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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

COMMON PRE-SEEN

(KC1 TO KC4)

DECEMBER 2017

Quickpharma (Pvt) Ltd

1. Background

Malik Fernando, a fellow chartered marketer, owns a majority stake in a pharmaceutical company called Quickpharma (Pvt) Ltd (QPL). The company imports drugs and has a chain of outlets and standalone shops in various locations spanning three provinces. Malik began his career as a sales representative at a fairly small pharmaceutical company. After two decades in the pharmaceutical industry and having made many contacts with healthcare professionals including doctors, he ventured out to set up his own company in 2007. Malik did not have the funding to fully meet the initial capital requirements, hence he partnered with his brother Lasantha Fernando, a fellow chartered accountant, and Gayan Ferdinando, a friend he met at his marketing class. Lasantha purchased 20% of the shares of the company in his own name and Gayan purchased 29% of the shares through his family company Transasia Holdings PLC.

2. Company overview

2.1 Shareholding structure (1,500,000 shares at Rs. 10)

Shareholders	**Percentage holding as at 30 September 2017**
Malik Fernando	51%
Lasantha Fernando	20%
Transasia Holdings PLC	29%
Total	**100%**

2.2 Directors of the company

Name of director	**Designation**	**Age (September 2017)**
Malik Fernando	Chairman/Managing director	65
Lasantha Fernando	Executive director	59
Sandesh Fernando	Executive director	32
Gayan Ferdinando	Non-executive director	45

2.3 Organisational structure

The company has a total workforce of 159, of which the management cadre only comprises 15 staff. The staff are generally well looked after. However, approximately only 10% of the staff have been in the company for over 10 years. Staff retention rates are low and most employees are not emotionally engaged according to the employee satisfaction survey carried out last year. Refer **Annexure 1** for details of the organisational structure.

2.4 SWOT analysis

The SWOT analysis is given in **Annexure 2**.

2.5 Product range

Most of the products sold by QPL are imported and approximately 30% of the product range consists of locally manufactured goods. The company is an agent for a few overseas drug companies and sells products through its standalone shops and chain of outlets. The company also sells various cosmetic items and a few grocery items, which amount to approximately 15% of the total turnover. The managing director's wife who owns a proprietorship supplies certain items to the shops and outlets at an inflated price, but the company has to sell these products to the customers at the normal market price in order to be competitive.

2.6 Sales and distribution

The distribution network consists of 10 standalone shops, which are owned by QPL, and 7 outlets located in leading supermarkets. 5 of these standalone shops were opened in the financial year 2016/17. The outlet space is rented and a limited range of pharmaceutical items are sold in them. The company-owned standalone shops have a larger range of items. QPL currently operates mainly in the western, central and northern provinces. The entire distribution is done using the company's own motor vehicles. During the year 2016/17, two motor vans were disposed of and one van was given to the managing director's wife.

The sales and distribution function is headed by Sandesh Fernando, the managing director's son.

2.7 Governance issues in the family business

In this family business, the company and family relationships are not clearly distinguished. Existing governance-related policies are informal. This has led to the reliance on key people rather than on structures and processes. Such common understandings may not continue in the future generations when the ownership changes. As a result, there could be some uncertainty for the external investors and non-family employees.

Weaknesses in the governance systems of this company are most evident in its internal controls, internal audit and risk management practices. Since the business is managed by the founders and their children, the control environment is largely tailored to their needs. The problem therefore is that the controls do not grow along with the company, as the business becomes more complex. This gap is a primary area of concern for external investors.

Some of the key concerns in governance are:

- Family directors are resistant to change; lack of management development.
- Inability to keep family issues out of the business; cannot balance the needs of the family and business.
- Growth is sacrificed for control. Therefore optimum solutions are not implemented.
- Founders are highly emotional. Their roles are inefficient and stifle innovation.

Gayan who owns 29% of the shares of QPL through his family company Transasia Holdings PLC has indicated that he would like to increase his shareholding by another 22%. This may be possible if the other shareholders decide to sell or reduce their stake in the business.

