THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

27510 - TOP CA CASE STUDY EXAMINATION

MAY 2013

Given below are the suggested answers. However, any other acceptable/justified answer will be given marks as appropriate.

<u>Question No. 01</u>

1. Assume that Aqua has appointed you as an Advisor to the board of directors, (prior to approaching an investment bank). Prepare a report to be submitted to the board of directors through the Chair-person of the company in order to resolve the managerial concerns currently confronted by the company. In your report you may also bring out any other issues which have not attracted the attention of the members of the board. (However you are not expected to further investigate the feasibility of the projects and the procedural aspects to be followed in listing a company).

(68 marks)

Answer

The report to the board of directors shall contain a letter to the chairperson, an introduction (or executive summary), and the body addressing the major managerial concerns under different headings and the other important issues and a conclusion.

Introduction

Aqua at currently at a critical juncture in its evolution. The company has gone through different phases of development since its inception. The company's growth has throughout been linked to the economic performance of the country. Accordingly, the company anticipated a steady growth after concluding the 30-year old civil war in the country. Contrary, to what was expected, since 2011 the company has been experiencing a decline in its sales and profits. Cheap imports (mainly from China) penetrating into the country has been one of the major causes of the problem. At this crucial point of time, the company has decided to take up the two important projects as a major strategic shift in its business focus. As the management has already been convinced about their feasibility, this report does not intend to address it in detail. **You may find the following observations/recommendations with regard to your major concerns directed to me. Further, the areas that require your attention are also highlighted.**

Prioritization of the two projects:

The top management of the company (the board of directors) are not in full agreement whether to go ahead with both projects at once and implement them in stages. The major concern of some of the senior managers is that the implementation of two projects at once will overburden the existing staff. However, this cannot be considered as a good reason for a company to postpone a feasible project. If the option of delaying a project brings substantial financial benefits to a company, it can delay the project. Managerial convenience is not a good consideration in this regard. If additional staff is required, the company shall recruit the required additional staff. Further, Aqua is known for quality. This is the strength that the company can utilize in launching the new advanced product series. The advanced product market would be more quality sensitive (than price). The company would not face a huge competition from cheap imports for this market segment. For this reason, Aqua should not delay its local project. Neither should it delay the Bangaldeshi project as the investment environment there might change in future.

As of now, the company can go for a BOI agreement with the Bangladeshi government that assures specific benefits over a reasonable period of time. Both projects are important for the company in terms of managing the risk of its business portfolio through diversifying its investment base both locally and internationally (regionally).

Timing for an IPO:

It is true that there was an IPO peak in the country in the post war period especially in 2011 and 2012. Some of these IPOs were not quite successful. However, the company should not consider the IPO and the projects as two different things. If the projects are to be implemented the company needs resources. Projects cannot be postponed purely because of the capital market sentiments. It is also difficult to expect the market to move to the post war bubble level in the near future. Despite some fundamental issues in the Sri Lankan economy, the market has shown some improvements during the last couple of weeks. The most important point here is that the projects are feasible. The company is also known for quality. These positive points could be used to market the IPO through investment banking channels. For quite some time, there has been a dearth of quality IPOs on the Colombo Stock Exchange. Therefore, there is a high probability that the market would welcome the Aqua IPO.

Valuing the company and pricing the IPO

The valuation is necessary to find the right price for the IPO. Although it is not necessary to convert the valuation surplus or other reserves to share capital in order to avoid any dilution of the ownership interest of the current shareholders, it is good for the company to bring its net assets closer to the market value before going for an IPO. That will reflect the fair value of the company. Irrespective of this, what is necessary is to find the right price for the share. If the issue price is wrong, there can be a dilution of ownership interest between the existing shareholders and the new shareholders. There are several approaches to value a business such as operating cash flow based valuation, dividend discount, relative valuation (P/E, P/B,). As it is difficult to find a comparable listed firm for Aqua on the Colombo Stock Exchange, we suggest using the operating cash flow based valuation as the basic valuation model. (Aqua being a family business the dividend discount model also cannot be used as a reliable one.)

Operating cash flow based valuation

- Operating cash flow reflects net cash flow from operation without adjusting non-operational cash flows such as investment income (interest/dividend) and interest payments. In relation to Aqua operational cash flows should be estimated including the two new projects.

