THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC5 – Corporate Strategy and Contemporary Issues

JULY 2017

Answer outline

1. Internal capabilities of the company and recommended strategies to capitalise on the opportunities present in the market and minimise the threats posed to the business.

<u>The internal capability analysis</u>

Strengths

- Entrepreneurial and visionary leadership of promotors (chairman and vice chairman)
  - Risk taking
  - Demonstrated success
- Competent leadership team
- Loyal and satisfied workforce
- Well-established mass market and mid-market brands
- State of the art computer-aided design (CAD) facility (competitive advantage)
- Balanced mix of product sourcing consisting of own factories, local contract manufacturers and foreign contract manufacturers
- Loyal and long standing exclusive local contract manufacturer relationships
  - Considered as business partners
- Economies of scale in raw material sourcing due to high volumes
- Well-established distribution network
  - Franchisees considered as partners
- Lean and mean operating structure
  - 60% of products sourced externally
  - 180 out of 207 stores are through franchise arrangements
- Genuine commitment to CSR which helps to build strong relationships with the community

Weaknesses

- Inability to read the changing market landscape in advance
  - Not seen the emerging online retail business
  - Not seen the emergence of high-end shopping malls
- Weak corporate governance structure
  - No independent or external directors
  - Most of the key senior management positions are filled by family members (5 out of 9)
- Lack of strong upmarket brands
- Inefficient factory in Horana (which adversely affects the overall gross margin and profitability)
- Absence of an integrated logistics management system
- High financial leverage

Internal threats

- Vulnerabilities associated with sourcing from foreign contract manufacturers
  - Non-exclusive relationships (low loyalty)
  - Serendib is not a large buyer for these foreign contract manufacturers (less than 10% their sales) (low loyalty)
  - Risk of copying proprietary designs
  - Longer lead times
  - Poor quality control mechanism
  - Inadequate process to ensure compliance
- Compressing margins

External threats

- Poor quality, low cost/priced imports
- Dynamic consumer behaviour
- Penetration of high-end international and global brands into the local market
- Emergence of online retailing

Market opportunities

Some of the threats are opportunities as well.

- Largely untapped export market
  - USD 86 million in 2015 with a fivefold increase during the period 2011– 2015
  - Presently less than 3% of Serendib sales
  - Availability of GSP+
- Growing online retailing space
- Emerging space in the high-end brands

Note: Alternatively, McKinsey's 7S model (strategy, structure, systems, shared values, style, staff and skills) or the Ms model (markets, machinery, money, make up, methods, material, men) or any other appropriate model can be used to identify the strengths and weaknesses of the company.

Strategies/plans to capitalise on the opportunities present in the market and minimise the threats posed to the business

Given the dynamic changes in the market, the strategic priorities of Serendib are as follows.

- Venture into online retailing (converting a threat into an opportunity)
  - Unknown territory
  - Has to be careful in order to manage risks (discussed under 2.2 below)
  - Will have to retain online business experts
  - Present reputation will help to build the confidence of customers
  - Entrepreneurship and the competent leadership team will help the business to carry out operations smoothly in this unknown territory.
- Enter the high-end market with global and international brands (converting a threat into an opportunity)
  - Negotiate exclusive dealerships from international and global brands (using current skills in forming international relationships).
  - Current reputation will help to build the confidence of customers.
  - Can leverage the existing distribution network. The proposed modernisation of the retail chain will help.
- Improve internal efficiencies to stay competitive, as this is critical to staying strong in the mass market given the intense competition from low quality cheap imports.
  - Modernise or shut down the Horana factory, subject to a detailed feasibility study. Most of the global footwear brands now rely entirely on outsourced manufacturing.
  - Invest in a modern Enterprise Resource Planning (ERP) system. This will help to achieve efficiencies in inventory management and production planning, and also help to manage lead times effectively.
  - Gradually increase sourcing from low cost countries such as Bangladesh, subject to implementation of comprehensive quality and compliance management systems.
- Timely responsiveness to emerging trends and changes in the market
  - Need to closely monitor developments in customer expectations and trends, both locally and globally. Tracking global trends in the retail industry is vital as these could come to Sri Lanka after a time lag.
  - Set up a dedicated unit under the marketing director for this purpose.
- Financial restructuring to reduce cost of funds (discussed under Section 3 below).
- Explore opportunities in the export market
  - A good business case for this exists, considering the availability of the GSP+ benefit.
  - Increasing volumes will allow the company to reach better economies of scale.

