



COMMON PRE-SEEN
(KC1 TO KC4)

JUNE 2017

Somachandra and Sons (Pvt) Ltd

Background of the company

Somachandra Appuhami founded the company Somachandra and Sons in 1920, with an initial capital of Rs. 30,000. It was located in Galle, on a land area of one acre. The initial activities of the business were milling of rice, kurakkan and other grains. By 1948, it had expanded into different segments. The business was incorporated in Sri Lanka under the Companies Ordinance No. 51 of 1938 on 9 January 1949 as Somachandra and Sons (Pvt) Ltd (SSPL). SSPL at present produces noodles, coffee, kurakkan flour, ulundu flour, rice flour, papadam, laundry bar soap and body wash soap. It has acquired a significant market share for the said products under the brand name “S&S” while competing with multinational companies in Sri Lanka.

S&S has been a household name for decades in the food sector. It is growing rapidly at the moment but cannot expand any more at its current location. When it was set up, there were no residencies around it. Today the area has become highly residential and for this reason, SSPL is not permitted by the authorities to carry out any expansion. Therefore SSPL is looking for a new plot of land to expand the factory, which is standing on a five-acre land at present in the environs of Galle.

SSPL believes that the manual manufacturing process is still possible although its competitors are using high-tech modern technology that requires only a few workers. This way the company could offer more opportunities to people and look after their families by creating jobs in the factories. It is remarkable that although the manufacturing process is manually operated and the overhead expenses are high, the company has achieved all international standards. SSPL has become a part of the national heritage for maintaining the originality of some of its products, particularly coffee powder, noodles, papadam and soap.

The current chairman of the group is Nihal Somachandra, the eldest son of the founder who is a mechanical engineering graduate from the University of Moratuwa. His younger brother Athula Somachandra is the group CEO and the youngest brother Kamal Somachandra, who is a Chartered Accountant, is the group finance director.

At a recent board meeting, the group CEO emphasised the need to change the operational process to be in line with new trends. If not, the company would not be able to compete with local as well as international competitors since most of the international markets are looking at minimum human intervention in the production of food products to allow high hygienic standards to be maintained throughout the production process.

SSPL has the following three main Strategic Business Units (SBUs) in operation under three general managers.

- **Food products:** All food products come under this unit and the majority of the group's labour force is assigned to it.

- **Fuel & lubricants:** Two fuel stations are established in Galle and Matara to provide services to the government and corporate institutions established in those areas.
- **Soap:** Laundry bar soap and body wash soap are produced under this unit.

S&S Distributors (Pvt) Ltd (SSD) is a fully-owned subsidiary of SSPL, established on 1 April 1980 by investing Rs. 5 million (consisting of 500,000 shares) as initial capital. It was established to maintain efficient distribution of the SSPL's products domestically. Kaldera Alphonso is the current CEO of SSD and he is a Chartered Marketer having his first degree from the University of Sri Jayewardenepura in Business Administration.

Supply chain management of SSPL

Since the company uses local raw materials for its products, it is very important to have an excellent supply chain in order to obtain a constant supply of good quality raw materials to produce high quality products under the S&S brand. This is the dilemma the company is facing currently. There is high competition in the domestic market. The company regularly monitors inputs at the collection centers and tries to avoid buying low quality inputs. However at the recent board meeting, Edward, Nihal's son who recently joined as a group director, critically evaluated the existing process and advised the board that he is not happy with the current process and the supply chain management system of the company. Edward joined at the request of the group CEO, just after his master's degree in Agro-Engineering from the Asian Institute of Technology (AIT) in Thailand. He advised the board that the cost of production of the company in average was 10-20% higher when compared to its competitors and requested the board to consider this matter as it could have a serious impact on the market share and image of S&S branded products. Edward suggested that the company should have an alternative plan to meet the competitors' challenges in the existing market and capture the market share of young people who are purchasing other brands. Since all the directors of the company are related, Edward believes that making decisions about the future of the company would not be a difficult task.

