



**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA**

**TOP CA CASE STUDY EXAMINATION - MAY 2013**

**THE EXAMINATION QUESTION, INSTRUCTIONS AND ADDITIONAL  
(IMPACT) INFORMATION**

**Instructions to candidates:**

- (1) **Time allowed:** 4 hours
- (2) **Marks :** 100 marks
- (3) This question paper should be answered entirely in the **ENGLISH** language.
- (4) Your answer must be submitted in the answer booklets provided at the Examination Hall.
- (5) Any pre-prepared papers included in your answer **WILL NOT** be marked.
- (6) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer.

## Updates on Aqua

The board of directors of Aqua met on several occasions in order to further deliberate the two investment proposals and the ways of raising the funds. They found that it was difficult to transfer the required amount of capital to Bangladesh as per the existing exchange control regulations in Sri Lanka. In the meantime Sanjeewa, the Managing Director (MD) of Aqua consulted Mr. Antonio in Italy at his mother's request. When Sanjeewa first communicated their ideas in brief to Mr. Antonio via an email, Mr. Antonio requested further details about Aqua's plans. Upon receiving the details, Mr. Antonio sent a reply expressing his interest in the Bangladeshi operations. According to him, the cost of production in Italy was prohibitively high especially due to the increased labour cost. There were cheap imports coming to the country from different parts of the world. Therefore, he had mentioned that it was time for him to gradually discontinue operations in Italy. He was getting progressively interested in importing quality products from overseas and distributing them using existing channels.

After several rounds of discussions, Mr. Antonio from Italy and Sanjeewa made a five day visit to Bangladesh to collect first-hand information. They visited the Board of Investment (BOI) head office in Bangladesh and other relevant institutions and collected necessary information. Aqua's partner in Bangladesh, Dhaka Electricals had organized the visit, and the business trip of the duo was very successful. Soon after their arrival in Sri Lanka and before Mr. Antonio left for Italy, Sanjeewa organized a board meeting of Aqua Ltd, and Mr. Antonio too was invited. At the board meeting Sanjeewa mentioned that most of their earlier estimates on cost of production including labour were correct. He, however, explained that there were certain conditions that need to be met in order to qualify for full BOI facilities in Bangladesh. He briefed the board regarding his major concerns. They are outlined below.

1. He highlighted the need for setting up a new manufacturing plant in Chittagong, Bangladesh instead of converting the existing assembly line to a fully-fledged factory so that the company could be eligible for most of the incentives offered by the Bangladeshi Government.
2. Further, he proposed the need for resizing the initial factory plan and implementing it stage-wise over a few years due to the exchange control restrictions that prevent taking the required capital out of Sri Lanka all at once.
3. As it is a requirement to export a minimum of 80% of production in order to qualify for the duty free import of necessary machinery to Bangladesh, he further proposed the need to run this new operation as a fully-fledged BOI project in Bangladesh.
4. According to him, there are three main routes to achieving the minimum 80% export requirement.

They are:

- a. Supplying the requirements of Mr. Antonio - this will amount to over 50% of the initial production in Bangladesh;
- b. Handing over to the BOI project the already established distribution channels of the Bangladesh assembly line; these channels are to neighbouring countries like Myanmar and India - these markets could be further developed with the cost effective operation of the proposed plant; and
- c. In case it should become difficult to achieve the 80% export requirement, dispatch the balance inventories to Sri Lanka until the export volume reaches 80% of production - this is possible due to the cost effective operations in Bangladesh.

He also mentioned that Aqua could not ignore the possibilities of penetrating to other markets due to the cost effective operations in Bangladesh. In this regard, he finally said “it's only a matter of time”.

5. Sanjeewa further stated that Aqua had to continue the export of components to the Bangladesh assembly line from Sri Lanka but in lesser volume as the new operation in Bangladesh would be taking over the exports volume due to the clear advantage coming from tax free operations. Also, he mentioned that any local sales out of BOI operations would be subject to tax in Bangladesh. As local sales could not exceed 20% of BOI production, he pointed out the need for continuation of the Bangladeshi assembly line.
6. As Bangladeshi assembly line operations will have to be curtailed when the BOI factory starts to function, he explained that the superfluous employees could be moved to the new BOI plant. Further, he pointed out the need for sending a few trained employees from Sri Lanka to Bangladesh initially.
7. He assured that no employees in the current Sri Lankan plant would lose their jobs due to the reduced exports to Bangladesh, as they could be employed in Aqua's planned new operations in Sri Lanka.
8. At the meeting, Mr. Antonio explained the problem he was confronting in Italy. According to him, the European Union policies encourage imports from Bangladesh to the Union. He further said “As I have decided to divest myself of my Italian operations I see this as an opportunity for me.” Also he inquired as to how Sanjeewa was planning to take the required capital to Bangladesh under the existing restrictions in Sri Lanka for capital transfers.
9. Replying to Mr. Antonio's query, Sanjeewa mentioned that only a listed company can take US\$ 500,000 out of the country per annum for investment outside Sri Lanka. Individuals or unlisted companies can take only a maximum US\$ 100,000 per annum. Therefore, he stated that Aqua had to be listed on the stock exchange first.

