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

**June 2017**

**Pre-seen**

## 1. Background

Serendib Footwear Industries (Pvt) Ltd (hereinafter referred to as “Serendib” or “the company”) is one of the leading footwear manufacturers and retailers in Sri Lanka. The company recorded an annual turnover of over Rs. 3,500 million for the financial year ended 31 March 2016 and possesses about a dozen household footwear brands in the country. The business is owned by the family of Sirisoma Perera, the founder and present chairman.

## 2. How the business started

The business had a humble beginning when its founders Sirisoma Perera and his wife Anoma Perera started the business in 1968 at their home in Horana. Anoma was a production manager at the number one footwear manufacturer in the country at that time when her husband mooted the idea of setting up a small workshop at their home to manufacture footwear for children. Anoma, a determined woman, with a helper from the neighborhood designed and made the first batch of shoes from home, while Sirisoma carried them to the Horana town to be sold to clothing and footwear shops. Supported by the neat craftsmanship and creative design of Anoma, the product was an instant hit. To cater to the increasing demand, Sirisoma mortgaged his house and obtained a bank loan to set up a small factory. Anoma looked after the production while Sirisoma oversaw sales in those early days. The business thrived in the 1970s with the help of a government policy that encouraged local manufacturing as opposed to imports. The business was well established when the Sri Lankan economy started its process of liberalisation in 1977. Through the sheer dedication and commitment of the founders, the company became one of the leading footwear manufacturers and retailers by the mid-1980s and it has maintained this to-date despite intense competition from imports and new entrants to the market.

## 3. Company overview

Serendib was incorporated in 1974. The business was carried out as a sole-proprietorship until this time when it was converted to a limited liability company.

### 3.1 Shareholding structure

The company does not have any external shareholders. The present shareholding structure of the company is given in the table below.

Name	Shareholding (%)
Sirisoma Perera	60%
Anoma Perera	20%
Kamal Perera	10%
Bimal Perera	10%
Total	100%

Kamal Perera and Bimal Perera are the elder son and younger son respectively of Sirisoma and Anoma.

### **3.2 Board of directors**

The board of directors of Serendib is given in the table below.

<b>Name</b>	<b>Position</b>
Sirisoma Perera	Chairman/Managing director
Anoma Perera	Vice chairman
Kamal Perera	Finance director
Bimal Perera	Operations director
Roshan Fernando	Marketing director

Roshan Fernando is a nephew of Sirisoma Perera.

### **3.3 Organisational structure**

Please refer Annexure 1 for the organisational chart of Serendib.

The company has a total workforce of over 1,000, of which the management cadre is close to 80. Over 70% of the staff members have been with the company for more than 10 years, while over 20% of the staff has been with the company for over 15 years. This indicates the loyalty towards the employer. A recent survey carried out by an external agency has affirmed that satisfaction levels of staff are very high.

The profiles of the board of directors and key management personnel are given in Annexure 2.

### **3.4 Historical financials**

The historical summary financials of Serendib are given in Annexure 3.

## **4. Business overview**

### **4.1 Product range**

Serendib caters to all segments of the footwear market. The product range of Serendib includes slippers (flip flops), school shoes, casual shoes, office shoes, ladies' shoes, kids' shoes and sports shoes. In addition, the company also sells a range of footwear-related accessories such as socks, shoe polish etc. Serendib's products can also be categorised in terms of materials used; leather, rubber and synthetic-based footwear.

## **4.2 Branding and market positioning**

The company has 12 well-established brands of its own. Most of these own brands have a high level of penetration in the mass market and have been strongly established as “Value for Money Footwear” in the minds of the consumers. Serendib has also been successful in developing a few brands in the mid-market segment.

Serendib’s attempts to introduce a home grown upmarket brand over the years have failed despite substantial investments made in product development, marketing and advertising. In fact, a few years ago, the company recruited a couple of internationally reputed footwear designers and set up a state of the art Computer Aided Design (CAD) facility to push its initiatives to develop high quality products for upmarket brands, all of which ended up with no noteworthy progress.

In addition to its own brands, Serendib imports and sells a few Indian brands, which command a decent premium over the company’s own brands. Some of the products under its own brands are also manufactured in Bangladesh where the labour costs are low.