2.8 Ethical issues

The managing director of QPL received many complaints recently from customers and doctors regarding the unethical practices adopted by the sales representatives of the company. Some of the complaints received were that QPL were:

- offering information to the public on "modern" lifestyle diseases, such as stress, to encourage people to ask their doctors for medicine.
- making inaccurate claims about the safety and efficacy of their drugs.
- offering doctors incentives (including kickbacks and gifts) to prescribe and promote drugs.

The managing director having obtained information about the possible lawsuits against the company, has taken the above matters very seriously and has had several meetings with the sales representatives about the complaints.

2.9 NOCLAR compliance requirements

The managing director also mentioned that the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) has decided to adopt the “Responding to Non-Compliance with Laws and Regulations” (NOCLAR) standard with effect from 15 July 2017.

3. Accounting and finance function

Kasun Pathiraja is the finance manager/chief regulatory officer. He joined the company two years ago on the recommendation of Sandesh Fernando. He monitors the day-to-day operations performed by the accountant and the finance executives. Monthly accounts are prepared by the accountant and month-end journal entries for inventory adjustments, sales incentives, accruals and various other provisions are approved by Kasun. Monthly accounts are submitted to the board of directors on the 10th day of the following month. The company follows Sri Lanka Accounting Standards (LKAS/SLFRS) when preparing financial statements. Kasun rarely gets any comments/feedback from the board of directors on the monthly accounts. Through experience, he knows that the directors are mainly looking at the revenue and bottom line.

In 2016/17, QPL entered into an agreement with ABC (Pvt) Ltd to purchase a well-known brand of medicine and thereby commence its manufacturing. In determining the purchase price of this brand, the directors of QPL and ABC (Pvt) Ltd agreed to get the involvement of a valuer.

QPL currently uses a bespoke ERP package that was developed by an employee in the IT department. The current audit of QPL is done by Messer's Silva & Co. Chartered Accountants.

QPL reported profits up to (including) financial year 2013/14. In the following two years, the company made losses. However in the financial year 2016/17 QPL made a profit (before tax) of approximately Rs. 6 million. The company has not paid any dividends to its shareholders in the past 3 years. Instead they invested in 5 new standalone shops in year 2016/17. In fact they also had borrowed a large amount of funds from the bank at an interest rate ranging between 16% and 17%. The loans were obtained for a period of 5 years. The investment in the new standalone shops seemed to have enabled the company to return back to profitability in the year 2016/17. **(Refer Annexure 3)**

Future growth and expansion

QPL is planning to further expand its local operations in order to meet the increased demand for drugs. In view of this the company is hoping to open 16 new standalone shops in the next few years. The locations are yet to be determined.

Although Malik is of the view that the expansion should take place, his brother Lasantha does not support this. As a result of this disagreement Lasantha has indicated that he may sell his shares and exit from the business.

Soon after the disagreement with Lasantha, Malik decided to sell a piece of land that was initially bought with the view of opening a new standalone shop in Maharagama, by dividing it into 25 lots.

Expansion plans (2017/18 – 2021/22)

- It is planned to open 16 new standalone shops in order to further strengthen the geographic footprint.
- During the financial years ending 2017/18, 2018/19 and 2019/20, it is planned to open 6 new standalone shops as set out below.

Standalone shop	Date of opening
1	01.01.2018
2	01.01.2018
3	01.09.2018
4	01.01.2019
5	01.09.2019
6	01.01.2020

- In each of the financial years ending 2020/21 and 2021/22, 5 standalone shops will be opened.