Then altogether Aqua as a company and its three main shareholders individually would be able to transfer US\$ 800,000 within this year. He further mentioned that they would also be able to complete the factory in Bangladesh this year with their Bangaldeshi partner's investment in the project. He is of the view that the second cycle of capital transfer could be done early next year in order to start the commercial operations of the first stage. His plan is to increase the capital base annually over a period of 4 to 5 years.

10. At this stage Mr. Antonio suggested, "If you all agree I will join you with some seed capital. My role will be similar to a venture capital company. I mean I don't want to keep my capital over there for a long period. I hope I could get my capital back within about 5 years. Further, I would be able to arrange a leasing facility for machinery from Italy." He requested the board of directors of Aqua to send him the detailed financial plan for the next five years so that he could make the final decision in this regard.
11. Mrs. Amara Salgado, the chair-person of the company could not understand the logic of importing finished goods to Sri Lanka from the Bangladeshi BOI project while exporting components from Sri Lanka to the Bangladeshi assembly line. She thought that this was a waste and raised a query about it. Mr. Antonio explained saying "Sanjeewa is going to use the tax differentials to his advantage, he is a smart guy". Mrs. Amara Salgado was silently proud of her son when she heard this comment from a respected person like Mr. Antonio, although she could not understand his explanation.

Within two weeks of Mr. Antonio's departure, the financial projections for the first seven years in relation to the planned Bangladeshi BOI project were sent to him. The expected initial capital was US\$ 8,200,000. The parties involved in the project agreed to contribute the initial capital in the following manner:

	<u>US\$</u>	<u>US\$</u>
Equity capital		
Aqua Ltd.	500,000	
Amara Salgado	100,000	
Sanjeewa Salgado	100,000	
Yalina Ellepola	100,000	
Dhaka Electricals	<u>400,000</u>	1,200,000
7.5 percent redeemable preference shares-		
Mr. Antonio from Italy		<u>7,000,000</u>
Total		8,200,000
		=====

Dividends on preference shares will be paid from 2014. Preference share capital will be redeemed over 4 years starting from 2015. Supply of preferred share capital by Mr. Antonio will be subject to the condition that no dividend will be paid on equity capital until the equity capital is built up to the level of US\$ 5 million through the infusion of new capital or accumulated profits. Both Aqua and Dhaka Electricals are confident of the prospects of increasing the equity base over US\$ 6 million by 2016 as evidenced by their financial projections. Aqua together with its current three main shareholders will also continue to infuse further equity at the same level and in the same proportion for three more years (2014 to 2016) to strengthen the equity base in the Bangladeshi BOI operations. Dhaka Electricals will also increase its share of equity capital proportionately.

The revised cash flow projections prepared in agreement with three parties (Mr. Antonio, Aqua and Dhaka Electricals), are given below in summary form:

***Summarized Cash Flow Projections - Planned Bangladeshi BOI Operation***

<b>\$ '000</b>							
<b>Year</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b><i>Sources of Cash</i></b>							
Equity capital	1,200	1,200	1,200	1,200	1,200	-	-
Preference share capital	7,000	-	-	-	-	-	-
Cash flow from operations	-	1,720	2,110	2,150	2,350	2,650	2,980
	8,200	2,920	3,310	3,350	3,550	2,650	2,980
<b><i>Uses of Cash</i></b>							
Initial expenses	315	-	-	-	-	-	-
Net capital expenditure	6,000	1,650	1,300	850	200	(240)	2,500
Investment in working capital	1,745	600	98	10	50	75	83
Dividends: preference shares	-	525	525	420	315	210	105
common stocks	-	-	-	-	300	900	900
Interest on temporary bank facilities			15	15			
Capital redemption	-	-	1,750	1,750	1,750	1,750	-
Tax on local sales	-	35	40	43	47	53	60
	8,060	2,810	3,728	3,088	2,662	2,748	3,648
<b><i>Excess/(shortage of cash)</i></b>	<b>140</b>	<b>110</b>	<b>(418)</b>	<b>262</b>	<b>888</b>	<b>(98)</b>	<b>(668)</b>
Cash/bank balance brought forward	-	140	250	(168)	94	982	884
<b><i>Cash/bank balance carried forward</i></b>	<b>140</b>	<b>250</b>	<b>(168)</b>	<b>94</b>	<b>982</b>	<b>884</b>	<b>216</b>



Sanjeewa’s view is that the success of an IPO depends on the prospects of the issuing company, and not necessarily on the macroeconomic conditions. He once said, “For quite sometime, I haven’t seen a listing of a company with good prospects”. He further believes that the projects in hand are marketable and that the market is now turning around.