## **4.3 Product design**

Driven by Anoma’s passion for innovative designs, the company has set up a state-of-the-art design center in Kandy. The original objective of the design center was to develop products for the high-end market, but the company could not succeed. The facility is now used to design all its products for the mass market and mid-end market. The company employs a well-qualified team of designers. The design center introduces new designs under each brand for the festive seasons in April and December and for the new school academic years. The design center has become one of the competitive advantages of Serendib as it continuously comes up with new designs to keep up with customer expectations and new trends in the market.

## **4.4 Supply chain**

Shoe manufacturing involves a highly skilled production process that requires specialised labour at each stage of production. Therefore, manufacturing engineering plays an important role in improving efficiency in the production process as well as ensuring the quality of the final product.

### **4.4.1 Product sourcing**

Serendib sources its finished products through its own factories, imports (via contract manufacturing) and local contract manufacturing. The present mix in sourcing is given in the table below.

<b>Brand</b>	<b>Source</b>	<b>No of suppliers' /facilities</b>	<b>% of product sourcing</b>
Own brands	Own factories	2	40%
	Local contract manufacturing	10	40%
	Imports via contract manufacturing	2	15%
Third party brands	Imports	2	5%
<b>Total</b>		<b>16</b>	<b>100%</b>

#### **4.4.2 Serendib's manufacturing facilities**

The company has two factories in Horana and Kandy producing all types of footwear, presently catering to 40% of the total requirement. The Horana factory is the older one and was established in 1974. The factory in Kandy was set up only in 2008.

Basic details of the two factories are as follows.

<b>Description</b>	<b>Horana</b>	<b>Kandy</b>
Year of set up	1974	2008
Efficiency level	66%	89%
Capacity utilisation	63%	91%
Gross margin	39%	46%

The Horana factory, being the older one is the least automated with a high level of labour involvement. There has never been any major revamping of this factory since its inception except for periodic capacity enhancements and marginal improvements in machinery and processes. However, the Kandy factory is modern with the latest technology at the time of setting up (in 2008) and has streamlined and efficient processes. Therefore, the Kandy factory has a high efficiency level of 89% compared to 66% efficiency level at the Horana factory. Serendib has developed an internal methodology to measure the efficiency level of its production facilities which takes into account raw material wastage, rework rate, production cycle time and labour efficiency. Thus, the Kandy factory generates a higher gross profit margin compared to the Horana facility. Therefore, when scheduling production, the Head of Manufacturing is keen to achieve maximum possible utilisation from the Kandy factory which will help to achieve better resource utilisation and financial results.

The main raw materials required for production include different types and varieties of leather, rubber, fabric and polymers. Leather and polymers such as PU and PVC are imported while rubber and fabrics are primarily sourced locally.

#### **4.4.3 Local contract manufacturing**

Presently 40% of Serendib's total sales are manufactured in its own production facilities. This has come down from 80% a few years ago. Being a mass market player Serendib rides the economic cycles where it becomes vulnerable to economic downturns. Hence, the company has made a strategic decision to reduce its reliance on internal sourcing as footwear manufacturing is a labour intensive industry. This way it can stay lean and mean under challenging economic conditions and compete with low-priced imports. Therefore, the company has successfully developed a contract manufacturing model where it outsources manufacturing to exclusive small to medium sized enterprises.

Presently, Serendib works with 10 such contract manufacturers in Sri Lanka. The company centrally procures and supplies all raw materials to the local contract manufacturers, who have invested in small to medium scale factories. This helps Serendib to achieve economies of scale when sourcing raw materials. Serendib has a strict quality control mechanism in place to ensure the quality of the contract manufacturers. Quality inspectors carry out surprise quality audits at regular intervals at the factories of contract manufacturers in addition to sample based quality control checks carried out on the delivery of finished goods. The local contract manufacturers being exclusive manufacturers to Serendib, are treated by the company as business partners. On this principle, Serendib provides the contract manufacturers with regular training and technical assistance to improve their production processes. All local contract manufactures are paid based on standard labour cost plus standard costing to recover the fixed capital investment and achieve a profit margin. Serendib supports local contract manufacturers when circumstances demand so. For example, Serendib once provided an interest free loan to a contract manufacturer whose factory was severely damaged due to floods. It is also pertinent to mention that, three out of ten contract manufacturers are ex-factory employees of Serendib, who left the company with the blessings of the chairman to set up their own enterprises. A part of the seed capital was also provided by Serendib on concessionary terms. However, the company is conscious not to create over dependencies on any single contract manufacturer as a risk mitigation strategy.