4. 5-year forecast

	2017/18	2018/19	2019/20	2020/21	2021/22
	Rs.	Rs.	Rs.	Rs.	Rs.
Revenue	362,524,913	430,898,247	549,627,469	687,752,851	821,717,588
Cost of sales	(242,529,649)	(298,239,660)	(397,661,386)	(512,087,925)	(621,297,739)
Gross profit	**119,995,264**	**132,658,587**	**151,966,083**	**175,664,926**	**200,419,849**
Other operating income	8,993,485	10,249,334	12,512,784	14,778,243	17,887,736
Administrative expenses	(67,876,565)	(70,878,654)	(72,108,946)	(80,765,464)	(94,486,893)
Selling and distribution expenses	(26,565,765)	(30,480,767)	(32,166,546)	(35,570,878)	(42,898,765)
Profit/(loss) from operating activities	**34,546,419**	**41,548,500**	**60,203,375**	**74,106,827**	**80,921,927**
Finance cost	(17,200,918)	(20,200,918)	(26,200,918)	(31,200,918)	(35,200,918)
Profit/(loss) from ordinary activities before tax	**17,345,501**	**21,347,582**	**34,002,457**	**42,905,909**	**45,721,009**
Income tax expense	(2,601,825)	(3,202,137)	(5,100,369)	(6,435,886)	(6,858,151)
Net profit/(loss) for the year	**14,743,676**	**18,145,445**	**28,902,088**	**36,470,023**	**38,862,858**

Forecasted sales (2017/18 – 2021/22)

Revenue	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**
	Rs.	**Rs.**	**Rs.**	**Rs.**	**Rs.**
Current standalone shops	234,410,953	272,399,082	310,807,047	349,882,433	391,722,760
Future standalone shops	34,405,491	62,413,018	123,281,923	212,240,308	294,455,363
Outlets in supermarkets	93,708,469	96,086,147	115,538,499	125,630,110	135,539,465
Total	**362,524,913**	**430,898,247**	**549,627,469**	**687,752,851**	**821,717,588**

The capital outlay for each of the new standalone shops ranges from Rs. 15 to 25 million based on the size of the shop. The main categories of capital expenses are given below along with estimates for a shop in the Rs. 15 million range.

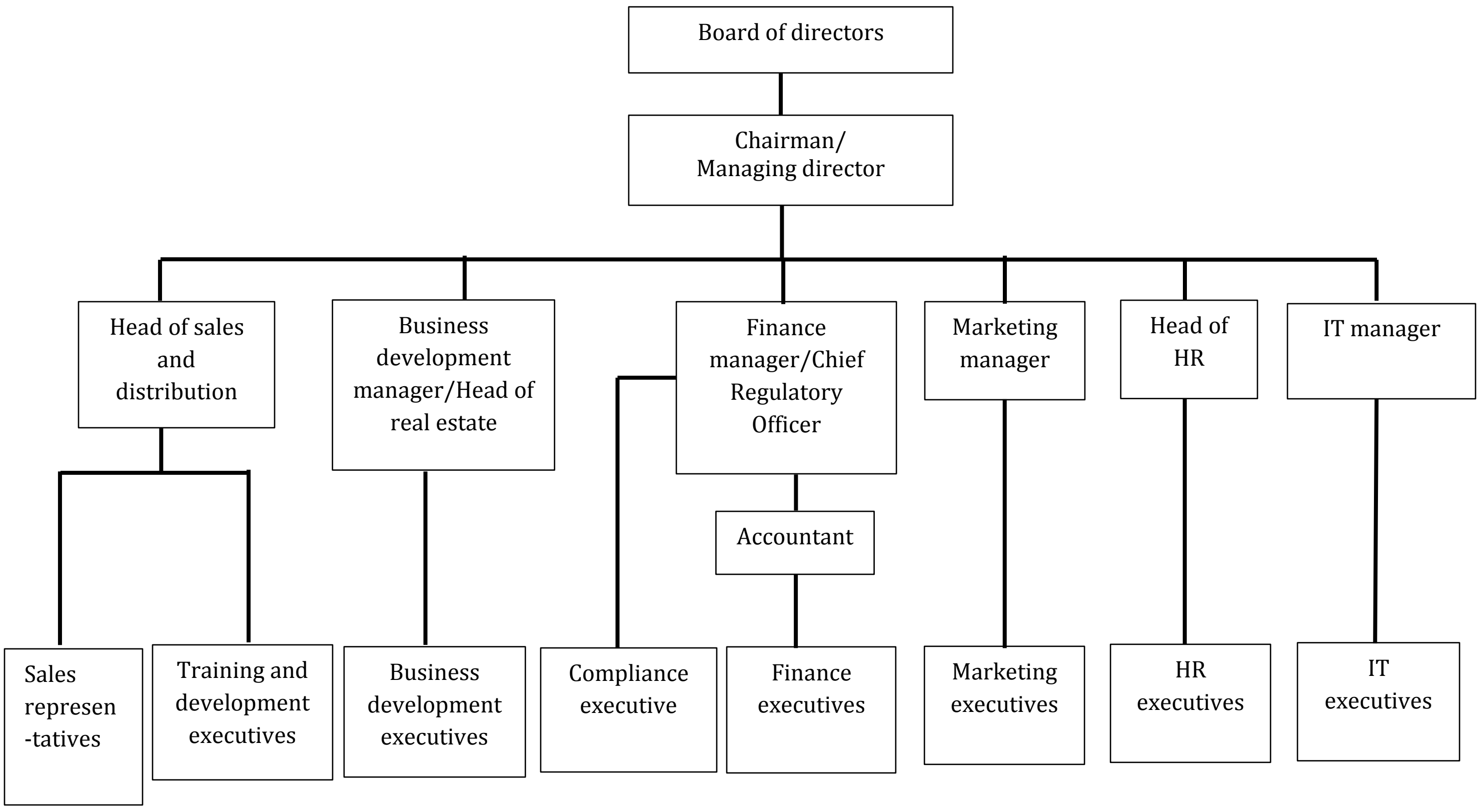
Capital expenses	**Rs.**
Building improvements	6,000,000
Computer equipment and software	1,500,000
Network accessories	1,000,000
Shelves, furniture and fittings	4,000,000
Other equipment (fridges/generators etc.)	2,500,000
Total	**15,000,000**