Coffee powder

S&S coffee (in bulk as well as in packets) is popular in the domestic market for its high quality. Coffee is an age old product of SSPL and it has now become the market leader. However, the company has realised that the supply of coffee seeds from local farmers has reduced due to competitive rivalry as well as the low production of seeds caused by a reduction in the cultivation area. The company still uses their old machinery to produce coffee products and they understand that the quality should be improved although there is a high demand for their products in the local market. Further, the gross profit margin has come down due to the high cost of production and the division is now running at a loss.

Edward emphasized at the meeting that they should not discontinue coffee production because it is a popular product in the domestic market. He requested the board to think in depth and bring in a few viable suggestions to the next meeting. Edward also had a strong

proposal to re-engineer the division in order to bring it back to being profitable. He further mentioned that the international market would pick-up in the near future as Sri Lanka will be able to tap European markets since the European Community is willing to grant GSP plus once again. Therefore the company will have a large market they can easily promote S&S products to, if they could find a solution to the current issues.

Normal noodles vs instant noodles

Historical data has given a true picture of the market share of normal and instant noodles. Lifestyles of people have changed and become very busy as both parents are employed in the majority of families. As such, the popularity of instant noodles is increasing than that of normal noodles. China and Hong Kong contribute to the highest consumption of instant noodles in the world (44%).

Edward has sent a paper to the board on his proposal to start manufacturing instant noodles under the brand name S&S to both the local and international markets (Annexure 01). He has briefed the board on the production line specifications as follows.

2016 Full Automatic Large Capacity Instant Noodles Production Line

FOB-price: USD 200,000 per machine

Production capacity: 40,000 bags per 8 hour shift

Moreover there is a company in Hong Kong named Supreme Food Processing (Hong Kong) PTE Limited (SFP (HK)) that is interested in investing in SSPL to produce instant noodles under the brand name S&S Supreme Instant Noodles. Edward is currently discussing the possibility of considering this investment as a cross-border investment.

Supreme Food Processing (Hong Kong) PTE Limited (SFP(HK))

Charlee Lee, the founder, established SFP(HK) in 1980 in Hong Kong as a private limited company to manufacture and process special varieties of food items such as premium Hong Kong egg noodles, Hong Kong Ee Fu noodles, spinach noodles, tomato carrot noodles, Japanese Ramen, Shanghai handmade noodles, Mee poh, Wonton skin, dumpling skin and dim sum skin.

Lee could diversify the business to market a variety of other products such as tea and spices in mainland China and also distribute these products to major airlines, hotels, restaurants, food courts, coffee shops, hawkers and government schools.

Nihal and Edward have a good relationship with Lee and they have approached him to invest in SSPL group to start the production of instant noodles.

Edward has a strong feeling that with this foreign partner, S&S products could enter the market in both Hong Kong and China as well as capture the European market in the light of

the GSP plus opportunity. SFP(HK) currently has a strong presence in markets in both Hong Kong and China with similar products. Lee has proposed that he is keen to invest in order to modernise and install the required machinery in the noodles production division as well as the coffee production division. SFP(HK) has also agreed to send one of their expert employees on a secondment basis for a specific period to train the local workers/staff to operate the instant noodles plant.

Lee and Nihal want to list out the issues and tax benefits of investing as an approved BOI project in Sri Lanka in a specially demarcated area that receives tax benefits and other concessions.

Further Edward mentioned that a draft agreement will be submitted to the board at the next board meeting.

Financial performance and financial strategies

The newly recruited financial accountant of the group, Thilak Fernando, approached the finance director and pointed out that the group does not prepare consolidated financial statements. He mentioned that the group should follow Sri Lanka Accounting Standards when preparing consolidated financial statements. The financial information of SSPL is given in Annexure 02.

The board of directors is concerned about the future of the company and wants to capitalise the revenue reserve built for internal growth instead of distributing it among the shareholders. There were arguments for and against this amongst them but it was finally decided to evaluate the situation in depth before coming to a final conclusion.

The board of directors took a board decision and paid a total dividend of Rs. 62.38 per share to the shareholders whereas in the previous year the dividend was only Rs. 43.19 per share. However Edward was not happy about this and he mentioned that SSPL should have capital reserves to fund organic growth in the future. He said that if SSPL distributes most of its profits to shareholders, the company will not be able to attract investors for the expansion projects and the existing owners will also not be able to fund any new project.

