CA | THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC5 - Corporate Strategy & Contemporary Issues

December 2018

As regards both companies, as a whole

(1) Evaluate the strategic issues which could have caused the present situation under the following categories.

(a) Governance and leadership strategy

i. From early days Migara had been striving to reach his goals but had not been cost efficient (i.e. designs made at his previous work places had been rejected)
ii. Amal Rangajeewa performing the functions of both Company Secretary and Auditor – does not lead to good governance.
iii. Appointment of Sujith as ED of Minerva Exports – when he did not have the relevant capabilities.
iv. The close friendship between Amal and Migara, preventing him from criticizing perceived weaknesses.
v. Migara's interest in activities outside the business would have resulted in lack of control
vi. Migara did not seem to have a consultative approach when making decisions.
vii. Payment for personal property using company funds and writing it off as expenses, i.e. as his remuneration, increasing the burden on company cash flows
viii. Poor project management procedures
ix. Drawings by directors, other than remuneration, when the company was defaulting on its loans.
x. No attention had been paid to board balance, division of power and authority.
xi. There was no remuneration committee. All recruitment decisions were made by Migara, Vijith and Sahan.
xii. The company relied heavily, on a few key management personnel.

(b) Human resources strategy

i. Rukshan and Lakshan left as there was no proper understanding about reward schemes
ii. Appointments to key positions had been based on friendship rather than ability, resulting in a weak top management structure.
    1. Sahan being a wild life enthusiast does not appear to suit the position Head of Personnel Management as he does not have experience in the relevant field.
    2. Sahan did not appear to have technical expertise on Telecom Services either.
    3. Vijith had experience but no technical qualifications.
    4. Sujith did not appear to have any knowledge about power panels.
iii. It appears that Vijith and Sahan are paid above market remuneration considering their relevance and knowledge of the subject (their remuneration had been 14.4/12 = 1.2 million p.m. in 2017/18)
iv. Due to the weaknesses of the GM, the employees recruited also appeared to be weak characters (middle aged unqualified people who would not have had state of the art capability).
v. Finance and HR being key functions are not headed by adequately qualified experienced people.
vi. Minerva had to engage subcontractors for skilled labour which means that HR had not been able to recruit the right resources.

vii. Harshana also did not appear to have the required skills, as they were losing business, due to providing wrong designs.

viii. Poor handling of operational issues as the store keepers had been allowed to go scot-free, after massive stock losses.

ix. No action had been taken against those project managers, who had taken material in an unauthorized manner.

(c) Risk management strategy

i. Minerva had always been dependent on main contractors. They didn't have exclusivity contracts.

ii. Decision making was not adequately evaluated and based on consultation.

iii. The risk of quotations being erroneous had not been considered, viz.

1. Having to pay higher rates for subcontract labour, and
2. Additional overheads incurred due to time extensions

iv. No risk assessment had been done on its ability to meet revenue targets, when Minerva Exports was established (particularly at inception).

v. Reputational risk needed to be addressed as Minerva Exports had been losing business for providing wrong designs.

(d) Finance strategy

i. It appears that the company had expanded without sufficient working capital (Over trading).

ii. Minerva Exports equity investment had been financed using short term borrowings.

iii. Having foreign currency in FD and borrowing LKR against it may not have been the best strategy. FCD may have earned 2-3% p.a. interest while the borrowings against them would have cost nearly 14%. In order to justify this LKR needed to depreciate by more than 10% p.a.

iv. Purchase of property had not generated any returns, as this was financed through bank borrowings, which would further aggravate the finance cost.

v. Letters of credit and Import demand loans generally relate to material imports. Non settlement of those loans meant that the company had not recovered material costs.

vi. Early importation of material means that working capital management had not been satisfactory.

vii. Poor internal controls resulted in stock losses. No action had been taken to rectify the problem, after the first issue surfaced.

viii. Balance sheet management strategy has been poor.

1. Initial equity had been only LKR 800k and LKR 90M of equity comprised revaluation surplus. Against 106M of equity there is 440M of debt making the company heavily geared. With marginal ROCE, the operating profits are not sufficient to meet the finance costs.
2. 106M had been with related parties (Receivable from RP 76M + Investment in subsidiary of 30M), which is in effect, equal to equity. As such Minerva Engineering had been entirely financed with Debt.

(e) Any other

i. Minerva being a subcontractor, is by nature, in a weak position to negotiate terms and conditions (time extensions and contract modifications)

ii. Minerva moved to the high-rise building sector without adequate expertise and ended up making losses.

iii. Minerva appeared to have performed well in overseas projects, but the good lessons learned there, had not been brought back to improve other areas of business.

iv. The idea of Minerva Exports had originally been mooted because of the power panels required for the projects carried out by Minerva Engineering, but finally it has been driven by different objectives.

v. Sourcing appeared to have been very poor as inventories had been stocked, even before the jobs had been awarded.

vi. There seemed to have been a lot of material wastage, as the amount of scrap sales was very high.