Financial benchmark figures of a similar listed company

Z PLC, which is listed on the Colombo Stock Exchange, reported the following results. These figures may be of use for a valuation of the shares of QPL.

- Dividend payout ratio: 15%
- Earnings per share (EPS): Rs. 10.50 (issued at Rs. 10 per share)
- The company was funded with a debt-to-equity ratio of 70:30
- Market price per share: Rs. 152
- Beta (based on ASPI): 1.78
- Current treasury bill rate: 9.0% per annum
- Market risk premium: 3.5%
- Market rate of return: 12.5% per annum

Annexure 1: Organisational structure



Annexure 2: SWOT analysis

Strengths

- The managing director has many years of domestic industry experience.
- Good distribution channel through outlets within supermarkets.
- Strong loyalty of customers and vendors.

Weaknesses

- A family company, therefore governance issues are prevalent, which may impact performance and future growth of the company.
- Lack of proper succession planning.
- Young management team with only a few years of industry experience.
- The company is gradually losing its good reputation in the market.
- Lack of internal controls/governance structure and risk management practices.
- Inability to install the latest technologies due to the huge financial outlay.

Opportunities

- Growth of the middle class in the country has resulted in fast changing lifestyles in urban areas and to some extent in rural areas too. This has opened a huge market for pharmaceuticals.
- Increasing growth rate in the pharmaceutical industry.
- New drug policy, which will help to expand the pharmaceutical industry.
- Export opportunities in the region.

Threats

- The pharmaceutical industry is controlled by the price regulations of the government and this has adversely impacted profitability.
- Low cost substitutes.
- Increased competition.
- Increased interest rates could impact future expansion.
- Unethical practices by competitors could impact sales.

Annexure 3: Financial information of QPL

Income statement

	Rs.		
For the year ended 31 March	**2017**	**2016**	**2015**
	(Un-audited)	**(Audited)**	**(Audited)**
Revenue	262,073,635	145,000,000	105,000,000
Cost of sales	(146,056,707)	(98,605,800)	(73,500,015)
Gross profit	**116,016,928**	**46,394,200**	**31,499,985**
Other income	7,700,000	5,400,000	2,700,000
Administrative expenses	(65,440,000)	(45,000,000)	(45,000,505)
Selling and distribution expenses	(23,001,099)	(10,006,000)	(8,989,646)
Other operating expenses	(11,507,747)	(4,344,892)	-
Profit/(loss) from operations	23,768,082	(7,556,692)	(19,790,166)
Finance cost	(17,456,000)	(4,080,655)	(1,676,555)
Profit before tax	**6,312,082**	**(11,637,347)**	**(21,466,721)**
Income tax expense	(1,767,382)	-	-
Net profit/(loss) for the year	**4,544,700**	**(11,637,347)**	**(21,466,721)**