SSPL has two sales outlets that were established in the two main towns of Galle and Colombo. The marketing manager mentioned in his weekly report to the board that 80% of the revenue is generated from wholesale sales and the rest from the retail sales. Meanwhile the CEO of the group has sent a note to the board requesting them to consider a price increase for all types of products (that do not come under price control), mentioning that they had not increased the prices of S&S products in the last two financial years. However the marketing director argued that since there are many competitors and different brand substitutes in the market, it is not an appropriate strategy to increase their prices in order to manage the segment's operating profit margin. He also warned the board that the soap segment is currently volatile due to the multinational companies that have acquired a significant market share.

The group CEO requested the finance director to evaluate the performance of the subsidiary that is providing services to the parent company to distribute its products through the national network, and collect receivables from the wholesalers and retailers. He pointed out that there is a significant amount of receivables that have gone beyond 60 days and that the subsidiary should be responsible for it. The following additional details were found in respect of the food products trade receivable collection process.

Sales and trade receivables

The food products SBU carries out 80% of its sales on credit terms, which is spread evenly over the weeks of the working year. As a result, 90% of SSPL's trade receivables represent the amounts receivable to this SBU. SSPL operates from multiple locations, where goods are handed over to corporate customers upon their request while all invoicing of credit sales is carried out from the head office. The sales documentation is sent to the head office via multiple distribution channels including normal post, registered post, hand delivery, email and courier services, which leads to a complicated tracking process. The head office shared service center then generates invoices and dispatches the same to customer locations via similar distribution channels. The management has made an assessment that 70% of credit sales can be collected without major delays, provided the data gathering at the head office and the invoice distribution process is re-engineered with a digital platform.

An analysis of the delay in invoicing (which is measured as the delay between the date of handing over the goods to the customer and the date of dispatch of the invoice to the customer), is shown below.

Delay in invoicing	Sales subject to this delay (probability)
6 days	10%
7 days	16%
8 days	40%
9 days	21%
10 days	13%

A further study revealed that debtors take 45 days on average to settle their debts from the date of dispatching the invoice to them.

Human resources

Factory workers of the group represent 60% of the employee cadre of SSPL and the majority of them have worked for more than 15 years in the company. They are loyal, hardworking employees. Modernisation of the production process will have an impact on manual labour. Hence the chairman pointed out that once the automation of the production process commences, the company should have an acceptable voluntary retirement scheme in place for the excess workforce.

Factory workers of SSPL

Segment	Number of employees
Food products	425
Fuel & lubricants	25
Soap	150
Total labour force	600

Major shareholders of SSPL (to date)

Name	% shareholding
Nihal Somachandra	55
Athula Somachandra	15
Kamal Somachandra	15
Edward Somachandra	10
Employees (25)	5
Total	100

Other matters

Since SSPL does not have any prior understanding of the various risks related to the instant noodles manufacturing process, the board of directors of the company decided to ask their external auditor, M&W Associates, to carry out a system review and provide a report to the board.

Sellahewa, a Chartered Accountant who is the newly appointed internal auditor of SSPL, submitted a board paper requesting an audit committee to be appointed, since it is one of the major requirements of corporate governance that could help attract foreign investors. However, the chairman negatively spoke about this at the board meeting and said “our company is a private limited company hence there is no need to consider such a request”. The finance director who has critically analysed the existing control system mentioned that the company presently relies on the integrity of personnel rather than having assurance from a control-based environment. He requested the board to consider his proposal on the automation of some parts of the traditional manufacturing process and to also have a fully-pledged ERP system for the financial and operational processes. This was positively considered by the board, and the finance director was asked to submit a comprehensive report that could be discussed at the board meeting scheduled to be held in September 2017.

Further, a cash loss of Rs. 25,524 was reported in one of the sales outlets when a surprise check was carried out by the internal audit department recently.

Competitor and industry information

The finance director has mentioned that a similar-sized company called XYZ PLC, which is listed on the Colombo Stock Exchange, reported the following results. These will be useful when benchmarking SSPL in any future negotiations.

