THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC5 - Corporate Strategy and Contemporary Issues

December 2016

Management Report

To: Director Planning Date:

From: Chief Financial Officer

<u>Recommendations on the applicable strategic analyses, issues and alternatives discussed at the meeting held on…with the Director Planning</u>

(a) **TFA Insurance company growth options:**

Applying Ansoff matrix

Market penetration: existing products, existing markets – Increase market share of the existing customers who purchase automobiles from TFA and have insurance from other brokers, by better salesmanship

Product development: New products, existing markets – A new product like a 'life policy' for existing customers buying motor insurance from TFA

Market development: Marketing motor insurance to other customer segments besides your motor insurance customers such as say other customers of Reliable Motor Finance buying leases for registered automobiles not imported through TFA or those who visit TFARW

Diversification: related–horizontal diversification –acquiring another insurance brokering company

(b) **Role of HR strategies in TFAIB's strategic capabilities and Competitive advantage**

This question needs to be answered from the perspective of how HR as a strategic capability can contribute to competitive advantage:

For HR to qualify as a strategic capability, HR needs to contribute to the company's capability for VRIN (page 107 of KC5 study pack)

Value to customers: TFA's HR practices in the form of offering comprehensive training contribute to building capabilities in motor engineering that is necessary to create customer value.

Rarity: Here, HR resources need to be rare. TFA's comprehensive in-house training is rare

Inimitability: How TFA's HR practices are difficult for competitors to imitate- TFA's comprehensive training offers integrated and cross-functional training for trainees and they have opportunities for applying for a range of professional preferences. These are difficult for competitors to imitate.

Non-substitutability: It is also not easy for competitors to acquire the same advantages by using some other resources. It is not easy for the competitors from the north western region to attract well trained staff of equivalent competencies with a very strong corporate culture such as that is available with TFA and also that offers wide ranging competencies.

(c) **Bearings division: Ways in which the supply chain can create value**

- Responsiveness: developing an ability to supply wide ranging needs of customers quickly as the 'waiting time' for a bearing is very short
- Reliability: means ability to deliver the right amount, of the right quality and at the time needed
- Relationships: Reliability and responsiveness helps to build strong relationships
- Operational efficiencies: Minimizing inventory levels without getting into stock out situations .Improving relationships also means the company can negotiate better prices

(d) **Business strategies for TFA Rent a Car**

Strategies need to be based on key strategic issues confronting the company

Important Opportunities and Threats and most important Strengths and Weaknesses ENVIRONMENTAL ANALYSIS	
Enormous corporate image / brand equity in Motor vehicles (S)	Can leverage for strategic success
Extended fleet of vehicles (S)	Have capacity to succeed here
Need to improve capacity utilization (W)	Very important to improve profitability
Not very customer oriented core/ key customer centric processes (W)	Very important to make processes customer centric
Prospects of increased tourism and economic prosperity/prospects in corporate markets (O)	Good opportunity to capitalize
High incidence of vehicle losses (T) Low profitability when financial results are evaluated from an EVA perspective (W)	Vulnerability-need to find ways to minimize risk of losses

Summary:

i) Low profitability when one takes in to account the EVA of this business, as the financials do not include finance costs and this seem to be due to low capacity utilisation. (W)
ii) Company's core customer centric processes need to be improved to improve strategic competitiveness. (W)
iii) Expected high growth prospects in business /corporate markets (O)
iv) Possible theft of vehicles needs to be addressed (T)
v) Enormous corporate image (S)
vi) Capacity for extended range of vehicles (W)

Workings: 2012- {(20*80,0000/-*12*.90+(8*30,000/-*12*.90) }= 19,872
2013- {(20*80, 0000/-*12*.80+ (8*30,000/-* 12*.80)} = 17,664
2014- { (28*80, 0000/-*12*.70+ (10*30,000/-* 12*.70) } = 21,336
2015- {(26*90, 0000/-* 12*.65+ (9*40,000/-* 12*.65)} = 21,060
2016- {(26*100,0000/-*12*.60+(9*45,000/-* 12*.60) } = 21,636

Drop in capacity utilization is one of the major drivers of low profitability
(For e.g. if we can improve capacity utilization to 80 percent
Turnover: 26*100,000/- *12* .75+ 9*45,000/- *12*.75 =27,045/=)
Identification of this fact and need to show how this has been derived

Strategic options:

i) Increase capacity utilization by ensuring minimisation of the idle non renting days by entering into long term rental agreements with corporate customers that also minimise the disadvantage due to non-imposition of VAT for individual customers from individual operators who will invoice without VAT.
ii) Improve customer response time from initial trigger point of entering the premises up to renting and exiting the premises by simplifying processes via a process re-engineering exercise and also benchmarking core customer centric competitor processes also with the aid of information technology.
iii) Reduce the risk of loss of vehicles by way of minimizing reliance on individual customers by developing corporate relationships so that vehicles will be rented to employees of corporates, resorting to technology such as obtaining GPS tracking and also by requiring verifiable referees before renting.