Statement of financial position

	Rs.	
As at 31 March	**2017**	**2016**
	(Un-audited)	**(Audited)**
Assets		
Non-current assets		
Property, plant and equipment	119,295,904	61,147,050
Intangible asset	3,500,000	-
Investments in unquoted equity securities	16,999,541	16,946,353
Deferred tax assets	4,814,882	4,057,249
Total non-current assets	**144,610,327**	**82,150,652**
Current assets		
Inventories	39,876,555	19,767,555
Trade and other receivables	25,005,065	12,453,944
Cash and cash equivalents	8,909,888	3,566,666
Total current assets	**73,791,508**	**35,788,165**
Total assets	**218,401,835**	**117,938,817**
Equity and liabilities		
Capital and reserves		
Stated capital	15,000,000	15,000,000
Retained earnings	40,259,178	35,714,478
Total equity	**55,259,178**	**50,714,478**
Non-current liabilities		
Retirement benefit obligation	15,034,889	15,604,191
Interest bearing loans and borrowings	65,700,000	13,231,728
Total non-current liabilities	**80,734,889**	**28,835,919**
Current liabilities		
Trade payables	43,908,014	27,865,432
Interest bearing loans and borrowings	19,898,765	4,578,766
Income tax payable	2,500,990	343,233
Other liabilities	3,500,000	-
Bank overdraft	12,599,999	5,600,989
Total current liabilities	**82,407,768**	**38,388,420**
Total liabilities	**163,142,657**	**67,224,339**
Total equity and liabilities	**218,401,835**	**117,938,817**

Annexure 4: Profiles of key management personnel

Name	Designation	Age	Qualifications	Industry experience (years)
Sandesh Fernando	Head of sales and distribution	32	BSc Marketing	7
Gayathri Fernando	Business development manager / Head of real estate	32	BSc (Hons) Real Estate	8
Nikesh Silva	Marketing manager	45	BSc Marketing, CIM – UK, MSLIM	12
Ranmalie De Zoysa	Head of HR	35	Diploma in HR from IPM	10
Kasun Pathiraja	Finance manager/Chief regulatory officer	32	MAAT	7
Methnuwan Ranasinghe	IT manager	27	Diploma in IT	6

Annexure 5: Profiles of the board of directors

Name	Brief profile
Malik Fernando Chairman/Managing director	A very well respected entrepreneur who was awarded the "Deshabandu" title by His Excellency the President of Sri Lanka in 2015. Malik has over 3 decades of experience in the pharmaceutical industry.
Lasantha Fernando Executive director	A fellow member of the Institute of Chartered Accountants of Sri Lanka who received his training at a reputed audit firm. After qualifying, Lasantha joined a multinational company as an accountant. Thereafter he rose to the position of financial controller overseeing the FMCG sector in a group of companies.
Gayan Ferdinando Non-executive director	Gayan is a chartered marketer and has obtained his bachelor's degree in Biological Science from a recognised university in Sri Lanka. Gayan is the owner of Transasia Holdings PLC a conglomerate listed on the Colombo Stock Exchange. He holds many directorships in listed and unlisted companies.
Sandesh Fernando Executive director/Head of sales and distribution	Obtained his BSc in Marketing from a reputed private university in Sri Lanka. Sandesh joined the company as a marketing manager and was promoted to director in 2016.

Annexure 6: Pharmaceutical industry overview

The pharmaceutical sector is a key component of the healthcare services industry in Sri Lanka. The market is estimated to be worth LKR 61 billion having grown by a compound annual growth rate of 14% over the last five years. Pharmaceutical sales within Sri Lanka have grown exponentially over the last decade with the bulk of pharmaceutical needs being met by India, followed by Switzerland, Pakistan and the United Kingdom. Whilst generic drugs dominate the market by quantity, branded drugs hold a larger market share by value.

