

**Role Play**

**Surfsub:**

Role of Sarah

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You are Sarah Barker, CFO of Surfsub Surfboards Australia - a well-known indie surfboard brand that designs and manufactures eco-friendly and innovative surfboards in Queensland, Australia. Surfsub was born 7 years ago when your younger sister Francine Barker approached you with an idea for high performance, eco-friendly surfboards (Eco-Boards). Francine has always been passionate about surfing and the oceans. The worsening environmental problems and plastic pollution in the ocean greatly appalled Francine, who then began developing her ideas for sustainable surfboards in earnest. After showing you a rough prototype, Francine asked you if you would be her CFO and join her in this venture. She had spent many hours developing ergonomic design and carefully selecting organic, non-toxic materials that were biodegradable and durable as inspired by ancient Polynesian cultures.

Having just graduated with an MBA from INSEAD, you were eager to put your newly acquired management and finance skills to use. You were thinking of pivoting to doing a start-up anyway and had been wanting to start something of your own for a while. Joining Francine on this journey seemed a reasonably safe way to dabble in business development. You envisioned experimenting with this cute concept for a few months and then moving on to bigger things. Little did you anticipate just how popular the concept of sustainable surfboards would be, and you never anticipated Surfsub to become a nationwide success. The start up’s unique mission to create innovative and sustainable surfboards caught the attention of Australian surfers and quickly went viral on Australian social media for its unique angle. Since then, Surfsub’s online social media accounts have remained an interesting mixture of flamboyant, eclectic surfboard designs and eye-catching infographics raising awareness about oceanic pollution and environmentalism. Along the way, you also managed to restructure the financing of Surfsub back to its owners – your sister and you – by devesting the burdening terms and clauses that the initial seeding funds and venture capitals imposed. As a result, Surfsub is now a full-equity company, with you and Francine being the largest equity holders, equally splitting the controlling shares. What began as two sisters working in their garage has now transformed into a leading premium brand in the market for environmentally conscious surfers, raking in AUD$18.7 million in revenue over the past financial year.

Here you are, 7 years later, still working on what began as an experiment between two siblings in the garage. With business expansion came more stress and more pressure to remain profitable. The recent years have been filled with countless arguments and debates with Francine about the trade-off between minimizing cost and maximising quality. Instead of going for the option that would minimize cost and maximize profit, Francine insists on using the best organic material to make the surfboards and goes to great lengths to personally ensure that each stage of the supply chain is transparent and fair. She also ensures that each Eco-Board is subject to the highest, most rigorous standards of environmental quality. While you admire her efforts and the intention behind these high standards, you also know that with more players entering the surfboard industry, Surfsub will likely lose market share to cheaper, faster competitors in the coming years. Still, it took a tremendous amount of effort and dedication for a small start-up to break into the surfboard market and target a niche market of premium, eco-conscious surfers. In the Australian market so saturated with huge multinational companies (MNCs) that manufacture surfboards through economies of scale, it was truly a remarkable feat to make a dent in the industry.

None of this would have been possible without the hard work, commitment and in-depth involvement of you and Francine. Your sister lives and breathes surfboards and could talk about the topic for hours and hours. Surfing, the ocean and surfboards are her biggest passions in life. However, Francine tends to be too naive in matters of business finance and profitability. She has great ambitions to ‘go global’ and enter Asian markets but does not realise that given the way operations have been going, Surfsub is simply not ready to scale globally. Right now, from the point of receiving an order from customers, it takes up to a month for the surfboard to be ready for delivery. If a customized surfboard is ordered, it takes up to three months for the surfboard to reach the customer’s doorstep. It works for now with the niche segment of hippie Australian surfers who don’t mind waiting for a surfboard that reflects their values; you are not so sure it will sit well with Asian consumers. With the cutthroat competition of Asian e-commerce, you are very sure that Surfsub will lose out to bigger, faster market players who enjoy economies of scale and have much higher rates of timely order fulfilment. You are less naive than Francine and you know that there is no way Surfsub can survive the Asian market alone, much less make any kind of splash globally in the coming decade without the help of a bigger, more established player.