(e) **An Offer to be made for RBF**

The possible valuation is a relative valuation:
Adopting P/E ratio method being a method of 'relative valuation', the only feasible option is Company Y
P/E ratio of Company Y
EPS = (208m)/2m =104/=. Therefore P/E ratio of Company Y=MV per share/EPS
=Rs 700/104' = 6.7 say 7

*adjusting for trading loss to enable valuation unaffected by 'trading' activity.

For a relative valuation we need to moderate the P/E ratio of company Y with a definitive known valuation to factor RBFs current relative performance on vital considerations such as say:

Risk compared to company Y and business experience as well as staff expertise. On all three categories RBF is inferior .Hence a relative P/E of for example 3.5 may be used.

Accordingly RBF valuation =EPS* 5
RBF EPS = (244m)/2m = 122/= Hence value per share of RBF on a relative valuation is 122/=* 5 /= 610/=

*Adjusted for trading profit

(f) **Advice on changes to be proposed for the RBF Company**

Workings:
Summary of key comparative financial indicators/ parameters:

	RBF	**X**	**Y**	**Z**
Interest yields:				
Interest Income/ business portfolios	2044/4925 =41%	12,199/56,733 =21 %	2644/9129 28%	1501/6815 22%
Borrowing rates: (reflecting perceived risk) Interest expense/total borrowings	964/5594 =17%	6075/57,207 11%	1502/10,558 14%	886/7328 12%
NIM based on core business Portfolios = net interest income Portfolios	1080/4915 22%	6124/56733 11%	1142/9129 13%	615/6815 9%

In most industries companies differ significantly from each other with respect to the way they strategically position their products in the market in terms of such factors as say the market segments they serve, product range, quality, advertising intensity etc. Because of these differences in most industries it is possible to observe groups of companies that seem to follow different strategies. These different groups are termed strategic groups. In the LFC industry as given in this case, the companies RBF Plc., and competitor company Y, seem to be in one group as much as X and Z seem to be in another group when we take into account the dimensions of their positioning strategies.

The similarities of strategies of the two groups

RBF Plc and Company Y - High risk customer groups/products(<u>more unsecured lending in portfolio- **only** 12% under secured category in RBF and 29% in Y),</u> charging higher rates of interest, more intense credit follow-up and hence higher follow up costs, and higher interest costs, limited geographic coverage/regional presence, low product variety.

Company X and Company Z - Lesser risk customer groups/products(more secured lending in portfolio 92% in X and 78% in Z under secured category), lower interest costs, low follow up costs, broader geographic coverage/Island wide presence (need to take in to account the futuristic positions prospective expansion for company Z)

Identifying possible competitive advantages and changes to competitive strategy:

It may be seen from this analysis that RBF Plc is underperforming in the product group-leasing and hire-purchase of vehicles (low risk products as they are secured) compared to their strategic group competitor company Y and therefore may strategize to increase its portfolio in the leasing and HP business as this is a segment where RBF is in possession of core competencies to exploit this market segment for non- corporates as most corporates are serviced by banks and larger finance companies who are able to lend at lower rates of interest due to their lower cost of funds.

Also by such a migration RBF also can reduce its risk profile by having more lending supported by tangible securities as well as lower its operating costs. Also getting in to lower risk levels would enable RBF to get a better 'rating' that will enable it to borrow at lower rates of interests and make the company more competitive.

(g) **Corporate Governance**

According to corporate governance guidelines applicable to LFCs, chairman will have to be a non-executive director and hence the same person cannot be the chairman as well. The reason being to preserve the independence towards the stakeholders.

(h) **Risk Management Strategies**

<u>Interest rate risk:</u>

RBF has two SBUs, namely small business financing and leasing /HP and RBF is now strategizing to increase its presence in lasing /HP.

Interest rate risk arises primarily due to miss-match in the maturity profile of the interest bearing assets and liabilities in its portfolio

In regard to assets side there is a miss- match in the <u>leasing portfolio</u> because liabilities funding these assets, are on an average of only 1-2 years against assets with a maturity cycle of 4-5 years.

But in regard to the SME portfolio such a miss- match does not exist because average lending is for only 1 year and can be funded with liabilities maturing in 1 to 2 years.

Hence there is a higher interest rate risk in connection with the leasing portfolio and may be better managed by financing strategies such as increasing long term funding such as securitization, interest rate swaps etc.

Credit Risk:

With the reconstitution of the portfolio spread to minimize lending to informal small business category and partly investing in leasing and HP which are secured RBF will minimize credit risk.

Higher supervisory controls, regular internal audits and pre granting controls such as effective cash flow based evaluations and following exact business processes as per the customary credit manuals for the small business categories will help manage risks better.

In the area of Leasing and HP proper valuations and vehicle inspections will help manage risks.

For all categories evaluation of customer credit rating through CRIB is an effective control.

Liquidity Risk

As a part of large group and lesser perceived risk by rationalizing the portfolio risk it will be easier for RBF to resort to increased bank borrowing to accommodate growth. Also its fixed assets also can be given as security or alternatively RBF may consider liquidating the fixed assets to improve liquidity risk.

Market risk

Since it is not proposed to exit the trading portfolio market risk exists for less than 10% of the company's portfolio.

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