- However, according to the reported information, Aqua has only valued the existing business without the new projects. Aqua has correctly adjusted the values of non-operational assets (excess land and investments) and liabilities in the operating cash flow valuation. Current cash holding should also be added to the valuation figure as it has nothing to do with future operations.

- Further, it is recommended to consider the cost of IPO (management and legal fees etc.) in deciding the amount of capital to be raised. In Sri Lanka this is about 2 to 3 percent of the total amount raised by an IPO. (Sri Lankan companies do not usually go for underwriting). Therefore, it is recommended to increase the amount raised by the IPO to cover the essential fees related to the IPO. Considering a minimum of 2.5% issue cost to be included in the total issue value the company will have to raise $\left(\frac{100 * Rs.2billion}{97.5}\right) =$

  Rs.2,051,282,051 ~ Rs. 2,052,000,000 through the IPO.

- Assuming that the company's other reported values are correct, we can find the value per share as per current operations, before taking the NPVs of the two new projects and how the shareholding will be divided among the existing shareholders and the new shareholders.

	Existing shareholders	**New shareholders**
Value of existing equity*	4,564,147,000	-
Value of new issue** 2,052,000,000		
Ownership proportion	68.98% ~ 69%	31.02% ~ 31%
The existing number of shares (69%)	100,000,000	
Number of shares to be issued (31%)		44,927,536 ~ 44,928,000
Value per share	45.64~ 46.00	
Price per share		46

* After adjusting Rs. 15,234,000 cash balance
** Including the cost of issue

- According to the above analysis if the IPO price is set at Rs. 46, the current shareholders retain control of the business by keeping 69% percent of the shareholding and they will not lose control of the business. Salgadu family can retain 65.48% (69% * 94.9%) ownership interest.

- Valuing the Bangladeshi assembly line using the local cost of capital is questionable - in valuing foreign operations, country risk and exchange rate risk have to be taken into account. This is relevant to both existing operations and the new BOI project. Therefore, we recommend, that the company reconsiders this.

P/E Ratio based relative valuation

- The above valuation is basically based on cash flows generated from operations. It is recommended to undertake a valuation using at least one alternative technique before setting the final IPO price. As there are no listed firms similar to Aqua on the Colombo Stock Exchange, it can apply the sector specific P/E ratio to value its equity. As Aqua has to be listed in the manufacturing sector of the CSE, the company can use the manufacturing sector average P/E ratio to value the company.

- The current manufacturing sector P/E ratio is around 12. When the market is performing well, this ratio happened to be more than 15. Therefore, we recommend applying an average ratio of 13.5 in valuing the share.

Value per share = Earnings per share * Manufacturing sector P/E ratio
= 3.18 * 13.5
= Rs. 42.93 ~ Rs. 43.00

- Value of the share is somewhat low when P/E is used, due to the reasons of current market wide low P/E ratios (as a result of depressed market conditions), the current low EPS of the company and the maintenance of some non operational assets (excess lands and investments) by the company. (The valuation based on P/E ratio will not capture the value of non operating assets properly.) Further, current EPS does not reflect the impact of the new projects.

- If the company sets the IPO price at Rs. 43, number of shares to be issued will become:

2,052,000,000/43 = 47,720,930 ~ 47,721,000 shares

New shareholders' ownership percentage = 47,721,000 /147,721,000 = 32.3%
Old shareholders' ownership percentage = 100,000,000/147,721,000 = 67.7%

- Even if the IPO price is set at Rs. 43, the current shareholders will not lose control of the business. Salgadu family can retain 64.25% (67.7%*94.9%).

- However, we do not recommend this price as it does not reflect the true value of the firm. Also, with good projects in hand the company would be able attract a higher price.

Other factors to be considered in setting the IPO price

- The company cannot be ignorant of the fact that all IPOs that came to the market during the last three years (2010 to 2012) in Sri Lanka had been priced in the range of Rs. 2.50 to Rs. 29.00 and the average IPO price had been around Rs. 15 per share. When the issue price is set too high, the liquidity of trading will be less in the post IPO market. Also, at the time of the IPO, the company will attract fewer applications for the IPO. Therefore, it is recommended to have a 1 to 1 share split before the IPO. This will double the number of shares and reduce the issue price by half.