#### **4.4.4 Sourcing via imports through contract manufacturing**

With intense competition from poor quality and low-priced imports especially from India and China, Serendib was compelled to explore low-cost sourcing options. This led to the advent of contract manufacturing with two Bangladeshi footwear manufacturers based in Chittagong commencing from 2014. These overseas contract manufacturers produce under Serendib brands. Serendib provides them with detailed designs and specifications and the contract manufacturers are responsible for sourcing of raw materials,

production and shipping to Colombo. Bangladeshi contract manufacturers must compete on price for each order unlike their counterparts in Sri Lanka. Further, these manufacturers are not exclusive and their present supply to Serendib only forms a small percentage (less than 10%) of their total sales. As shown from the data in the table below, sourcing from foreign contract manufacturers yields the highest profitability with a gross margin of 55%.

<b>Source</b>	<b>Gross margin</b>
Own factories	40%
Local contract manufacturing	51%
Imports (via contract manufacturing)	55%

Despite attractive margins generated by foreign contract manufacturers, Serendib has been careful when sourcing from these suppliers due to longer lead times, fear of copying proprietary designs and unwillingness to disturb well-established partnerships with local contract manufacturers. Further, the company has still not developed systems to ensure quality controls and compliance aspects related to these Bangladeshi manufacturers.

#### **4.4.5 Imports of third party brands**

In addition to its own brands, Serendib has exclusive distributorships in Sri Lanka for two leading Indian footwear brands. These distributorships were obtained last year as a mechanism to penetrate the upper-end of the mid-market segment. The initial dealership agreement is for 5 years and is renewable at the end of the period on mutual consent of both parties. So far, these products are sold via a limited number of retail stores located in main cities and suburbs. Serendib is responsible for the entire marketing and sales of these brands in Sri Lanka while the Indian principals share their electronic and print media advertising materials complementarily. The quality and durability of these products are greater than that of Serendib's and hence sales have been increasing gradually.

### **4.5 Sales and marketing**

#### **4.5.1 Budgeting and sales forecasting**

Serendib's budgeting cycle is in line with its financial year (1<sup>st</sup> April to 31<sup>st</sup> March). Each year, the budgeting process starts in January where all retail outlets (both owned and franchise) must give their product-wise monthly sales projections to the finance department through the marketing department. The initial sales forecasts are revised and finalised via a constructive, consultative process with the finance, marketing team and retail sales teams considering the market dynamics, economic conditions and long term business plan. These numbers are finally approved by the board

every March for the next financial year commencing from 1<sup>st</sup> April. Such approved product-wise monthly sales projections are updated on a rolling basis every month. Therefore, at any given time, the company has product-wise sales projections for the next 12 months.

Based on these monthly sales forecasts, the marketing department places internal orders 3 months in advance with the operations department. Within 2 weeks of receiving such internal orders, the operations department allocates and places the orders between different supply sources such as Serendib's own factories, local and foreign contract manufacturers and direct imports.

#### **4.5.2 Distribution network**

Serendib has four warehouses in Horana, Kandy, Matara and Anuradhapura. The Horana and Kandy warehouses are located next to the factory premises. The Horana warehouse receives all imports consisting of both third-party brands and products manufactured by foreign contract manufacturers. Products of local contract manufacturers are received at appropriate warehouses depending on the proximity to the contract manufacturer. Serendib does not have an integrated logistics management system. The item-wise stock position at each warehouse and retail store is maintained in a simple standalone inventory management system. Hence, logistics decisions related to the dispatch of finished products between warehouses and retail stores are done in a spreadsheet after extracting information from the above mentioned standalone inventory management system. This has created a lot of inefficiencies in Serendib's logistics management.

The company's retail distribution network consists of its own stores and franchise outlets. Franchise outlets are operated by individuals who have entered into franchise agreements with Serendib. This franchise holder is responsible for the entire investment in and management of the store. The franchise holder is entitled to a franchise fee based on the turnover of the store. Serendib has introduced a slab-based franchise fee structure where the fee percentage gradually increases with sales.

