers contact details after he has left DMG.	1
	Available	**30**
	Maximum	**15**
	Communication skills – logical argument	*1*
	Total for part (c)	**16**

Part (d)	**Describe the key considerations, supported by calculations, DMG should take into account in determining an appropriate selling price per miniature bottle in FY2019**		**Marks**
1	**Calculations**	**R**	
	Raw material costs	420 000	1
	Other direct production costs	480 000	
	Distribution costs	75 000	
	Depreciation of new equipment	25 000	1
	Indirect manufacturing overheads	275 000	
	Incremental costs to be recovered	1 275 000	1C
	Hence average cost per unit, and therefore break-even point, before sales commission is R8,50		1
	As this only achieves break even, a profit margin should still be incorporated into the selling price		1P
2	***Other considerations***		
2.1	Sales commission would be either 10% or 20% of revenue.		1
2.2	A price comparison should be undertaken between the 750ml and 50ml bottles. Equivalent pricing would suggest a minimum price per 50ml bottle of R13,27. However, one would expect a premium for a smaller bottle.		1P
2.3	Other direct production costs per ml of 50ml bottles are significantly different to those for 750ml bottles, is this reasonable?		1
2.4	DMG might for the first year offer lower prices simply to attract more business (i.e. a price penetration strategy).		1
2.5	The current gross profit margin is between 47,5% and 52,5%, providing a useful benchmark.		1
2.6	Could the miniature bottles be seen as a marketing tool, and therefore DMG could earn lower margins on this product?		1
2.7	Consider the opportunity costs that may arise, for example any other projects DMG that the capital required could have been invested in, or the opportunity cost from forgoing savings on existing costs that might have been achieved in the long-term if the miniature bottles were not introduced.		1
2.8	Consider the long-term sustainability of the project (otherwise the ten-year write-off period used to determine the minimum/breakeven price might be inappropriate).		1
2.9	DMG should undertake proper market analysis to determine the market for the product, what prices competitors are charging, to determine whether price elasticity exists, and if they would be a price setter or taker? As the Gin is low alcohol they might be a price setter.		1
2.10	As DMG product is low alcohol they are differentiating themselves and thus don't need to differentiate by a lower price. DMG could probably adopt a premium pricing strategy and extract value from customers willing to pay a premium for perceived quality.		1
2.11	DMG should adopt a target costing approach, i.e perform market research, choose a pricing strategy and determine if they can produce at the target or less.		1
2.12	DMG should consider whether it would be able to enter into long-term contracts with e.g. hotels, and if a lower price could be offered accordingly.		1
2.13	Should any financing costs incurred as a result of the upfront costs be incorporated into the calculations? *Alt. An NPV calculation should be performed since this is a long-term pricing decision*		1
2.14	Consider using a higher packaging cost in the calculations – it seems the current supplier is unethical, and DMG might, as a result, choose not to order from PackFast despite the significant discount offered.		1
	Available		**19**
	Maximum		**8**
	Communication skills – clarity of expression		*1*
	Total for part (d)		**9**
TOTAL FOR PART I			**54**