Imagine your relief when a Beijing-based conglomerate named BojinWaves expressed interest in buying the company out. BojinWaves is a beachwear and apparel company with a strong record for inorganic growth through acquisition of companies showing strong growth potential. In the past year, they acquired 3 companies in the following areas: beachwear, swimsuits and underwater gear. It seems logical now that they would want to acquire a surfing company, and it would be reasonable to expect potential synergies. Given their track record, it was incredibly impressive to have caught the attention of such an established multinational company (MNC). Being acquired by BojinWaves is the perfect exit strategy. You have been wanting to move on to other things for a few years now, but Francine does not seem to take the hints that you have been dropping. It felt too awkward to confront Francine about this, and being her older sister adds an uncomfortable family dynamic to any business-related matters, so you try not to rock the boat too much. Being bought over by BojinWaves provides the perfect cover for you to leave this business and move on. You are incredibly excited at the prospect of selling Surfsub for a handsome price, taking the money and investing it to create several streams of passive income. After this, you intend to retire early and spend the rest of your days in Hawaii. After all, you deserve it after an expensive MBA education and seven years spent growing a niche start-up to nationwide success.

Even if you were to disregard all personal perks of this deal, it is clear that BojinWaves could only benefit Surfsub as a company. Becoming a subsidiary of BojinWaves would greatly smooth the transition to Asian markets in multiple ways. Firstly, piggybacking on BojinWaves’s operational excellence by outsourcing manufacturing to BojinWaves’s Chinese factories will ensure faster production, greater order fulfilment, and more consistent product quality. Secondly, BojinWaves has great economies of scale to offer, which would greatly lower manufacturing costs and make for leaner operations. Surfsub could focus on designing the surfboards in Australia, manufacture them in China, and deliver it straight to Asian consumers from China. After entering the Asian market under the wing of BojinWaves, your financial projections predict an almost twofold increase in revenues in the next 3-5 years. There are many potential synergies between the two companies that would make for a successful acquisition, and you are sure that the Chinese buyers see this too.

You are not afraid to boldly sell Surfsub’s value proposition to BojinWaves to make them realise the value of this start-up to extract as much money as possible from the conglomerate. After all, Surfsub has achieved unprecedented success in the Australian market, having broken into a market saturated with MNCs as the underdog. You put in your fair share of effort to ensure this. You are determined to reach an agreement with them to sell them your company for as high a valuation as possible. In a few months, you will sell off your share of the equity for a good sum of money. It is critical to you that this deal go through-- there are no other major companies currently interested in acquiring Surfsub, and certainly none with the financial resources BojinWaves brings to the table.

Francine has previously expressed reservations about big conglomerates, citing issues like opaque supply chains and exploitation of workers along with the environmental degradation that big MNCs often contribute to. She is proud of Surfsub’s social mission and commitment to environmental sustainability. Although BojinWaves has come under fire a couple of times in recent years for toxic dye runoff in areas near their factories producing beach apparel, they have reaffirmed their commitment to sustainability and pledged to improve these processes by making several changes to their internal value chain. This is a commendable effort from an MNC, especially given the fact that these scandals barely hurt their bottom line. You believe that BojinWaves is making an earnest effort to turn towards sustainability – their intention to acquire Surfsub instead of any other surfboard company clearly reflects this motive. You are confident of Surfsub’s value proposition, both in terms of the financials as well as the aspect of sustainability.

As you prepare for this negotiation, here are some of the issues at the forefront of your mind.

1. **Avoid being undersold by showcasing Surfsub’s value proposition to BojinWaves.** Surfsub’s continued success in the Australian market is testament to the potential of this business model and you want to make sure that Surfsub is not undersold to them. There are many potential synergies that you know will be important to BojinWaves. Exhibit 1 quantifies such synergies. For this same purpose, it is also important to understand where BojinWaves stands. Exhibit 2 provides an overview of the acquirer and some information about the Chinese capital markets.
2. **Get as high a selling price for Surfsub as possible**. You aim for 10 to 20 percent gains from your valuation of the firm in your sale to BojinWaves.
3. **Exiting Surfsub**. You do not wish to commit to a leadership role within the Surfsub division after being acquired by BojinWaves. On the contrary, you would like to cash in and exit Surfsub as soon as possible after the sale.
4. **Maintain a positive relationship with your sister.** Francine is one of the closest and most important people in your life. Thus, you hope to finish this negotiation with a relationship with your sister that is as good as it has been in the past. You are less concerned with your relationships with the BojinWaves negotiators, since you intend to leave Surfsub after the acquisition.