There are two types of retail stores named "Serendib Store" and "Serendib Grand". Serendib Store is a basic outlet displaying only mass-market affordable products. All Serendib Store outlets operate under the franchise model and are located in most cities and towns in the country. Serendib Grand outlets are mid-market stores with elegant store designs and a wider product range including mid-market brands. There are only a limited number of Serendib Grand outlets in selected key cities.



The composition of retail stores is given in the table below.

<b>Description</b>	<b>Own stores</b>	<b>Franchise stores</b>	<b>Total stores</b>
Serendib Store	Nil	180	180
Serendib Grand	12	15	27
<b>Total</b>	<b>12</b>	<b>195</b>	<b>207</b>

Serendib treats its franchisees as important stakeholders of the business. The franchisees are given training on sales, entrepreneurship, financial management and working capital management by Serendib. In addition, the staff at franchise holders are given frequent training on sales skills and customer service. Franchise agreements run for 5 years (except for first timer franchisees) which are renewed at the end of the term based on satisfactory performance. First time franchisees are given a term of only 2 years. The best performing sales staff at its own stores and franchise stores are recognised annually for their performance with various qualitative incentives such as foreign trips.

#### **4.5.3 Exports**

Serendib's sales are primarily in the local market with exports making up less than 3% of total sales.

#### **4.5.4 Corporate social responsibility (CSR)**

Serendib is genuinely committed towards its CSR obligations under the guidance of the chairman. Serendib has carried out a number of community projects in Horana and Kandy where the factories are located. The company has built several modern laboratories in a few selected schools in these areas. The company regularly sponsors annual social, cultural and religious events in several parts of the country. Serendib recently launched a scholarship scheme for needy and deserving students who successfully complete the year five scholarship examination. The scholarship scheme covers the children of its employees and small-scale local contract manufacturers. Further, the company has been distributing free footwear for school children in economically underdeveloped areas for the last two decades.

## **5. Footwear industry in Sri Lanka**

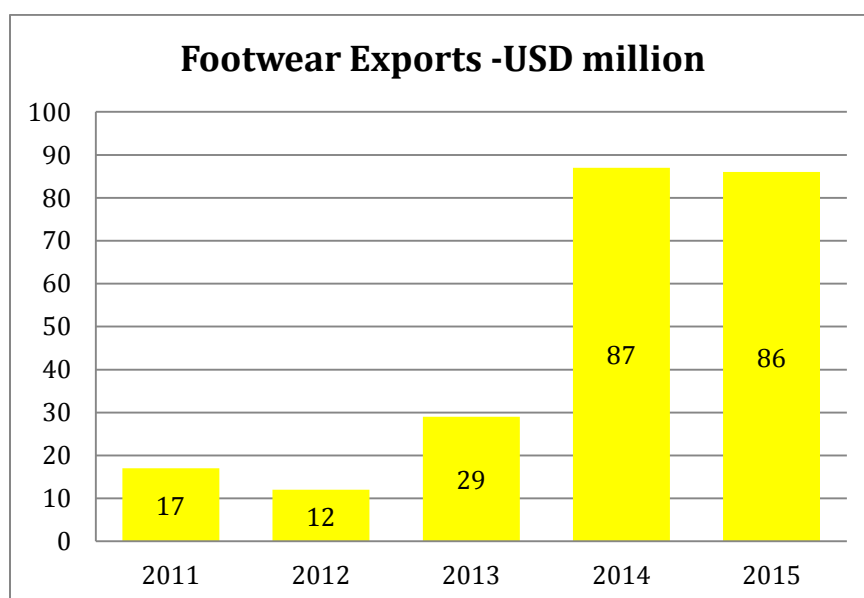
### **5.1 Industry overview**

Sri Lanka's total clothing and footwear market is estimated to be around Rs. 300 billion, of which the contribution of footwear is estimated to be approximately 10%. Sri Lanka has over 3,000 footwear manufacturers as follows.

Description	Number of manufacturers
Large scale enterprises	7
Medium scale enterprises	30
Small scale*	3,000

\*Approximate

The industry provides over 40,000 direct and indirect employment opportunities. The footwear industry is considered as a thrust sector by the government given its huge export potential. Footwear exports have increased by 5 folds from USD 17 million in 2011 to USD 86 million in 2015.



Sri Lanka has a few high-quality shoe manufacturers who target the export market. These high-end manufacturers supply to global brands such as Marks & Spencer, Bata France, Clarks and Nike. Sri Lanka's major export destinations for footwear have been US and EU markets.

