

CA



THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

**27510 - TOP CA CASE STUDY EXAMINATION**

MARCH 2015

## **Environmental Analysis**

### **SWOT Analysis**

#### **Strength**

- Cost reduction strategies adopted by KML
- Efficient and effective controls on production process-short lead time
- Enhanced ERP system
- Wide product mix
- Loss reduction over last years

#### **Weakness**

- Conflicts in Family shareholdings
- Fixed pricing strategy
- Maintain slow moving inventories
- Changes in HR levels
- Narrow GP margin

#### **Opportunities**

- High prospects in the industry
- High GDP and Per-capita Income increase
- Fuel price reduction reduces the production cost
- Providing Fabrics to SAL
- Positive political relationship with European countries GSP +
- Growth in tourism sector
- Low interest rates in the country
- Development of Social media and communication sector together with life style of people

#### **Threats**

- Unexpected seasonal variations
- Impact of new competitors in the market
- Exchange rate fluctuations
- Political uncertainty of the country and other countries in the world
- Newly introduced taxes, EPF rules etc.
- Merger can loss key staff members

### **PEST Analysis**

#### **Political/Legal**

- Frequent changes in Economic and tax policies
- Political disputes of the country and other countries in the world
- Current prospects on tourism
- Government positive perspectives to promote exports

### Economical

- Low interest rates
- High level of infrastructure development over last few years
- High level of economic growth
- Capital market development

### Social

- Life style changes of people
- Improvement of awareness on different brands
- Low communication cost
- Low salary level leading to high labor turnover
- Increasing semi-urban population

### Technological

- Improvement of IT and communication technology, fashion design technology
- Increase of Credit card usage
- Development of accounting and retail software developments

## **Analysis of five forces Model**

### Threat of new Entrances

- Less regulatory within the industry will encourage for new entrances
- Market attractiveness will encourage for new entrances
- Brand loyalty with the existing players will discourage new entrance.
- Switching cost will be high in the industry
- Access to the current suppliers

### Bargaining power of the customer

- Lower switching cost from one product to another
- Brand loyalty
- Price sensitivity

### Bargaining power of the suppliers

- Switching from one customer to another can be high
- Backward integration by the retailers have reduced the bargaining power of the suppliers
- Due to expand of the industry the number of suppliers were high.

### Threat of Substitute products

- Vast amount of retailers in the country
- Price differentiation
- Brand loyalty

### Threat of rivals

- Newly introduce brand to the market
- Customers want to experience new brands
- Customers brand loyalty
- Few players in the market with end to end delivery
- Apart from the above, candidate can provide an analysis of the Sri Lanka's economic growth for past few years. It's also important to mention that company fails to capture the full benefits of the economic growth where the other competitors had capitalized it and company need to find out reasons for such failures.
- Candidate can also mentioned about the Sri Lanka's tourism growth and its impact in the industry. Also can mentioned about the changes in the spending patterns of the tourist. Specially on the Indian tourists which not only coming for the purposes of leisure but also spending on shopping and entertainment.
- They can also highlight about the well-established design schools which provide fashion designers and most of the premier garments companies will have their own schools to produce the best designers to the market.

### **Proposed Business Strategies**

- Candidate need to identify the following proposed business strategies.
- Need to use the Brand identity which have been already built by the company of the current business to enhance the business of both companies.
- Critical analysis of the supply chain process to identify the current issues and look for opportunities to increase the efficiencies in the system.
- The future business strategies of moving to the semi urban markets to increase the sales volume.
- Company need to identify the important of expanding its business to the international markets and the factors such as financial feasibility, attractiveness of the high end fashion, risk relating to exchange rate and rules and regulations relating to countries need to be look at.
- The company also need to identify its future opportunities in the current market place and to see the possible business strategies to compete with new rivals and market giants.
- Company also need to identify new business models and need to cater for such facilities such as e commerce, personalized customer services etc...
- Company need to identify the best practices available within the industry and introduce a good corporate governance system to the organization.
- Tax structure of the both Companies need to be analyses to obtain the benefits given by the governments on mergers and acquisitions.
- Merging or acquiring is a strategic business decision which give benefits for the company through the backward integration. Reduces supplier bargaining power, Cost minimization

strategies and Operational synergies based on the reduction of the staff are such of those benefits.

**(20 marks)**

## Financial Analysis

Candidate need to carry out the computation based on the free cash flow method on the information provide using the appropriate discount rate ( 26%) to find out the per share value. This amount can be compare with the value which was mentioned by the CEO the company to check the company is under or over value.

The candidate can calculate the overall value for the KML and that can be compare with the value given by the Sivian consultancy private limited to check the appropriateness of the value.

Based on the final valuation the candidate can decide whether a merger or an acquisition is appropriate or not.

Apart from the above calculation candidate need to identify the other factors which can have an impact on the above decision. There will be accounting implication due to the new SLFRS standards which can have an impact on the accounting.