Prepare for your meeting with Francine, then move on to the team-on-team negotiation with the BojinWaves representatives, Jiayi Zhang (M&A) and Ruiyan Peng (PR).

Exhibit 1

Quantification of the Synergies

Sources of the synergies: The potential synergies for Surfsub will arise after acquiring it. They will mainly manifest through a more streamlined production process and faster expansions into Asian markets.

Short-run Effects: After the acquisition, the synergies will help boost Surfsub’s Free Cash Flows (FCFs) in the immediate five years by:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| ***Changes* in FCF** | +585 | +606 | +627 | +641 | +652 |

where all numbers are in thousands of AUD.

Long-run impact: The synergies have long-run benefits. Specifically, from year 5 onwards, Surfsub’s annual FCFs are expected to grow at 1.8% per annum – a much higher rate than the stand-alone growth rate.

Risks involved: As the synergies mainly arise from manufacturing and expansion in the same “surfing industry,” the operation and business risks remain unchanged as what a stand-alone Surfsub faces. Consultations with experts in the industry suggests that such risks translate to a 9.3% cost of capital per annum for a typical pure-play company in surfing.

Exhibit 2

Overview of the Financials of BojinWaves

|  |
| --- |
| **BALANCE SHEET (latest fiscal year, CNY\* millions)** |
| Cash and Equivalent | 1,708 |  | Short-term Debt | 1,297 |  |
| Accounts Receivable | 2,502 |  | Accounts Payable | 1,439 |  |
| Inventories | 1,338 |  | Long-term Debt | 9,724 |  |
| PP&E | 34,335 |  | Equity Capital | 27,423 |  |
|  | 39,883 |  |  | 39,883 |  |
| **INCOME STATEMENT (latest fiscal year, CNY millions)** |
| Sales revenues | 5,410 |  |
| Cost of Goods Sold | 4,088 |  |
| Operating Expense | 934 |  |
| Operating Profit | 1,322 |  |
| Interest Expense (Profit) | 735 |  |
| Other Income Expense (Profit) | (506) |  |
| Pre-tax Income | 1,093 |  |
| Tax Expense | 273 |  |
| Net Income | 820 |  |
| **CHINESE CAPITAL MARKET DATA (latest, annualized returns)** |
| One-year T-Bill | 2.36% |  |
| Five-year T-Note | 2.92% |  |
| Ten-year T-Note | 3.08% |  |
| Chinese Corporate AAA 5-year Index | 4.11% |  |
| Chinese Corporate BBB 5-year Index | 6.50% |  |
| Expected Return of SSE Composite Index | 13.32% |  |
| Expected Return of SZSE Composite Index | 14.27% |  |
| \* CNY1 = AUD0.2 based on the current market data |

Highlights

* BojinWaves is a large conglomerate focusing on beachwear and apparel headquartered in Beijing, China. While maintaining its own brands, its recent growth and expansion are largely driven by mergers and acquisitions with domestic to international peers.
* Operation: Last year, a total revenue of CNY5.4 billion was booked, together with a record high profit margin of 28%. Moving fast with the eCommerce in China, an increasing fraction of the revenue is made from online sales from barely 1% ten years ago to 88% last year.
* Financing: BojinWaves has maintained a stable capital structure, with a (net-)debt-to-equity ratio of 1:3. Most of the debt is in the form of corporate bonds with a “Baa3” rating from Moody’s and an “BB+” from S&P. The equity shares are largely held by Chinese mutual funds, hedge funds, and banks. Industry reports forecast a 12.91% annual return for listed Chinese apparel companies featuring similar business as BojinWaves. While seemingly high, as a beta-neutral industry, the number appears reasonable when compared to the Chinese stock market returns.