## 5.2 Industry trends

The domestic footwear industry is going through a rapid transition along with the changes in demographics in the country. With increasing urbanisation, a growing middle class, rising disposal income levels and more women in the workforce, the Sri Lankan consumer has become more sophisticated. Thus, a lot of consumers are moving from a low-end market to a medium and high-end market demanding greater variety, new designs and international brands. Further, there is a strong trend towards more casual

and youthful styles due to increased exposure to global fashion trends. In terms of retailing, several high-end shopping malls have come up in the recent years combining fashion and footwear with related lifestyle items, entertainment and restaurants. Medium to high-end international and global footwear brands have also made inroads into the market. Online retailing has started to make a considerable impact on traditional players. In certain segments such as consumer durables, computers and accessories, online retailing has really threatened the traditional brick and mortar business model and it is expected to impact other retail segments as well. Several online retailing startups have fetched attractive equity valuations from private equity investors indicating strong growth potential in this space.

## **6. Future and direction of Serendib**

At the last board meeting of Serendib, there were extensive discussions on the future direction of the company.

Roshan, the marketing director made a very important observation. He said, “We are very strong in the mass market. But the Sri Lankan consumer is getting sophisticated. We can see a major shift towards international brands and the consumer is seeking quality more than ever before. Our past attempts to introduce home grown high-end brands have failed. I feel people who could afford such brands will only pay a premium price for international brands. Therefore, we should seriously think about obtaining sole distributorships for selected international brands in Sri Lanka. We will also have to think of modernising our retail chain to suit the changing expectations of the consumer”.

Bimal, the operations director, supported Roshan’s view. He further stated “It looks like future retailing would be primarily via online and mobile platforms, especially for the youth and high-end consumers. I recently met the CEO of a startup online retailer of consumer durables. They are doing great. Sales are increasing rapidly month after month”.

Kamal, the finance director had a different viewpoint. He stated “Even though our sales have been increasing steeply over the last few years, our margins are under pressure due to rising costs and high gearing. Approximately  $\frac{3}{4}$ <sup>th</sup> of our operating profits are eaten up by the finance costs. At this stage, if we are to make fresh investments to modernise our retail chain and develop an online platform, we will have to increase our borrowings, which will insert further pressure on our margins and bottom line”.

Bimal said, “To improve margins we have to look at two strategies. We need to increase sourcing from Bangladesh (or similar low cost countries), where the cost of production is very low and also break into the high margin upper middle and high-end markets. Without this we have no survival in the long run”.

The chairman, an entrepreneur with great foresight, was listening carefully to the conversations of the younger board members. Finally he opined “We have to adapt ourselves to the market and go with it. Otherwise we will perish with time. Hence, we should carefully study future trends in the industry and plan our future course of action. To counter-pressure margins, I feel we should build more supplier relationships in Bangladesh and similar low cost countries where our costs would be significantly low. Of course we have to be mindful about compliance and ethical aspects when sourcing from such countries. I also agree with Bimal; we must have more presence in the high-end market though some international brands”.