### Forecasted cash flows for next five years (Rs. Million)

	2014/15	15/16	16/17	17/18	18/19	19/20	20/21
Net Operating Profit After Tax (NOPAT)	(224)	107	267	459	601	842	912
Add: Depreciation	10	12	12	13	13	15	17
Less: Increase in WC requirement	(24)				(5)		
Cash from operations	(238)	119	279	472	609	857	929
Cash flows are growing for the future periods							NCF/COC 3573
Discount Rate (26%)	0.79	0.63	0.50	0.40	0.31	0.25	0.20
Present Value	(189)	75	140	187	192	214	900
Net Present Value	<b>1,519</b>						
Less: Debt	(701)						
	818						
<b>Value per share (818/113)</b>	<b>Rs.7.20</b>						
Calculation of WACC for business valuation of Knitny Mills Pvt. Ltd							
Tax rate - 28%		Weights					
Average Cost of Debt	(11% X(1-.28)) 7.92%	9%					
Cost of equity	28%	91%					
<b>WACC</b>	<b>26%</b>						

(20 marks)

### **Acquisition of KML**

Price per share 7.20 and Bidding price 15 to 20, accordingly acquisition is financially not bifacial

### **Merger with KML**

Present value of SPL = Rs.5,712 million

Value per share of SPL along  $5712/272 = \text{Rs.21}$

Value per share of KML = **Rs.7.20**

Present value of merged firm (SPL+ KML) = Rs.7,985 million

Value per share after merge =  $7,985/(272+113/3) = \text{Rs.25.8}$

**Gain 25.80-21= 4.80 Gain**

**Assumption:** Shares are given to KML at 3:1 ratio or Student can take any other ratio for share exchange.

(Value per share of SPL =21, SP of KML =7.20 therefore share exchange ratio )

Based on above assumption, merger is not financially beneficial

Or

Another calculation

Present value of merged firm (SPL+ KML) = Rs.7,985 million - Cash Paid ( $113 \times 7.20$ ) = 813.6 = **Rs.7171.4**

Present value of SPL = Rs.5,712 million

Present value excess on Merger =  $7171.4 - 5,712 = \text{Rs.1,459}$

Therefore, students can prove that merger is financially beneficial.

Verification of the Answer:

$(272+113/3) = 310$        $1459/310 = 4.80$  gain

**(10 Marks)**

### **Other factors**

#### **Acquisition of KML and Merger with KML common factors**

Cash flows sufficiency of the SPL

Beating the competition

Operating as a main fabric suppliers and as a result low production cost

Attraction of new customers

Implementation of flexible pricing strategies

Benefit of forward integration strategies

Benefit of ERP system of KML

Economies of scale

Complementary resources

Eliminating inefficiencies

Industry consolidation

Surplus funds/ low cost of capital

Diversification

#### **Acquisition of KML**

Elimination of Family problems

Compatibility of information systems

#### **Merger with KML**

Cultural issues/fit

Re arranging organization hierarchy

**(10 Marks)**

## **Risk Management**

- Though there are many risks to which a business is exposed some of the key risks impacting SPL are discussed below.
- Changes in Macroeconomic conditions impact SPL. The increase in per capita income and tourist arrivals are catalysts for growth of the target market segment of SPL.
- The changes in the economic projections and performance are closely to be monitored to understand the impact to SPL. The product offer and communication of the value are tailored to recognize the change of customer needs and aspirations.
- The ability to fund the business at competitive rates is crucial. The changes in fundamentals which drive interest rates in the market are closely monitored. Also SPL should actively develop the relationship with a multitude of lenders and potential sources to broaden the funding options.
- The quality of service provided by employees and their work ethics and integrity are also important aspect of risk management. The staff should be recruited through a screening process and provided with regular training and development opportunities to hone their skills. The environment is created to encourage commitment and participation. The orientation towards defined systems and procedures to be followed in most areas of work and the checks and balances in place to ensure compliance are regularly reviewed and improved where necessary.
- The ability to source the products efficiently and be able to ensure a range which appeals to the SPL customer is an important aspect of managing product risks.
- Maintenance of highest quality standards is synonymous with SPL brand. SPL has a diverse and broad base of suppliers and continuously monitors the changes in fashion to ensure the range carried mirrors the latest trends.
- The assets should be safeguarded physically where relevant and also insured as appropriate to mitigate risks of damage and unintended use. These measures too are reviewed by the internal audit and a comprehensive assessment is made annually of the coverage of risks through insurance. Also the ability of the underlying ICT systems to scale with expanding business requirements to be closely monitored. The continuing business growth requires support of latest ICT to ensure efficiency and effectiveness of delivery.

**(10 Marks)**



**Justification**

Based on the calculations and case analysis, students are required to rationalize the answer.

Merger is financial viable based on financial calculations

Synergy benefit is 4,80 per share

Acquisition is not viable because the value per share is Rs.7.20 and bid price range is Rs.15 to Rs.20

But it is expected to rationalize the final decision for the merge with KML but following factors should be considered in your decision

**(05 Marks)**

- To overcome existing family problems among shareholders
- Mitigate the cultural issues in KML
- Avoid the information compatibility issues

**(05 Marks)**

**05 Marks for the format**

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