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## **KC5 – Corporate Strategy and Contemporary Issues**

**December 2016**

**Pre-seen**

## **The TFA Group**

### **Background**

Trouble-Free Automobiles (Pvt) Ltd (TFA), incorporated in 2003, is a renowned vehicle importer and marketer based in Kurunegala. Mevan Peiris, the principal owner of TFA, is a qualified mechanical engineer who graduated from Katubedda University. In the mid 1980s, whilst working at the former Ceramics Corporation, Meven was awarded a scholarship to Japan. This opportunity enabled him to develop some valuable contacts in Japan. As the only son born to a wealthy family owning estates, Mevan used to spend his spare time with his father who operated a vehicle trading operation, buying and selling a range of used vehicles, popularly known as 'Kurunegala Motor Traders'. Owing to the familiarity with vehicles he had plenty of exposure to this field and was a keen motor enthusiast by the time he reached Japan. Mevan spent his leisure time abroad with a group of Sri Lankans who had similar interests in Japanese vehicles. This was in fact the period that coincided with the astronomical growth of the Japanese automobile industry.

Following the return to Sri Lanka upon completion of his 5-year scholarship he continued his tenure with his employer. Spending time in employment and regularly travelling to Japan during his spare time keeping his contacts alive Mevan eventually inherited his father's business. In 2003 he, together with his brother-in-law Ruwan, incorporated TFA. Mevan was appointed the Chairman/Managing Director of the company and TFA gained considerable popularity as a regional powerhouse importing and marketing high quality, reconditioned vehicles as well as quality used vehicles. By 2005, TFA had become a shining example of a well-run family business under the chairmanship and technical competence of Mevan. He considered sourcing the right quality of vehicles for the Sri Lankan market as one of the most important factors that determined the success of a vehicle importing business in this intensely competitive industry. For this capability, Mevan relied heavily on his Japanese counterparts.

Ruwan, who had a outgoing personality, was responsible for the company's sales and marketing. TFA is considered a leading reconditioned/second hand automobile supplier in the North Western region of the country. 'A vehicle for every purse' is the sales pitch of TFA and they have a generous inventory of vehicles available at all times for most customers looking for an automobile.

### **Growth of TFA**

Mevan, the chairman of TFA, sacrificed his professional career to grow his family business. He had far reaching ambitions of growing the company beyond a mere vehicle importer and marketer. Mevan envisioned TFA becoming a group of companies with diversified business interests. Ruwan, the marketing director is considered a passionate sales personality and leads the company's sales and promotional activities.

## **TFA Safe Repair Workshop**

In 2006, TFA Safe Repair Workshop (Pvt) Ltd (TFASRW) was established to operate a state of the art workshop that provided vehicle repairing and servicing facilities to a wide range of vehicles. The services were primarily aimed at TFA customers, and the venture was financed by disposing one of the prime plantations owned by the Peiris family. Mevan was a hardworking individual with a scientific and professional upbringing that helped him manage complex issues and solve problems. Moreover he was influenced by Japanese managerial techniques and always considered the productivity of his workforce to be top managerial priority.

“Our Sri Lankan consumers love their vehicles and are always in search of secure workshops that provide reliable and speedy repair services, where they can leave their vehicles. We can offer such comfort and peace of mind”, commented Mevan, explaining TFASRW’s raison d’être at the point the board decided to make this investment. He also believed in the importance of absorbing and nurturing a satisfied technical workforce in accomplishing the business success of a repair workshop. At one of the board meetings Mevan described his formula for building a satisfied workforce that will foster high engineering productivity as, “Let us be the preferred institution that provides excellent training in automobile engineering and management for youth in the North Western region. Our training will include a highly practical curriculum with required best practices and a proper balance of theory and practice; not only in engineering but all facets of automobile management. This is one sure way of attracting high quality staff at an affordable cost. Those who opt to make a career with us will have an excellent opportunity for a progressive career path in a wide ranging spectrum of businesses in the corporate portfolio. Upon successful completion of the programme, trainees could also apply for other vacancies within the group, should they opt for a different professional discipline. Through scientific training we can combine and integrate staff development as well as develop a culture that can help us win customers, provide employee satisfaction and promote lifetime employment”. This was in fact a traditional hallmark of Japanese managerial philosophy in the 1980s.