XYZ PLC:

- Dividend payout ratio: 25%
- Earnings per share (EPS): Rs. 125.75 (issued at Rs. 10 per share)
- The company was totally funded from equity; no borrowings were reported
- Beta (based on ASPI): 0.68
- Current treasury bill rate: 11% p.a
- Market risk premium: 4%
- Market rate of return: 15% p.a

Annexure 01

Instant noodles industry in Sri Lanka: Analysis of growth, trends and forecasts (2017 - 2022)

Sri Lanka is an attractive market for instant noodles in the world with new companies considering entering the production of instant noodles in the country. The market is mature in Sri Lanka and is limited to a few players. A recent ban on Maggi, a Nestle product, has created scope for locally-made instant noodles like Prima Stella.

A growing youth segment, increasing working population, rising incomes and purchasing power, high brand consciousness, changing consumer preferences, growing urbanisation and an increase in the middle class population are the biggest drivers of growth in the instant noodles industry of Sri Lanka. Further, a lack of time, fast-paced lifestyles and changing food preferences are also helping the instant noodles sector to grow.

The instant noodles industry in Sri Lanka, unlike in other emerging economies, is still very traditional in nature and is largely controlled by a few cooperatives and independent instant noodles companies. Street markets play an important role in the instant noodles industry in Sri Lanka as most of the population does their shopping here.

Apart from Prima, major brands that have successfully gained a market share are Maggi, Alli and Delmege. There are roughly 10 brands available in Sri Lanka and the market is still open for new entrants offering smart products. A large share of the instant noodles market is held by Maggi.

From being an importing nation, Sri Lanka is slowly growing towards being an exporting nation. Almost all FMCG products are now manufactured in Sri Lanka and some of them are even exported to neighboring countries. However, Sri Lanka is still lagging behind in raw material availability, which it sources from India and China. India is the biggest trading and strategic partner of Sri Lanka, and it greatly helped the country to stabilise the economy especially during the civil war. Sri Lanka sources most of its wheat, which is a necessary ingredient for instant noodles production, from India.

(Source: <https://www.mordorintelligence.com/industry-reports/instant-noodles-industry-in-sri-lanka>)

Annexure 02

Financial information of SSPL

Somachandra and Sons (Pvt) Ltd		
Income statement for the year ended 31 March	2017	2016
	Rs. '000	Rs. '000
Revenue	2,455,963	2,519,070
Cost of sales	<u>(1,947,512)</u>	<u>(1,915,122)</u>
Gross profit	508,451	603,948
Other income	<u>31,807</u>	<u>16,874</u>
	540,258	620,822
Distribution expenses	<u>(275,709)</u>	<u>(295,851)</u>
Administrative expenses	<u>(174,534)</u>	<u>(168,224)</u>
Operating profit	90,015	156,747
Net finance income	<u>13,887</u>	<u>17,633</u>
Net profit before income tax expense	<u>103,902</u>	<u>174,380</u>
Income tax expense	<u>(28,053)</u>	<u>(47,083)</u>
Profit for the year	<u>75,849</u>	<u>127,297</u>
Profit attributable to equity holders	<u>75,849</u>	<u>127,297</u>

Somachandra and Sons (Pvt) Ltd		
Statement of comprehensive income for the year ended 31 March	2017	2016
	Rs. '000	Rs. '000
Profit for the year	75,849	127,297
Other comprehensive income		
Net change in fair value of available-for-sale financial assets	2,541	5,141
Actuarial loss from re-measurement of employee benefit obligations	<u>(7,788)</u>	<u>(954)</u>
Deferred tax reversal on actuarial loss	2,181	-
Total comprehensive income for the year	72,783	131,484

Somachandra and Sons (Pvt) Ltd		
Statement of financial position		
As at 31 March	2017	2016
	Rs. '000	Rs. '000
Assets		
Non-current assets		
Property, plant and equipment	638,102	650,898
Intangible assets	4,802	1,635
Investment in subsidiary	5,000	5,000
Available-for-sale investment	37,951	35,410
Total non-current assets	685,855	692,943
Current assets		
Inventories	132,840	144,054
Related party receivables	26,452	21,756
Trade and other receivables	407,540	317,237
Cash and cash equivalents	147,686	175,155
Total current assets	714,518	658,202
Total assets	1,400,373	1,351,145
Equity and liabilities		
Equity		
Stated capital	10,000	10,000
Other capital reserves	7,011	7,011
Available-for-sale reserves	20,473	17,932
General reserves	12,439	12,439
Retained earnings	999,921	992,066
Total equity attributable to owners of the company	1,049,844	1,039,448
Non-current liabilities		
Deferred tax liabilities	32,331	29,278
Employee benefit obligations	63,816	49,980
Total non-current liabilities	96,147	79,258
Current liabilities		
Trade and other payables	174,646	145,064
Current tax liability	12,071	18,650
Bank overdraft	67,665	68,725
Total current liabilities	254,382	232,439
Total liabilities	350,529	311,697
Total equity and liabilities	1,400,373	1,351,145