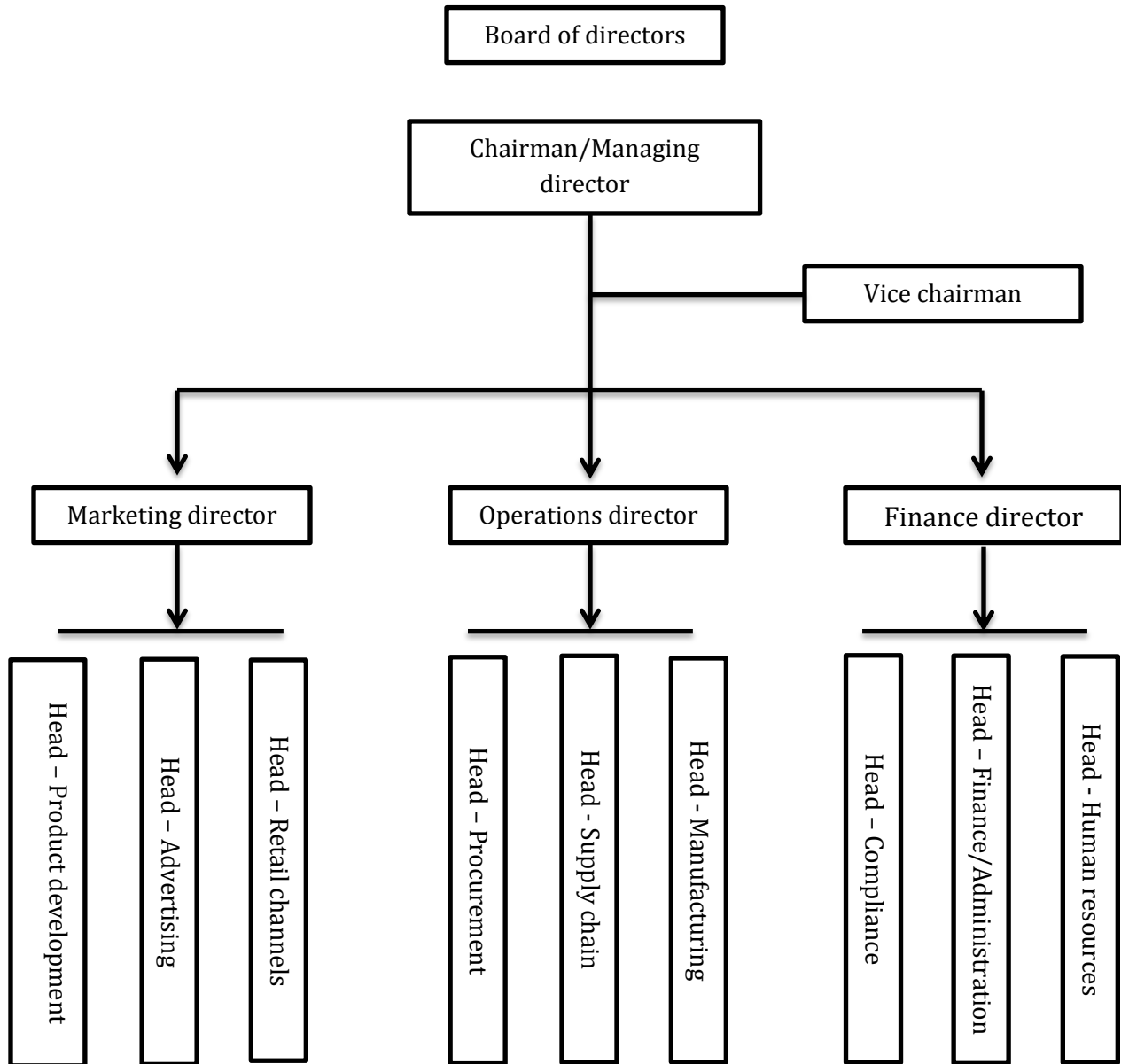
Bimal responded “We need not increase our borrowings to finance our intended investments. We have anyway been thinking of going public for a long period of time. I feel with the plans we discussed today, this is the ideal time to list our company on the stock exchange. The proceeds from the Initial Public Offering (IPO) can be used to finance the investments”. Bimal further mentioned, “It is also worth considering issuing a listed debenture as it may give access to non-banking sources for debt funding. We can probably raise a debenture cheaper than obtaining bank funding”.

The chairman requested the executive directors to work on detailed plans and the feasibility of launching an online footwear business, modernisation of the retail network and obtaining exclusive dealerships for a few leading international brands.

The meeting ended with no specific decisions being made. However, all board members and senior management walked out of the boardroom with a lot of enthusiasm and energy.

## Annexure 1 – Organisational chart

The organisational chart of Serendib up to the level of department heads is given below.



Note: - Five out of nine department heads are relatives of Sirisoma Perera.