Due to its central location (bordering the main road in Kurunegala) and being well stocked with a range of spare parts for most Japanese and continental vehicles, TFA’s board of directors expected this workshop to be a one stop shop for the middle and upper middle class executive level customers that required high quality repairs for their automobiles. The workshop manager was an engineer, who was carefully selected by Mevan. He was considered to be quite adept in providing quality oriented solutions for all technical problems of the company’s customers. All vehicles purchased from TFA carries an inspection certificate under the seal of TFASRW, which the directors considered to be an assurance of the quality of the vehicles imported by TFA as well as the means by which future repairs and maintenance needs can be met.

TFASRW also acquired the agency rights of a reputed Japanese brand of automobile bearings and established a dealer network to distribute these bearings island wide. This sub division is supervised by Ruwan, and a national sales manager has been appointed to overlook the sales and more importantly the achievement of targets agreed at the annual budgeting sessions of the group. The company would import and sell the bearings to a carefully selected network of agents in all major towns, who will in turn distribute these to retail shops marketing automobile spare parts. A sales representative of TFASRW will work alongside each agent’s sales staff in order to

monitor the sales of respective agents and ensure budgeted sales volumes are met as well as the range of products that has to cover many popular models of Japanese vehicles marketed in Sri Lanka.

Working with Japanese principals require careful attention to the achievement of sales targets as well as maintaining high levels of customer service agreed at the principal's International Annual Marketing Conference. Apart from importing bearings TFASRW also imports a range of low end, commonly required and fast moving spare parts such as filters, brake pads, fan belts as well as consumables like cleaning material, break oil etc.

### **TFA Insurance Brokers**

TFA Insurance Brokers (Pvt) Ltd (TFAIB) was incorporated in 2007 primarily with the object of making 'vehicle insurance' available for TFA's automobile customers as a value added service. This would position TFA as a one stop shop providing all customer requirements in connection with owning and running an automobile. It would also help to keep up with the corporate mission of TFA. Mevan, as a proponent of the Japanese traditions of lifelong relationships, wanted TFA to provide their customers with a host of aligned facilities such as repairs, servicing and insurance. During the induction sessions conducted for all new sales executives, Ruwan advised them to pass the following message to customers. "When you purchase a vehicle from us you can drive away a quality vehicle with the peace of mind that all in connection with vehicle ownership such as repairs and insurance are taken care of".

The company believes that they have developed trust, confidence and loyalty amongst the middle and upper middle level executives, the principal market segments of TFA who do not have much time to attend to their vehicles due to their busy schedules. TFA would be the one stop shop or the ideal option to fill this void.

### **TFA Rent-A-Car (Hiring of automobiles)**

In 2011, TFA Rent-A-Car (Pvt) Ltd (TFARAC) was added to the corporate portfolio as the group's rent-a-car company. "TFA is all about passenger vehicles and meeting the evolving vehicle related needs of potential customers", expressed the group chairman when the board decided to acquire an already established and reputed rent-a-car business as a going concern. This business was owned by a leading businessman in Kurunegala and was operated under the trade name 'Kurunegala Rentals' (Appendix A).

## **The pinnacle of TFA growth**

On 17 September 2016, which happened to be the 60<sup>th</sup> birthday of Mevan, a special board meeting was summoned for a momentous announcement about the group. Mevan addressed the audience with an aura of emotion and declared that he was in the process of obtaining professional advice for TFA to acquire a 'finance company' named Reliable Business Finance (RBF) as their latest corporate strategic initiative. He also cautioned the board members that in the event this initiative becomes a success, the group will face a more regulated business environment. Mevan further mentioned that this move of acquiring a finance company (referred to as licensed finance companies) in the category of a non-bank financial institution (the NBFi sector) was a landmark development in the journey of the group. He was astute enough to place before the board not only the enormous opportunities that will unfold with such an acquisition but also the many challenges that will confront the group as it is currently operated predominantly as a family company. "The transition from a family owned, dynamic, informal business culture to a highly regulated formal company environment customary in a financial organisation, and the necessity of being managed by a professional board in conformity with strict tenets of corporate governance, is what we will have to come to terms with if and when this acquisition becomes a reality within a couple of days", advised Mevan.