**Valuing the company and pricing the IPO**

Mrs. Amara Salgado wants to keep the company under family control. According to her, even after the IPO, at least 60 to 65 percent of shares should be with the family. Sanjeewa strongly feels that it is necessary to revalue each piece of asset and record the surplus in the company accounts before an IPO in order to safeguard the interest of the current shareholders. According to Yalina, it is not necessary to revalue all the assets and record the valuation surplus. From her point of view, what is necessary is to decide on the correct price for the shares. If assets are revalued and the surplus is recorded as an increase of stated capital (with an increase in the number of shares), then the issue price will have to come down. Otherwise, it should be proportionately high. Jagath points out that normally companies in Sri Lanka go for revaluation of assets before IPOs.

His suggestion is to value the assets on the following bases:

<u>Asset</u>	<u>Basis of Valuation</u>
Investment in securities	Market value
Part of the land not used for the current operation (100 perches)	Market value
Investment in Bangladeshi assembly line	Present value of future cash flows at current exchange rate
All other assets used in operations	Present value of future net operating cash flows

Further, he suggests the book value of all liabilities be deducted to find the value of equity.

Value derived based on the above principles are presented below:

<b><i>Valuation of current operations/assets</i></b>	<b><i>Rs. '000</i></b>
Excess land	75,000
Bangladeshi assembly line	328,800
Long-term investment	221,000
Short term investment	94,240
Value of operating cash flows	<u>4,355,000</u>
<b>Total Value of Assets</b>	<b>5,074,040</b>
<b><u>Deduct Total Liabilities</u></b>	<b><u>525,127</u></b>
<b>Value of Equity</b>	<b><u>4,548,913</u></b>

<i>Number of shares (number)</i>	<i>100,000,000</i>
<b><i>Value per share</i></b>	<b><i>Rs. 45.49</i></b>

**Note:** 1. Bangladeshi assembly line has been valued at the same cost of capital applied to value the Sri Lankan operations. However, the value taken to the above computation represents only 75 percent of total value converted on the basis of current exchange rates. (Aqua has invested only 75 percent of equity of Bangladeshi assembly line).

Jagath further points out that if the company does not wish to increase the shares held by its current shareholders, the IPO price should be around Rs. 45 per share. However, he is of the view that this is a high price for an IPO in terms of the Sri Lankan context. He further suggests going for a 1-for-2 stock split before the IPO to make the IPO price attractive. Though Yalina agrees with Jagath's approach, she argues that there is a big piece missing in these valuations. She raises the question, as to where the positive NPV's arising from the new projects are reflected in these valuations.

### **Employee Concerns**

The company's plan for going public has been misinterpreted by the employees. A rumour has been spreading that the company will be sold by its current management in the near future. Employees who have not been satisfied with the style of management adopted by Sanjeewa are in the forefront of this move. A group of such employees are already in touch with some political parties and are planning to form a trade union within the company. Already the majority of the employees have agreed to support this move. Some employees, those who joined the company at its inception, say, "They can't take such decisions without even talking to us. This is not only their factory. We have laboured so many years to bring this company up to where it is today. This is ours as well". They always refer to Mr. Steevan Salgado as "Rathran Mahatteya" (literally a golden master – a master with good qualities). Some employees from time to time recollect his sterling qualities making comments such as, "He was very friendly and understanding, he even used to pocket out money

when someone went to him with his or her domestic problems”. The employees see a sharp contrast between Steevan’s management style and that of Sanjeewa’s.

The chair-person has been annoyed by the employees activities but feels that there should not be a confrontation with them at this time. However, Sanjeewa states that the employees should understand that the management is not planning anything against them. He notes, “These plans are for everybody’s future”. He openly says, “I have no time to waste on unnecessary talks”. Some directors point out that the company has to first address the employee unrest before going for any big plans. They even, suggest adopting an employee share ownership plan (ESOP). Sanjeewa is reluctant to do that as employees share ownership plans cannot be implemented on the basis of their performance. Jagath believes that whatever it is, they should immediately start a dialogue with employees to minimize the distance, between the management and the employees and clear up any misunderstandings.

**Required:**

1. Assume that Aqua has appointed you as an Advisor to the board of directors, (prior to approaching an investment bank). Prepare a report to be submitted to the board of directors through the chair-person of the company in order to resolve the managerial concerns currently confronted by the company. In your report you may also bring out any other issues which have not attracted the attention of the members of the board. (However you are not expected to further investigate the feasibility of the projects and the procedural aspects to be followed in listing a company).  
(68 marks)
2. Highlight the salient features of the leadership and management styles of Mr. Steevan Salgadu and Mr. Sanjeewa Salgadu taking into consideration the transformation taking place within the company.  
(16 marks)
3. If you have an opportunity to personally advise Mr. Sanjeewa Salgadu, MD of the company and Mrs. Amara Salgadu, chair-person of the company, then briefly explain the content of your advice to them.  
(16 marks)