Segmental information	All figures in Rs. '000							
	Food products		Fuel & lubricants		Soap		Total	
	2017	2016	2017	2016	2017	2016	2017	2016
Revenue	1,497,241	1,525,908	624,512	678,817	334,210	314,345	2,455,963	2,519,070
Operating costs	(1,388,183)	(1,335,889)	(619,828)	(672,979)	(321,642)	(300,959)	(2,329,653)	(2,309,827)
Segment operating profit before depreciation	109,058	190,019	4,684	5,838	12,568	13,386	126,310	209,243
Depreciation	(57,805)	(59,391)	(172)	(90)	(10,125)	(9,889)	(68,102)	(69,370)
Segment operating profit	51,253	130,628	4,512	5,748	2,443	3,497	58,208	139,873
Other operating income/(expense)							31,807	16,874
Net finance income							13,887	17,633
Profit before income tax expense							103,902	174,380
Income tax expense							(28,053)	(47,083)
Profit after tax							75,849	127,297
Assets and liabilities								
Assets								
Operating assets	758,714	758,311	305,295	213,775	145,727	163,494	1,209,736	1,135,580
Available-for-sale investment							37,951	35,410
Investment in subsidiary							5,000	5,000
Cash and cash equivalents							147,686	175,155
Total assets							1,400,373	1,351,145
Liabilities								
Operating liabilities	164,096	155,194	63,305	44,584	26,981	32,661	254,382	232,439
Deferred tax liabilities							32,331	29,278
Employee benefit obligations							63,816	49,980
Total liabilities							350,529	311,697

Retained earnings of SSPL	2017	2016
	Rs. '000	
Balance b/f	992,066	908,914
Profit for the year	75,849	127,297
Actuarial loss	(7,788)	(954)
Deferred tax reversal on actuarial loss	2,181	-
Interim dividend	(28,794)	(19,196)
Final dividend	(33,593)	(23,995)
Retained earnings	999,921	992,066

Segmental information

All figures in Rs. '000								
Statement of budgeted operating profit	Food products		Fuel & lubricants		Soap		Total	
For the year ended 31 March 2017	2017	2016	2017	2016	2017	2016	2017	2016
Revenue	1,709,017	1,647,981	725,000	712,758	364,640	339,493	2,798,657	2,700,232
Less: Operating costs	1,452,664	1,318,385	717,750	705,630	339,115	312,334	2,509,529	2,336,349
Operating profit	256,353	329,596	7,250	7,128	25,525	27,159	289,128	363,883

Price list							
Current price list	Weight/Size	Wholesale price	Consumer price	Gross revenue	Capacity	Gross revenue	Capacity
		Rs.	Rs.	(%)	(%)	(%)	(%)
Food products				2017	2017	2016	2016
Coffee	200g	275	320	2	60	3	65
Coffee	100g	140	160	3	55	3	60
Rice noodles	400g	102	120	22	75	28	85
Kurakkan noodles	400g	102	120	12	60	11	75
Rice flour	400g	50	56	43	80	42	80
Kurakkan flour	400g	130	155	2	60	3	70
Ulundu flour	200g	155	165	1	50	1	50
Papadam	70g	45	60	5	95	3	95
Hopper mixture	400g	92	110	5	75	3	75
Kithul treacle	350ml	220	250	2	65	1	65
Soy sauce	350ml	106	125	1	75	1	75
String hopper flour	700g	90	100	2	75	1	75
				100		100	
Soap							
Bar soap	700g	250	275	20	95	25	95
Bar soap	350g	125	140	35	95	30	95
Body wash soap	70g	32	38	45	95	45	95
				100		100	