- We recommend going for an Employee Share Option Plan (ESOP) in the range of 3%-4% depending on the number of employees. Assuming that the company chooses to issue 3.5% shares from the total planned outstanding shares under an ESOP together with the new issue and 1 to 1 split the new ownership structure will be:

Current shareholders*	200,000,000	(66.75%)
Public issue*	89,856,000	(29.75%)
ESOP	10,512,912	(03.50%)
	300,368,912617	(100.00%)

*After 1 to 1 split is incorporated to the first valuation

As of this analysis, the company should issue 89,856,000 of common stocks at a price of Rs. 23.00 per share to cover the capital requirement including cost of IPO. After the IPO and ESOP, the shareholding in the company will be distributed as follows:

Mrs. Amara Salgadu, Chairperson		(42.72%)
Mr.Sanjeewa Salgadu, Managing Director	128,000,000	(10.31%)
Mrs. Yalina Elepolla (nee Salgadu),Director Finance	30,900,000	(10.31%)
Family Members		**(63.34%**)
Mr.Janak Dikkumbura, Director Operations	30,900,000	(0.03%)
Mr.Rohitha Nanayakkara, Director Sales and	**189,800,000**	(0.03%)
Marketing	100,000	(3.35%)
Mr.Jagath Ramanayake (Non-Executive Director)		**(66.75%)**
The current shareholders	100,000	(29.75%)
New shareholders (Public Issue)		
ESOP	10,000,000	(03.50%)
Total	**200,000,000**	(100.00%)
	89,131,000	
	10,486,620	
	299,617,620	

- The above analysis provides the value per share without incorporating the NPVs of the two new projects (only required investment value Rs. 2 billion together with the cost of issue have been taken into account). If the company does not consider the NPVs of the new projects in the valuation, the benefits of the new projects would be proportionately enjoyed by the existing and new shareholders. If the NPV is fully adjusted for in the valuation of the shares, the benefits will be basically absorbed by the existing shareholders and the resulting issue price will be higher. In that case, there is hardly any chance for immediate increase of the share price in the post IPO market. Therefore, it is recommended to partly incorporate the NPVs of new projects (i.e.50%) in to the valuation of shares. If this is done, the issue price as well as the existing shareholders ownership interest would go up.

Employee issue

- The recent happenings in relation to employee behaviour clearly show that the employees of the company are not happy about the developments taking place in the company mainly due to the none-availability of credible information. Further, they seem to be suffering from a lack of a sense of belonging within the company especially after the demise of Mr. Steven Salgadu. The distance between the employees and the management has widened.

- At a time when the company is planning large-scale transformation, it is essential to keep the employees informed of the planned changes within the company. Due to the lack of communication from the top management, the employees seem to be in the dark and they have started to trust various bogus rumours spreading within the company.

- When the formal channel of communication is not properly functioning and the management is not open to the subordinates, it would create a vacuum enabling a third party to interfere. Politically motivated people would have taken the prevailing situation in the company as an opportunity. Therefore, management must be extremely careful handling employee affairs within the company.

- It is also important for the management to realise that it will take some time to transform an organization that functions based on informal relations to an objective and professional one.

- It is suggested that the management start a consultative dialogue with its employees in various departments/branches and show that their future is safe despite the transformation taking place within the company. Any change will not be successful within an organization if the employees are not convinced and supportive. In addition, it is very important to change the management style of the key managers including Sanjeewa Salgadu, MD, to a more people oriented one.

- The management should convince the employees that their jobs would be secure within the company only if the company could grow and be innovative.

- The employee share ownership plan is a good reward that the company could implement to win the hearts of employees. Especially such a scheme will help employees to think they are also a part of the company. In this regard the company has to identify clear objectives of the plan and a mode of implementation. The objectives of such a plan can be rewarding, retaining, and motivating employees. The company can consider factors such as the rank of the employee, the numbers of years of service and the employee performance in implementing the scheme.

Other considerations

1. **Other options of Financing:** It is suggested the company considers cost/benefits of other optional financing plans before finalizing the IPO.

   a. The company's current debt/equity ratio is very low (around 15%). The company would be able to raise a part of the required additional funds through debt. As debt interest is tax deductible this will improve the future cash flows to the shareholders. However, it would be difficult to raise the total requirement through debts. Further, interest income on corporate bonds (debentures) has also been exempted from tax by the 2013 government budget.

   b. Another option would be a private placement of equity to a financial institution together with partial debt financing.

   c. In any case, the company should not borrow from Bangladeshi banks at this stage as Bangladeshi BOI operations are going to be tax exempted.

d. On the other hand, the company should not forget the fact that it has to redeem the preference share capital coming from Mr. Antonio within five years. Also it has to gradually increase the equity base of the Bangladeshi BOI operations over five years. Therefore it would be advisable for the company to raise the required capital through equity rather than debt.

