THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No. of pages: 07

Corporate Strategy and Contemporary Issues

KC5

JULY 2017

<u>Instructions to candidates</u>

(1) Time allowed: Reading and planning – 20 minutes
Writing – 3 hours

(2) Total: 80 marks

(3) The examination will be conducted as an open book examination.

(4) This question paper should be answered entirely in the **ENGLISH** language.

(5) Your answer must be submitted in the answer booklets provided at the Examination Hall.

(6) Any pre-prepared papers included in your answer WILL NOT be marked.

(7) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer booklet/s.

Online footwear business division

Immediately after the board meeting which was held in February 2017, the marketing director instructed Aravinthan Shankar, the head of retail channels to obtain a market intelligence report on the online footwear business in Sri Lanka from a leading market research agency. Approximately a month after the board meeting, the three executive directors sat with the management team to discuss the launching of the online footwear business and modernisation of the retail network. Aravinthan had the market intelligence report in his hand as he sat for the meeting. He summarised the report as follows.

- The pioneering online website in Sri Lanka dedicated for footwear is "Click & Go" which presently has sales of around Rs. 10 million a month.
- Click & Go has recorded an exponential growth in its sales over the last 6 months.
- There have been substantial repeat purchases by the customers given the high quality of services of Click & Go and the wide product range on offer including global and international brands.
- The prices offered by Click & Go for branded imported products were significantly lower (around 20% lower) compared to the prices quoted at the physical showrooms of Serendib and other competitors for similar products.
- In addition, the registered customer base of Click & Go has been increasing rapidly day by day.
- The market research agency expects the middle to high end customers of footwear to turn more towards online purchasing as the market evolves.
- The report also says that at least one other traditional footwear retailer is presently working on launching an online platform.

After listening to these highlights, the three executive directors concluded that Serendib must have its own online footwear business division if it is to sustain in the long run in the medium to high end segments.

The chairman said, "We are moving into an unknown territory. Therefore, it is important for us to assess the risks involved in an online business model, which will help us to take necessary precautions to mitigate such identified risks."

Siva Gopalan, the head of supply chain said, "We will face new challenges when managing the supply chain for the online business model. Managing lead times and inventory, delivering to customers across the country, inventory and delivery tracking, costing and pricing will all be new challenges the company will have to face". The operations director, agreed with Siva. He added "We will also have to give the online customers the option to pay cash on delivery as our society may still be uncomfortable using online payment options due to the perceived risk". He also said, "We must see how best we could realign the supply chain and the ways of mitigating risks associated with the online business".

The finance director requested the marketing director and head of retail channels to submit a note on the estimated capital investment required to roll out an online footwear business and the key assumptions related to revenue and cost projections. The operations director stressed the importance of factoring in the cannibalising impact of online sales on the physical retail network.

Annexure 1 shows the note submitted by the marketing department on projections.

Financing for modernisation of the retail chain

At the same time, the marketing director was also working with his team on the modernisation plan of the retail chain. The company hired an international consultant to advise on this. The idea was to give the retail outlets a modern look to attract the young and growing middle class. After weeks of work, the marketing team came up with a comprehensive modernisation plan for a budget of Rs. 1,300 million including a new high end mall to be constructed on one of the lands the company owns in a Colombo suburb. After reviewing the plan, the chairman scaled down the project to Rs. 1,000 million. The chairman stated, "The market dynamics and consumer behaviour are changing rapidly. Therefore, we need to act fast to seize the opportunities. I feel we are already late given the success of Click & Go". The finance director stated that they would have to rely on external funding to make such a large investment of Rs. 1,000 million as they didn't carry a significant amount of excess cash reserves.

The chairman instructed the marketing director to submit the modernisation plan for board approval at the next meeting as he intends to commence this modernisation project immediately.

Compliance issues of foreign contract manufacturers

One of the contract manufacturers of Serendib in Bangladesh is Chittagong Footwear Limited. A recent newspaper article in Bangladesh highlighted potential compliance issues of Chittagong Footwear Limited (Annexure 2).

Required:

Assume you are Kamal Perera, the finance director of Serendib. As the finance director, you are required to submit a report at the next board meeting evaluating the following and making appropriate recommendations (where necessary).

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.

2. Financial feasibility of the proposed online footwear business division.

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

4. Financing options available for the modernisation of the retail chain and the recommended financing 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).

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.

Mark allocation	**Marks**
Introduction	02
Executive summary	08
Analysis and recommendations	
- Internal capability analysis	20
- Financial feasibility of the online footwear business division	10
- Redesigning/realigning value chain	15
- Financing options and strategy for modernisation of the retail chain	15
- Compliance issues	10
Total	**80**

The recommendations can be presented along with the analysis under each section.

Annexure 1 – Note on key assumptions related to the proposed online footwear business

(i) Estimated capital investment of Rs. 250 million to be made at the beginning of the project.

(ii) Estimated revenue and costs over the first four years are as follows.

	Rs. million			
	Year 1	Year 2	Year 3	Year 4
Revenue	25	100	300	450
Variable cost	11	45	135	202
Fixed cost	50	55	58	63

(iii) Cannibalising impact on existing business - it is assumed that sales of existing retail outlets will drop on average by 20% of the revenue generated via the online footwear business division. Assume that the existing retail business has a contribution margin of 50%. There will not be a material change to the fixed cost structure of the existing retail chain despite this revenue decline.

(iv) The depreciation charge on the capital investment for the online footwear business division is estimated to be Rs. 50 million per annum over the next five years. This amount is included in the fixed costs.

(v) Working capital requirement for the online business is estimated to be equivalent to two months' sales of the online business. This working capital requirement will arise at the beginning of the corresponding period. (Ignore any working capital implications due to the cannibalisation of existing sales. Assume there is no change in working capital beyond the forecast period).