## Annexure 2 – Profiles of the board of directors and key management personnel

### Board of directors

Sirisoma Perera – Chairman/Managing director	Sirisoma, aged 82, is the founder and present chairman/managing director of Serendib. Today he is one of the most respected entrepreneurs of the country. He has over 50 years of experience in marketing and sales of retail products. He started his career as a marketing executive of a fast moving consumer goods (FMCG) multinational company soon after completing his school education he has a knack for reading consumer behaviour well, which has been the critical success factor for Serendib. Sirisoma is a natural risk taker and enjoys experimenting with new ideas and concepts.
Anoma Perera – Vice chairman	Anoma, aged 78, has nearly 50 years of experience in product designing and production management. Anoma started her career at the age of 24 when she joined as a production executive of a leading footwear manufacturer at that time. With her strong commitment and dedication to work, she became a production manager of the same company within a short period of time. Anoma was managing the entire production and design function of Serendib in its early years until professional managers took over the production in the early 1990s. Presently she plays a passive role in the business.
Kamal Perera – Finance director	Kamal, aged 52, is a chartered accountant with an MBA from a local university. He looks after the finance, administration and human resources functions of the company. He completed his initial accountancy training at one of the leading international accountancy firms and had worked at a mid-sized manufacturing company as an accountant for 5 years prior to joining Serendib as its head of finance. He played a key role in streamlining the finance function of Serendib.
Bimal Perera – Operations director	Bimal aged 45 is an engineer who graduated from a prestigious UK based engineering college. He oversees the production and the entire supply chain of the company. Prior to returning to Sri Lanka, Bimal had worked at a European footwear manufacturing company as a production engineer.
Roshan Fernando – Marketing director	Roshan, aged 38, has a MBA from a leading university. He completed his first degree in management and specialised in marketing. He started his career as a management trainee of a multinational company. He rose to the position of a marketing manager within a very short period of time given his excellent performance and strategy formulation skills. Thereafter, he was posted as the head of marketing of the same multinational in one of its South Asian offices. The chairman invited Roshan to join Serendib as its marketing director upon returning to Sri Lanka from his foreign posting a few years ago.

## Key management personnel

Name	Designation	Qualifications	Industry experience
Aravinthan Shankar	Head of retail channels	BSc (Marketing), CIM, MBA	22 years
Niluka Rajapakse	Head of advertising	CIM, MBA	14 years
Gayani Dissanayaka	Head of product development	BSc, MSc (Architecture)	15 years
Faizal Carder	Head of manufacturing	BSc (Engineering), MBA	21 years
Siva Gopalan	Head of supply chain	BSc (Business Administration)	15 years
Ranjith Perera	Head of procurement	G.C.E. (A/L)	30 years
Ranjani Gamage	Head of human resources	BSc (HR Management)	12 years
Kithsiri Silva	Head of finance /administration	FCA, MBA	20 years
Ruvantha Perera	Head of compliance	BSc (Business Administration)	8 years

## Annexure 3 – Summary historical financials

The summary financials of Serendib are given below.

<b>Serendib Footwear Industries (Pvt) Ltd</b>	<b>Rs. million</b>	
<b>Summary Income Statement</b>	<b>Audited</b>	
<b>For the year ended 31 March</b>	<b>2015</b>	<b>2016</b>
Income	2,904	3,543
Gross profit	1,394	1,630
Operating profit	222	251
Finance cost	(155)	(192)
Profit before tax	67	59
Profit after tax	53	50

<b>Serendib Footwear Industries (Pvt) Ltd</b>	<b>Rs. million</b>	
<b>Summary Balance Sheet</b>	<b>Audited</b>	
<b>As at 31 March</b>	<b>2015</b>	<b>2016</b>
Non-current assets	2,000	1,990
Current assets	989	1,221
<b>Total assets</b>	<b>2,989</b>	<b>3,211</b>
Non-current liabilities (borrowings)	1,240	1,194
Non-current liabilities (other)	128	229
Current liabilities (borrowings)	330	329
Current liabilities (other)	504	635
Shareholders' funds	787	824

#### Annexure 4 – Financial projections

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

#### Annexure 5 – Maturity profile of long term borrowings

Maturity profile of existing long term loans are as follows.

Maturity profile of existing long term loans					
Year	31.03.2017	31.03.2018	31.03.2019	31.03.2020	Total
Due amount during the financial year – (Rs. million)	165	478	418	299	1,360

The weighted average interest rate of existing loans is 13% p.a.

#### Data sources:

<http://www.srilankabusiness.com/footwear-and-leather/>

<http://www.sundaytimes.lk/141012/business-times/sri-lankan-shoe-makers-face-growing-threat-of-bankruptcy-121544.html>

<http://www.asiantribune.com/node/86359>

<http://www.news.lk/news/business/item/12141-sri-lanka-s-footwear-and-leather-exports-in-2015-shows-strong-growth>

Sri Lanka Export Development Board