2. Management of foreign exchange risk

The company is going to be exposed to a huge risk of exchange rate fluctuation. It has planned to pump capital into Bangladeshi operation over the next five years. On the other hand Bangladeshi BOI project has to redeem the preference share capital over 4 years starting from 2015 and pay dividend on them from 2014. It seems that the company has so far not thought of clear strategies to control the foreign exchange risk arising out of these planned transactions. (Candidates are supposed to propose some strategies in this regard.) (Hedging would be one of the strategies available to the company)

3. Strengthening the board of directors:

If the company decides to go for an IPO together with the two projects, the company has to adopt a professional approach to its management as it is a going to be a huge transformation. As an initial step in doing this, it would be better to strengthen the Board of Directors with more experienced people. As a part of this, it is better to appoint a CFO who understands both the business and the regulatory requirements of the stock exchange/Securities and Exchange Commission.

4. Choosing the right investment banker to manage the IPO.

5. Use the pending IPO as a tool for attracting top talent to the company and the board.

6. It is suggested the company makes sure of the accuracy of all financial projections and discounting process and the cost of estimated capital once again.

7. Managing the IPO process jointly with the investment bank. (promotion through brokerage network and proper media coverage, demand survey of institutional buyers, and setting the final IPO price.)

8. Ethical business practices and industrial safety in Bangladesh has become a general consideration after the collapse of a garment factory in Dhaka. Aqua to consider this as it plans to supply its products to affluent markets in Europe (Italy.)

<u>Question No. 02</u>

2. Compare and contrast the leadership and management styles of Mr. Steewan Salgadu and Mr. Sanjeewa Salagadu taking into consideration the transformation taking place within the company.

(16 marks)

Answer

Show that Mr. Steewan Salgadu's leadership and management style is quite in contrast to that of Mr. Sanjeewa Salgado

Mr. Steewan Salgadu:

- Humanitarian management style through trusting people
- Applies his experiences as a student leader in managing the company
- From a small beginning succeeded in building the company with a loyal group of employees
- Seemed to be very open with employees, and ran the business like a family.
- Less ambitious and is contended with keeping the company at a particular level (without huge plans for expansion)

Mr. Sanjeewa Salgadu:

- Tries to capitalize on the knowledge gained through his foreign training to initiate a performance culture in the company
- Highly performance oriented, driven by results, less concerned about employees' perspective
- Not very open to the employees, seems to be trust on his strength
- Very ambitious and wishes to take the company to great heights through practicing best management / industry practices and through expansion

<u>Question No. 03</u>

3. If you have an opportunity to personally advice Mr. Sanjeewa Salgadu, MD of the company and Mrs. Amara Salgadu, Chair-person of the company, then briefly explain the content of your advice to them.

(16 marks)

Answer

In advising Mr. Sanjeewa Salgadu, MD and Mrs. Amara Salgadu, Chairperson the candidates could draw attention on the following points:

Advice to Mr. Sanjeewa Salgadu (MD):

- Need to adopt a more human approach in managing people. As the employees have remained loyal to the company for a long period, he needs to ensure that the employees maintain the same loyalty in the future too. Employees should feel a sense of belonging. They should not be allowed to feel that they are not secure within the organization.

- Management should be open to employees. Otherwise, employees will work on assumptions, which will not be true. Therefore, there is a need to take prompt action to clear any misconceptions in the minds of employees and show them the benefits from the future course of action and thereby get the employees cooperation.

- Possibly obtain the services of a change-leader (externally) to facilitate an employee awareness program

Advice to Mrs. Amara Salgadu (Chair-person):

- As she has not got involved much in managing the company from its inception to date and

- does not have any formal training in managing a company, nor professional qualification it is advisable for her to seek professional advice when attending board meetings and regarding the operational formalities etc. once the company goes public.

- She needs to get educated on how the future management of the company will differ (once it goes public) from what she has been experiencing until now (as a family business).

Common advice to both Mr. Sanjeewa Salgadu (MD) and Mrs. Amara Salgadu (Chair-person):

- The need to strengthen the board of directors of the company and other professional layers
  (this point has been already highlighted under the answer to question 1.)
- Appointment of new experienced CFO
- Appointment of a few more independent directors.
- Recruiting a few staff at the senior management level

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