2. Financial feasibility of the proposed online footwear business unit

						Rs Mn	
Year		-	**1**	**2**	**3**	**4**	
Revenue			25.0	100.0	300.0	450.0	
Variable Cost			11.0	45.0	135.0	202.0	
Fixed Cost			50.0	55.0	58.0	63.0	
Online Business Unit		-	**1**	**2**	**3**	**4**	Remark
Computation of Profitability							
Contribution	A1		14.0	55.0	165.0	248.0	Revenue - Variable Cost
Canibalizing Impact on Revenue			5.0	20.0	60.0	90.0	20% of sales
Canibalizing Impact on Contribution	A2		2.5	10.0	30.0	45.0	50% contribution margin
Incremental Contribution	A3		11.5	45.0	135.0	203.0	A1-A2
Fixed Cost	A4		50.0	55.0	58.0	63.0	
Profit	A5		- 38.5	- 10.0	77.0	140.0	A3-A4
Computation of Incremental Cash Flows							
Profit			- 38.5	- 10.0	77.0	140.0	
Add depreciation			50.0	50.0	50.0	50.0	
Incremental Investment in Working Capital		- 4.2	- 12.5	- 33.3	- 25.0	-	Refer Working Capital Computation
Capital Investment		- 250.0					
Net Incremental Cash Flow		- 254.2	- 1.0	6.7	102.0	190.0	
Cum Net Cash Flow			- 1.0	5.7	107.7	297.7	
Payback Period		3.8	Years			43.5	
Working Capital Computation							
Cummulative Investment in Working Capital		4.2	16.7	50.0	75.0	75.0	2 months sales
Incremental Investment in Working Capital		- 4.2	- 12.5	- 33.3	- 25.0	-	

Serendib's target payback period for capital investments is 4 years. The projected payback period of the online footwear business is 3.8 years. Accordingly, the project is financially feasible.

Candidates should make appropriate assumptions and calculate the WACC of the company in order to compute the NPV of this project. Also, they should argue on the company's policy to use the payback period, which ignores the time value of money. They must advise the board about the importance of considering time value. Finally, candidates should advise on the appropriate decision the board should take after considering the NPV.

3. How to redesign/align the company's entire value chain to suit the online footwear business

- Design an attractive and easy to use online store to display and sell products.
- Product range should be appealing to the youth and track the changing tastes in the market.
- Integrate the online store with online payment channels (optional for the customer).
- Use online and mobile-based marketing campaigns/platforms to promote the online store.
- Deploy a sophisticated order and inventory tracking system from the point of placing the order to final delivery to the customer. The tracking facility needs to be available for both the internal use of Serendib as well as the use of the customers. Modern GPS technology can also be deployed. This will be the most critical element of managing the supply chain. The system will be able to identify the delivery address, scan the nearby retail stores or warehouse for availability of the ordered item, print the bill, arrange packaging etc. It will also enable mobile pick up of the item, delivery to the customer and the collection of cash if required and internal cash/inventory adjustments.
- Order and inventory management system will ensure availability of items displayed in the online store and manage lead times to the satisfaction of the customer.
- Serendib will have to have its own mobile fleet or outsourced fleet capable of delivering to any part of the country within the promised delivery time. Promised delivery time should ideally be within 24–48 hours in order to be competitive in the market.
- Serendib will have to come up with an accurate costing system to price items sold on the online store inclusive of the delivery cost depending on the address of the customer.
- Serendib will need to have a secure system to minimise the risk of misuse of cash by delivery staff when customers opt to pay by cash on delivery. A mechanism has to be in place to bank and track the cash collections on a daily basis. To mitigate this risk, customers should be encouraged to make online payments, pay by credit card on delivery or use a mobile payment platform.

4. Financing strategy for modernisation of the retail chain and the recommended financial strategy

Please ignore the impact of the proposed online footwear business division of Serendib for this discussion and disregard the implementation time needed for modernisation of the retail chain.

4.1 Financing options available

Any business has two primary financing sources:

- Equity
  - Private equity (private equity funds or private investors)
  - Listed equity via an IPO
- Debt
  - Bank loans (including syndicated loans)
  - Debentures (listed or private) and other debt instruments such as commercial papers

Advantages and disadvantages of equity financing (through an IPO)

Advantages	Disadvantages
No fixed commitment/obligation as in debt financing. This is important given the already high finance costs of Serendib.	Highest cost financing option – theoretically, the cost of equity is higher than the cost of debt due to higher risk.
Promotor shareholders of Serendib share risks with external shareholders.	Sirisoma Perera's family will have to dilute the ownership of the company.
Serendib will have enhanced credibility as a listed company.	Decision-making may slow down due to outside/independent directors.
Improves financial gearing and credit worthiness.	As a listed company, Serendib will have to disclose more information to the pubic, which may impact its competitiveness.
Serendib will have a higher level of financial and operational flexibility (due to reduced gearing).	An equity raising exercise takes a long period of time compared to obtaining bank financing. Serendib may have to delay the project until financing is available. Success and valuations will depend on market conditions.
Improves corporate governance and transparency.	
Serendib can improve the quality of decision-making due to external/independent directors.	