(vi) Serendib's target payback period for new investments (inclusive of initial working capital) is four years.

(vii) Ignore tax implications.

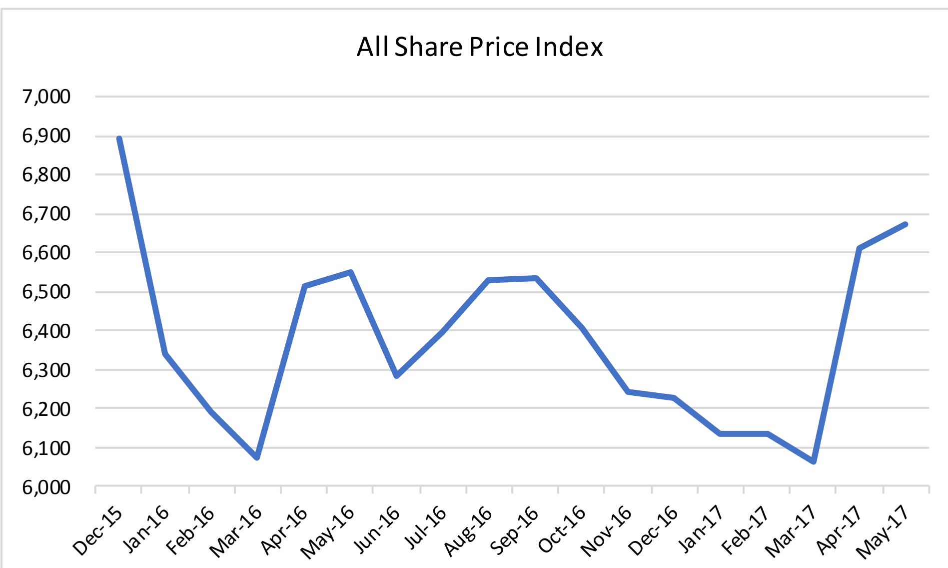
Annexure 2 – Bangladesh newspaper article

Chittagong Footwear Limited warned for using child labour

A leading footwear manufacturer and exporter in Bangladesh, Chittagong Footwear Limited, has been warned for the use of child labour in one of its factories in the Chittagong Export Processing Zone by a European buyer, according to informed sources. This was revealed in a spot audit conducted by the buyer as a part of its global compliance management programme. A senior official of the company who wished to remain unidentified confirmed that the company has received a formal warning from the buyer who has immediately stopped new orders being placed with the company until it addresses the issue in a satisfactory manner. Chittagong Footwear Limited reportedly exports around USD 30 million worth of footwear annually.

Annexure 3 – Stock market conditions

The movement of the All Share Price Index of the Colombo Stock Exchange is depicted in the graph below.



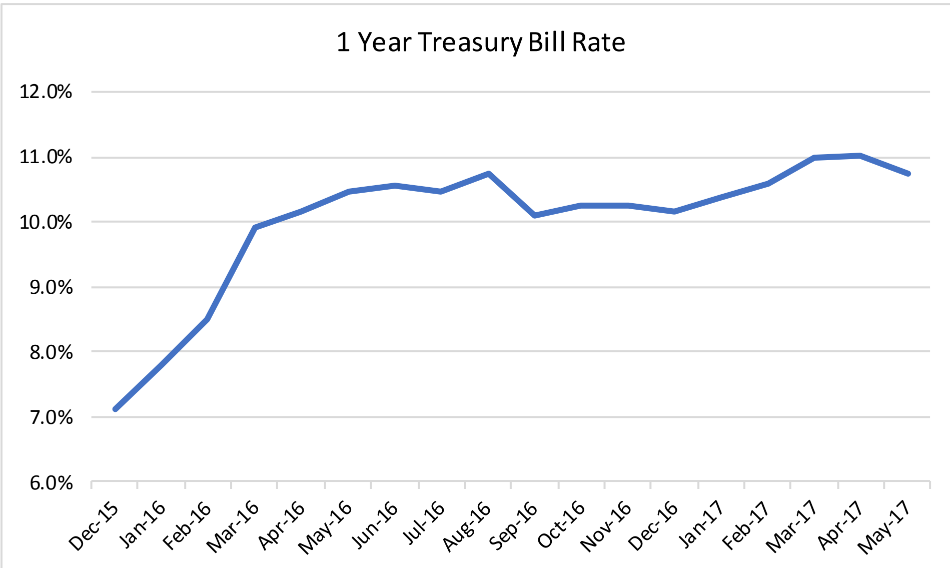
(Source: Colombo Stock Exchange)

<u>Corporate debt</u>

The market for listed debentures has slowed down substantially with the withdrawal of tax benefits given. Further, the proposed changes to tax regulations may also adversely impact the issuance of privately placed debt instruments.

Annexure 4 – Interest rate scenario

The movement of interest rates as indicated by the one-year treasury bill rate is given in the graph below.



(Source: Central Bank of Sri Lanka)

Annexure 5 – Financial projections (reproduction from pre-seen)

Selected extracts from the financial projections of Serendib are given below.

	Rs. million				
	Actuals		**Projections**		
	31.03.2016	**31.03.2017**	**31.03.2018**	**31.03.2019**	**31.03.2020**
Revenue	3,543	4,252	5,740	7,462	8,954
EBITDA	450	540	861	1,119	1,343
Note: EBITDA denotes earnings before interest, tax and depreciation					

There have been no material changes to the capital structure and its components since 31.03.2016.

Note:

The above projections include incremental sales from the proposed modernisation of the retail chain but exclude the impact of the proposed online footwear business division.