In 2015 Mevan's son Amal, who had completed his master's degree in business management and was awaiting the results of his doctoral studies in development economics from a prestigious British University, joined the TFA board as the planning director. Per his insistence the company organised their annual strategy session in October 2016 at a hill-country hotel. Working closely with Achala, the CFO of TFA, he assimilated some initial information and analysis of certain operating units under the TFA's corporate level to be discussed during these sessions. Amal also forewarned Achala to gain sufficient knowledge, particularly in relation to the financial dynamics of a NBFi sector organisation, that will equip him with the capability to advise the top management of TFA on the decisions that will confront them soon in connection with the proposed acquisition of a finance company (Appendix B). The acquisition has to be made before the dawn of the new year 2017.

## Appendix A

### TFA Rent-A-Car (Pvt) Ltd (TFARAC)

At the point of acquiring 'Kurunegala Rentals' in April 2011, Kurunegala Rentals had just replaced its fleet of vehicles and were in possession of a new fleet of twenty mid-sized Japanese passenger vehicles. These were immensely popular amongst tourists and locals for their travelling needs. The fleet also consisted of eight small cars of Indian origin that were popular for self-drive purposes. These were mostly rented by office staff during times when their own vehicles were on repair as well as individuals for their occasional and emergency requirements.

At the beginning of 2013/14, another eight Japanese vehicles and two Indian origin cars were added to the existing fleet of vehicles. Nevertheless the company lost two Japanese vehicles and an Indian vehicle at the beginning of 2014/15.

TFARAC charged a rental of Rs. 80,000 net of VAT for the Japanese vehicles and Rs. 30,000 for the Indian vehicles during the financial years 2011/12, 2012/13 and 2013/14. This was increased to Rs. 90,000 and Rs. 40,000 for the Japanese and Indian cars respectively at the beginning of 2014/15 and then to Rs. 100,000 and 45,000 respectively at the beginning of 2015/16.

The chairman of TFA believes that careful management of the fleet of vehicles will always result in an appreciation of the market values of the vehicles. Therefore he required all vehicles to be revalued every three years' of use for management accounting and profitability reporting purposes.

The rent-a-car industry is a popular entrepreneurial opportunity for vehicle loving Sri Lankan entrepreneurs as well as individuals who wish to invest their retirement benefits or savings in a small business in order to earn high returns. Whilst individual vehicle owners always rent their vehicles accompanied by a driver, more established rent-a-car organisations have fleets of wide ranging vehicles, mostly passenger vehicles, for self-drive as well as accompanied with drivers. The capital requirements are easily met through leasing/hire-purchase facilities, a very popular mode of finance for acquiring vehicles. These facilities are offered by a host of financial institutions that include licensed finance companies (LFCs). This is a sector that has amazingly low customer response times in granting financial facilities even for individuals with no formal financial records to support their financial affordability.

Diversity in the rent-a-car industry is quite high, as both individuals and reputed organisations compete in the same market. Increasingly discerning buyers that even include foreigners are always on the lookout for competitive prices. The acquisition of 'Kurunegala Rentals' by TFA added a new dimension to the perceived corporate status. It now enjoys the superior quality image of the parent company and is considered a very reliable place to hire a vehicle that is trouble free and well maintained.

It is expected that with the anticipated growth in the tourism industry, the government may bring in new quality and safety control parameters that will strengthen the structural foundations and regulate the industry. The marketing manager has indicated that since the advent of the new government there are clear signs of growth in the tourist segment as well as the general rent-a-car opportunities due to growth in all

major economic sectors. Nevertheless he has also pointed out the need to improve core processes in serving customers and consider simplifying and relaxing some control requirements such as proof of identity, independent references and security controls like taking inventories before and after renting. The finance manager has responded that these restrictions were brought about after the company lost some vehicles that were rented by tricksters posing as rent-a-car customers.

Summary of income statement extracts of TFARAC (extracted from TFA's annual, SBU income statements) are given below.