Additional aspects related to private equity financing

- Private equity investors may impose strict conditions related to board composition, delegation of authority, decision-making rights, reporting of information, sale of shares etc.
- Private equity investors will seek a definitive exit route for their investment.
- Private equity investors will put a lot pressure to improve business and financial performance of the company.

Advantages and disadvantages of debt financing

Advantages	Disadvantages
Sirisoma Perera's family can retain full ownership of the company.	Fixed financial commitment/obligation. This can be a major concern due to the already high finance cost.
Serendib, as a profitable company, will have the advantage of the tax shield created by the interest costs, which will effectively reduce the cost of borrowings.	Sirisoma Perera's family will continue to bear the entire risk of the business.
Obtaining a bank loan will be faster than raising funds via an IPO or private equity.	Financial leverage/gearing will increase further.
Faster decision-making	Reduces financial/operational flexibility.
	May have to compromise future growth due to inadequate funding. The retail expansion project may have to be scaled down or phased out.
	No pressure or incentive to improve corporate governance.
	Banks may impose restrictive covenants given the relatively high gearing position of Serendib.
	Given the large quantum of funding required, banks may demand physical security against the loan.

Additional aspects related to listed debentures

- Serendib will have to obtain a credit rating to raise funds via a listed debenture.
- Listed debentures will broad base Serendib's debt financing beyond the banking sector to include insurance companies, unit trust funds, pension funds etc.
- Typically, most of the listed debentures are issued without any physical security unlike bank loans.
- Listed debenture will take a longer period for execution due to the regulatory process involved compared to a bank loan.

- Due to the larger investor base, listed debentures may be able to raise funds at a lower interest rate compared to a bank loan (despite the fact that tax benefits are removed).
- Listed debentures impose higher disclosure and compliance requirements.

Note: A well-presented analysis of debt vs equity financing is acceptable without going into sub-options such as private equity and corporate debt/debentures.

4.2 Recommended financial strategy

When deciding on the financing strategy for modernising the retail chain, which amounts to Rs 1,000 million, the following factors need to be taken into account:

- Impact on the gearing level of the company
- Ability to service the company borrowings
- Analysis of the market conditions and circumstances of Serendib

The main decision to be made is what the primary form of funding should to be (either debt or equity) and then decide on the exact funding strategy based external market conditions.

Impact on gearing

Impact on Gearing	Present* Situation	If Debt Financed	If Equity Financed	Mix Funding**
Non Current Borrowings	1,194	1,194	1,194	1,194
Current Borrowings	329	329	329	329
New Debt	-	1,000	-	500
Total Borrowings	**1,523**	**2,523**	**1,523**	**2,023**
Existing Equity	823	823	823	823
New Equity	-	-	1,000	500
Total Equity	**823**	**823**	**1,823**	**1,323**
Debt to Equity Ratio	**1.9**	**3.1**	**0.8**	**1.5**

* Based on the information given, no material changes to the capital structure since 31 March 2016.

** Mixed funding assumes the project is financed with debt and equity on a 50:50 basis.

To start with, the existing gearing position as measured by the debt to equity ratio is relatively high → 1.9 times. The gearing level will further rise to an extremely high level of 3.1 times if the company decides to finance the project entirely with debt. This may increase the financial risk of the company to an unacceptable level. On the other hand, financing the project entirely with equity would bring down the gearing to a very conservative level of 0.8 times, which may not be optimal from the shareholders' perspective. However, from a gearing perspective, a combination of debt and equity funding brings the gearing position to an acceptable/prudent level. For example a 50:50 debt to equity mix will make the debt to equity ratio 1.5 times.

Hence, it is recommended to finance the new investment via an appropriate mix of debt and equity (50:50).

Debt serviceability

Ability to service the borrowings of the company is an important consideration in deciding the financing strategy. The loan schedule of existing term loans is produced below.

			Rs Mn
Loan Term Loan Schedule - Exisitng Loans	**31.03.2018**	**31.03.2019**	**31.03.2020**
Brought Forward Balance	1,195	717	299
Paid durng the Year	(478)	(418)	(299)
Carried Forward Balance	717	299	-
Average Balance	956	508	150
Interest Cost at 13%	124	66	19

Cash flow available for debt servicing

			Rs Mn
Cash Flow Available to Service New Loans	**31.03.2018**	**31.03.2019**	**31.03.2020**
EBITDA	861	1,119	1,343
Interest Cost on Long Term Loans	(124)	(66)	(19)
Interest Cost on Short Term Loans*	(28)	(40)	(49)
Long Term Capital Repayment	(478)	(418)	(299)
Cash Flow Available to Service New Loans	**231**	**595**	**975**

* **Rough estimation (pro-rated based on turnover). Candidates may ignore this impact in their answers.**

As recommended under the gearing analysis, financing through a 50:50 debt to equity mix will require cash flows of Rs. 65 million in order to finance the incremental interest cost at 13% p.a. for new borrowings of Rs. 500 million, which would leave around Rs. 166 million of additional cash for the year ending 31 March 2018. It would be prudent to negotiate a grace period of one year for capital repayment of the new debt. The cash flow position is fairly comfortable from the 2nd year onwards.