Sri Lanka has a small local pharmaceutical manufacturing industry. It accounts for approximately less than 10% of the private sector supply of pharmaceuticals. 90% is supplied by private firms in Sri Lanka who are the designated local agents for pharmaceuticals imported from international principals. It is these private providers who largely import 'generics' or 'branded generics' and 'originators'.

At a media briefing convened in connection with the launching of a pharmaceutical manufacturing project at the Koggala Export Processing Zone in 2016, The Sunday Times reported that pharmaceutical exports from Sri Lanka in the future are expected to surpass earnings from tea exports.

A large state-of-the-art pharmaceutical manufacturing plant will be set up at the Koggala Export Processing Zone with an investment of USD 30 million to dispense quality drugs to needy Sri Lankans at an affordable price as well as for export purposes.

The project, a joint partnership with Laugfs Gas PLC and Premium International (Pvt) Ltd, had an initial investment of USD 30 million. It was recently inaugurated in Koggala by the chairman of Laugfs Gas and the CEO of Premiun International and other officials by cutting a sod of earth at a simple ceremony.

The chairman of Laugfs Gas noted that Sri Lanka's biggest problem was related to the shortfall of export earnings for the development of the country. He said, "As far as the pharmaceutical industry is concerned, 90% of the drugs are imported to the country while only 10% are made in the country by foreign companies. Therefore we thought that it was apt at this juncture to manufacture pharmaceutical drugs for local consumption as well as for export purposes. This will be the largest investment in the country as far as the pharmaceutical industry is concerned and the best technology will be employed in the manufacture of pharmaceutical drugs".

The chairman of Laugfs Gas was optimistic that pharmaceutical export revenue in the future will surpass the earnings from the tea exports. He expects the manufacturing facility in Koggala to transform the healthcare and pharmaceutical sector in the country on many fronts. He said, "Boosting the healthcare sector through technology transfer and capacity building will deliver numerous benefits to the country's economy as well as the local consumers. We see tremendous prospects in the export market where there are lucrative opportunities for contract manufacturing. With favorable patent protection regulations compared to some of our neighbouring countries, Sri Lanka is a more attractive destination for contract manufacturing".

Meanwhile, according to a recent report, the demand for healthcare and medication worldwide is expected to rise and reach USD 1.17 trillion by 2017. Most multinational pharmaceutical manufacturers have plans to adopt regional production strategies by using certified contract manufacturers for exports.

Problems with the pricing mechanism

The new pricing system announced in 2017 was derived from the Indian model, which is suitable for a large domestic market with a substantial domestic drug-manufacturing base. It is considered less suitable for Sri Lanka.

With the majority of Sri Lanka's pharmaceutical drug needs being dependent on imports, where costs vary with every shipment due to exchange rate variability, fixed prices have become highly infeasible. The new pricing rules have strongly impacted branded generics and originators, and they could also result in shortages and restriction of patient choice. Early reports indicate that several originator drug companies have signaled they would discontinue supplying to the Sri Lankan market. The regulator should consider an 'automatic pass through' for exchange rate changes (up or down), where a quarterly revision of prices is linked to the Central Bank approved exchange rate. In the absence of such a mechanism, a devaluation for instance would result in each pharma importer requiring National Medicines Regulatory Authority (NMRA) pricing committee approval for price increases on all products stemming from a change in exchange rate over which the importer has no control.

A further impact of the recent gazette notification on the price controls over drugs is that good quality drugs developed with innovation in the originator countries would no longer be supplied to Sri Lanka, and only cheaper generics would be available. This affects not only the choice of individual consumers, but also the country's ability to have access to the latest medication. Moreover, price controls can lead to the proliferation of lower quality and counterfeit drugs, which is dangerous to public health.

(Source: Modified extracts from reports published by PWC and the Ceylon Chamber of Commerce and an article by The Sunday Times)