	<b>(Rs. '000)</b>				
Year ended 31 March	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Hiring income (net of VAT)	<u>19,872</u>	<u>17,664</u>	<u>21,336</u>	<u>21,060</u>	<u>21,636</u>
Less: Operating expenses					
Depreciation	10,200	10,200	15,057	15,144	15,122
Maintenance and insurance	3,200	3,335	4,525	4,698	4,894
Rent and office expenses	<u>2,412</u>	<u>2,598</u>	<u>2,829</u>	<u>3,255</u>	<u>3,706</u>
Total operating expenses	<u>15,812</u>	<u>16,133</u>	<u>22,411</u>	<u>23,097</u>	<u>23,722</u>
<b>Operating profit/(loss)</b>	<b>4,060</b>	<b>1,531</b>	<b>(1,075)</b>	<b>(2,037)</b>	<b>(2,086)</b>
Gain on revaluation (Excess over written down value)	-	-	7,120	-	-

## Appendix B

### Licensed Finance Companies (LFCs) sector and Reliable Business Finance Company (RBF)

This sector in Sri Lanka comprises over forty LFCs with a total collective branch strength of over a thousand branches. Larger companies in this sector enjoy the cost advantage of scale due to their extended branch networks and the ability to obtain their funding requirements at lower interest rates. Accordingly such large companies have the capability to attract and service more creditworthy customer segments such as corporates who are more discerning about their cost of borrowing. Such organisations usually grant their facilities after careful credit evaluations and examination of formal documentation.

Even though the business volumes of this sector are a fraction of the more fancied and prestigious 'banking sector' within the financial industry, LFCs often deal with more informal customer segments that generally have less access to banks. Such customers include the self-employed, small businesses and rural sectors of the country's economy. Therefore LFCs provide a yeomen service in promoting financial inclusiveness and regional and rural growth in the country. The products offered by this sector range from leasing/hire-purchase of all kinds of automobiles to equipment leasing, mortgage loans, pledge loans, non-asset backed loans, personal loans and micro-credit facilities.

RBF is a finance company incorporated in 2013. It is amongst the LFCs mentioned above with its registered corporate office in Kurunegala. RBF has four branches in Kuliyaipitya, Kandy, Nittambuwa and Dambulla. It is owned by a wealthy family in the region, but the owners have now decided to dispose their interests following their decision to migrate.

RBF was founded by the eldest son of the family Dineth, who obtained a master's degree in 'small business' financing. As a wealthy individual with ample resources for investment Dineth was driven by a vision that it is the small businesses that form the backbone of an economy in a country like Sri Lanka and therefore small business financing will be the right direction for financial organisations like LFCs. Dineth was a very patriotic individual and while pursuing his studies in Singapore he recalled how some of his friends used to critically analyse the lack of Sri Lanka's progress compared to Singapore, despite having plenty of scope for an increase in agricultural exports due to the country being endowed with a large amount of fertile land. Accordingly RBF has made a conscious effort to conduct most of its business in small ticket working capital loans for individuals and a comparatively smaller portfolio in vehicle leasing and hire-purchase, the more fancied line of business amongst LFCs.

The small business sphere is not an easily definable business landscape because there is a thin line of distinction between deployment of institutional finance by clients in this rather informal sector, in a 'business' and 'personal consumption'. Despite enjoying a very high growth at inception, the company experienced some problems in growth with the streamlining and strengthening of credit appraisal systems and procedures introduced by the newly appointed general manager. These were following recommendations made after an annual inspection audit by the Central Bank's non-banking supervision division.

Given these developments, the professional consultant advising the TFA board with regard to the proposed acquisition has welcomed the new general manager's suggestion for the creation of a corporate structure by way of two separate business units: one for 'small business finance' and the other to conduct more traditional financing offered by LFCs in the form of 'leasing and hire-purchase'.

The new general manager has also advocated that RBF will have to carefully evaluate its performance compared to some other companies in the LFC sector.

A comparison of the financial statements of four competitive LFCs with a strong presence in the North-Western region is presented below.