Note: Candidates may compute the debt service cover ratio under certain assumptions, but it is not really expected by the examiner.

Analysis of market conditions

Market conditions need to be analysed in the light of the proposed funding mix of 50:50 between debt and equity. In addition, Serendib's readiness for a public listing and urgency of funding should also be taken into consideration.

Based on the financial projections given, Serendib anticipates a steep growth (CAGR of 26%) in its EBITDA over the next 3 years. This growth, backed by a well-presented "retail story", fulfils important pre-requisites to fetch an attractive equity valuation for an equity raising exercise, either by way of an IPO or private equity. However, the main issue with an IPO is the volatile nature of the Sri Lankan equity market. Despite a positive trend being seen since April onwards, until sustainable market conditions persist, an IPO is a risky proposition to consider given the urgency of funding. If equity market conditions suddenly turn negative, the IPO would have to be held back, which would delay the modernisation programme of the retail chain. Further, Serendib's readiness for an immediate public listing is doubtful. Listing requires major improvements to the corporate governance structure such as the introduction of independent directors, formation of board sub committees (such as audit committees, remuneration committee etc.) and increased disclosure requirements to the public. Being a closely held family-managed company, Serendib may need a longer time to adopt and comply with the corporate governance framework expected from a listed company. Hence, it is recommended that Serendib opts for a private equity placement for the equity portion of funding. Together with the private equity investor, Serendib can build the business and improve corporate governance practices for a subsequent public listing a few years down the line depending on the future funding needs.

As far as the debt component is considered, a listed debenture issue is not recommended, as listed debentures are no longer attractive with the withdrawal of tax benefits extended to investors. This is clearly evidenced by the drastic drop in new listed debenture issues in 2017. Further, the appetite of investors for privately placed corporate debt is also unlikely to be attractive, given the uncertainties of tax implications with impending changes to tax regulations. Hence, for the debt component, a direct bank loan facility is recommended. This would be fast as well. As a result, Serendib can proceed with the modernisation project using the bank loan until the equity component is worked out with a private equity investor. Given the drastic increase in interest rates, it may be prudent to negotiate a loan facility with variable interest rates so that Serendib can benefit from a potential fall in interest rates in the medium to long term.

In conclusion, it is recommended that the proposed investment of Rs. 1,000 million is financed via a debt to equity mix of 50:50. The debt component is recommended to be raised via a direct bank loan facility given the urgency of funding and the adverse tax implications of listed debentures and other forms of corporate debt. A private equity placement is recommended for the equity component given the lack of readiness of Serendib for a public listing and the present uncertainties and volatilities in the listed equity market in Sri Lanka.

Note: this is only a recommended outline for this part of the answer. An alternative funding structure is acceptable provided the candidate has presented it in a logical manner, with reasonable arguments supporting the recommendation.

5. Potential compliance issues (other than child labour) that may arise when sourcing via overseas contract manufacturers, and recommendations on how to improve the company's internal controls and quality assurance systems

Potential compliance issues (excluding child labour)

- Compliance with applicable local rules and regulations in the country of origin – legal compliance
- Other labour related issues
  - Health and safety
  - Adverse working conditions in the factory
  - Minimum wage regulations
  - Working extended hours
  - Unfair treatment/discrimination
  - Forced labour
  - Sub-contracted labour not complying with local regulations
- Improper disposal of waste/pollution
- Social and community issues
- Poor quality raw materials used
- Corrupt business practices

Strategies to improve compliance and quality assurance

- Develop a close business relationship with a long term focus
- Develop a comprehensive compliance management system for all foreign suppliers, taking into account of local rules and regulations and international best practices. Prospective suppliers need to be brought in for implementation of such a system, citing long term benefits such as access to developed markets, better industrial and community relations etc. Such a system shall include:
  - Labour aspects
  - Environmental aspects
  - Social and community aspects
  - Transparent business practices
  - Raw material sourcing
- Carrying out a thorough due diligence of suppliers before selection
- Specifying a code of conduct.
- Provide technical assistance where possible to the suppliers to improve compliance.
- Insist on internationally accepted compliance and quality certifications.
- Develop a rating system for foreign suppliers.
- Carrying out frequent spot audits and inspections.
- Have a thorough pre-screening process for foreign suppliers prior to starting a relationship with them.
- Have an annual review process of compliance related matters and devise specific plans to address any issues identified in such a review.

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