(2) Demonstrate possible causes of not being able to win tenders.

(a) Main contractors who had M&E capability could quote more competitive prices.

(b) M&E and Telecom Services divisions being profit centers would have made the quoted prices further uncompetitive due to their focusing on divisional profits.

(c) Very high level of overheads mainly due to heavy expenses of directors.

(3) Propose modern cost management techniques which may be used to optimize and better manage costs so that their pricing would be competitive.

The students were expected to discuss methods such as lean management, kaizen costing and Manufacturing Resource Planning (MRP II).

(4) Critique Migara's view on the Minerva brand

(a) The brand had no uniqueness and did not appear to have developed or managed a brand strategy.

(b) The brand had not been able to command premium prices and had been frequently rejected in tenders.

(c) Minerva had not been able to attract good talent and the labour market preferred its competitors.

(d) The company was not making any super profits.

Under the above circumstances the brand does not seen to have any claimable value.

With specific reference to Minerva Engineering

(5)

	LKR '000	
Operating Profit 2017/18	55,271	
Less: 20% thereof	(11,054)	
Estimated profit 2018/19	44,217	
	LKR '000	
Adjustments		
Depreciation	1,211	
Scrap sales	(9,340)	With belter management expected to be eliminated.
Interest income	(5,687)	Evaluated on a debt free basis and debt taken against deposits
Payments to directors	35,860	All payments to directors and Chairman
Reasonable remuneration to MD	(12,000)	Assumed 1M per month for a MD of this size company.
Maintenance Cap-ex	(3,000)	Estimated - This type of a company is not PPE heavy
	7,044	
Adjusted Op FCF 2018/19	51,261	
FCF in 2019/20	53,311	
Discount rate	18%	
Growth rate	4%	
Estimated business value	380,795	

Add: Non- operating assets

Lands	40,000	The two lands not directly used for the business taken at market value.
RP Investment	30,000	Taken at book value subject to realisation.
RP receivable	75,575	Taken at book value subject to realisation.
	526,370	

Minerva Engineering alone was having a value of approximately LKR 380 million.

The lands and related parties investment and payables can be separated and not included in the above value.

However Migara will have to settle the loans	**LKR '000**
Non-current liabilities	(129,575)
Current liabilities	(311,240)
	(440,815)
Short-term investments	88,320
Disposal proceeds	380,795
Surplus	28,300

The transaction will not leave any significant residue for Migara.

However he will be left with the two lands worth LKR 40M after being relieved from all debt obligations.

Further Minerva Exports will not have to settle LKR 75M due to Minerva Engineering.

(6)

	LKR '000
Restructuring proposals	
1. Set off Short-term investments with Short-term liabilities	88,320
2. Sell the two lands and reduce liabilities	40,000
3. Recover RP receivables (practicality to be assessed)	75,575
4. Migara to make an equity injection	50,000
5. Banks to give a concession from accumulated interest	35,000
	288,895
	440,815
Remaining amount of borrowings	(151,920)

This will reduce the interest cost from present 56M to approximately 20M.

	LKR '000
Accordingly 2018/19 Operating profit	44,217
Interest	(20,000)
Adjustments	
Scrap sales	(9,340)
Interest income	(5,687)
Payments to directors	35,860
Reasonable remuneration to MD	(12,000)
	33,050

Minerva Exports

(7) Evaluate the strategic issues, with reference to the competitive environment surrounding Minerva Exports, which may have caused the present situation.

The students are expected to provide an evaluation on the following.

- Issues in pricing
- Issues in tendering
- Issues in recruitment
- Improper analysis done on the customer environment
- Lack of marketing expertise
- Lack of marketing plan/strategy

(8) Propose marketing and business development strategies for the medium term.

- Show customers that it is not a typical subcontractor. Minerva should be able to let customers know that the company had the facilities and operational capabilities, to handle projects and meet their needs.

  Building a strong relationship with customers is important to make many connections as possible, so that a close network of relationships would help the company in winning contracts.
  E.g. Organizing informal gatherings

- The company needs to pay attention to branding as it must add value to the company. E.g. establish brand identity with a professionally designed logo. Add the company's logo in construction sites, to machinery, team member uniforms, web sites etc.

- Leveraging design capabilities as it will give the company a competitive edge in negotiating projects.

  Value its engineering capability, and the company's demonstrated ability in resolving customer problems through design & modifications, which would be a stronger selling point.

- Have a clearly defined marketing strategy and a plan.

- Communicate efforts, successes and failures among team members, to avoid repetitive mistakes.

- The need to pay attention to emerging trends such as wind technologies, green building requirements, lean construction practices etc..

- Branding should communicate 'strength and the durability', as clients will be interested in knowing that the projects will be finished on time and completed well.

- Cost plus pricing can be adopted as each job or contract is different.

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