Draft income statement extracts – for the year ended 31 March 2016				
	<b>(Rs. million)</b>			
	RBF	Finance Company X	Finance Company Y	Finance Company Z
<b>Income</b>				
Interest income	2,194	12,199	2,644	1,501
Interest expense	(964)	(6,075)	(1,502)	(886)
<b>Net interest income</b>	<b>1,230</b>	<b>6,124</b>	<b>1,142</b>	<b>615</b>
Fee based income	216	636	143	96
Trading gain/loss	51	899	(87)	105
<b>Operating income</b>	<b>1,497</b>	<b>7,659</b>	<b>1,198</b>	<b>816</b>
Less: impairment charges	(247)	(1,416)	(164)	(49)
<b>Net operating income</b>	<b>1,250</b>	<b>6,243</b>	<b>1,034</b>	<b>767</b>
<u>Less: Operating expenses</u>				
Personnel expenses:				
Non-marketing	(103)	(552)	(74)	(66)
Marketing	(448)	(1,577)	(479)	(258)
Administrative	(142)	(506)	(105)	(79)
Marketing	(171)	(585)	(75)	(149)
VAT on financial services	(69)	(249)	(49)	(52)
<b>Profit before tax</b>	<b>317</b>	<b>2,774</b>	<b>252</b>	<b>163</b>
Income tax	(73)	(622)	(44)	(30)
<b>Profit after tax</b>	<b>244</b>	<b>2,152</b>	<b>208</b>	<b>133</b>

Draft statement of financial position extracts as at 31 March 2016

	<b>(Rs. million)</b>			
	RBF	Finance Company X	Finance Company Y	Finance Company Z
<b>Assets</b>				
Cash and short term investments with financial institutions	362	3,121	410	267
Investments held for trading	605	3,876	1,945	585
Loans and advances	4,314	4,614	6,514	1,505
Lease rentals receivable and stock out on hire	611	52,119	2,615	5,310
Other financial assets	16	78	31	34
Property, plant and equipment	<u>1,481</u>	<u>2,398</u>	<u>293</u>	<u>775</u>
<b>Total assets</b>	<b><u>7,389</u></b>	<b><u>66,206</u></b>	<b><u>11,808</u></b>	<b><u>8,476</u></b>
<b>Liabilities</b>				
Amounts due to banks	505	29,086	6,560	3,821
Amounts due to customers (deposits)	5,089	28,121	3,978	3,507
Others	<u>76</u>	<u>341</u>	<u>134</u>	<u>59</u>
<b>Total liabilities</b>	<b><u>5,670</u></b>	<b><u>57,548</u></b>	<b><u>10,672</u></b>	<b><u>7,387</u></b>
<b>Shareholders' funds</b>				
Stated capital and shareholder funds	<u>1,719</u>	<u>8,658</u>	<u>1,136</u>	<u>1,089</u>
<b>Total liabilities and shareholders' funds</b>	<b><u>7,389</u></b>	<b><u>66,206</u></b>	<b><u>11,808</u></b>	<b><u>8,476</u></b>

## **Finance companies X, Y and Z**

Company X has been a long established company in the LFC sector that conducts business in all parts of the island and particularly has its presence in the same towns as RBF. Its 'loans and advances' portfolio largely consists of mortgage loans and pledge loans. The company has proficient teams of legal professionals and regional valuers, which are required in dealing with mortgage loans. Business knowledge of imports and excellent judgment are required to effectively manage a portfolio of pledge loans of some major importers and distributors of merchandise. X's leasing and hire-purchase portfolio comprise a wide range of vehicles in several categories that include two wheelers, motor vehicles, three wheelers, lorries, tractors and harvesters. They also plan to diversify into equipment leasing, debt factoring and invoice discounting for local sales as well as in relation to working capital needs of exporters.

Company Y is a finance company that has its head office in Kandy. It has four branches, three of which operates in similar towns as RBF. The fourth branch is located in Nattandiya. Its loan book balances mostly consist of small business loans that can be classified under the broad category of small business financing as described earlier. With nearly a decade of business experience, Company Y has trained and developed a contingent of loan officers who have experience in this business model and are considered to be business savvy and people centric. It's leasing and hire-purchase portfolio consists of investments in vehicles and three wheelers.

Company Z is a subsidiary of a large established bank. The bank acquired this small finance company consequent to the LFC sector institutional integration initiatives launched by the Central bank of Sri Lanka (CBSL) in 2014 that permitted banks to acquire finance companies. This company, with a current branch network of four branches in addition to its Chilaw based head office plans to expand island wide with immediate effect assisted by its parent company. The majority of its present product portfolio includes leasing and hire purchase of vehicles and three wheelers. However, it also has a portfolio of mortgage loans as well as some non-asset backed loans.