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KC5 – Corporate Strategy and Contemporary Issues

July 2016

Pre-seen Case Study

MD Builders PLC

Background

Kapila Ramachandra was one of the best known corporate leaders in the Sri Lankan construction sector in 1980. He possessed a bachelor's degree in civil engineering as well as a master's degree in business administration. Kapila began his career at TN Constructions Limited, a company based in the United Kingdom. Upon his return to Sri Lanka he started his own construction company called HK Equipment and Constructors (Pvt) Ltd (HK) in 1971. The company recorded an average growth in revenue and profit after tax of 30% and 25% respectively during the first few years of operations. Accordingly HK became one of the most successful construction companies in Sri Lanka winning several local and international construction awards. In 1980, at the age of 45, Kapila passed away tragically after meeting with an accident. This unexpected incident meant that his wife Ramani, who had no prior business experience, had to take over the operations of HK. The different style of management adopted by Ramani led to many operational problems among the top management and the company started to record a downturn after 1980.

TMD Constructors, a leading Thailand - based infrastructure provider, with subsidiaries in 10 countries around the world, acquired HK and entered the Sri Lankan market in May 1981. They established it as a public limited company in 1982 and the company was listed on the main board of the Colombo Stock Exchange (CSE) in November 1983. HK PLC was subsequently re-named as MD Builders PLC (MDB) in December 1990. Later, MDB diversified its operations in the same industry as well as in other related sectors in the country. Accordingly MDB has a long history in the Sri Lankan construction industry. MDB has grown its operations diversifying into various sub areas in the construction industry such as piling, roads, highways, bridge and apartment constructions.

Strategic business units (SBUs) of MDB

MDB Engineers, one of the SBUs of MDB, has undertaken and completed large steel fabrication projects in the public and private sectors. Currently MDB Engineers is focused on providing engineering solutions for air conditioning applications, data processing centers, telecommunication facilities, switching stations, networking rooms and other heavy industrial applications. It has undertaken a number of large telecommunication, air-conditioning and IT infrastructure projects in the public sector due to having strong relations with many top level government officials.

With the view to further expand and support MDB's government projects, MDB Piling, a pioneer in Sri Lanka, commenced operations in 2003 as another SBU of MDB. MDB Piling has undertaken large piling contracts in both the public and private sectors in Sri Lanka.

MDB today is a well-established company with managerial, technical and financial support provided by TMD Constructors, its parent company in Thailand.

Currently MDB has an underperforming SBU called MDB Development Unit which focuses on the real estate sector. MDB's further expansion is directed towards the real estate sector in Sri Lanka, which has been growing at a remarkable rate over the past few years. MDB believes that the real estate sector offers affordable quality housing units for public sector employees and look forward to expand its existing portfolio. The real estate sector is expected to encompass state of the art technology in terms of construction and sustainable design while providing buyers houses with modern day amenities to facilitate 21st century living.

Over the past few years, MDB has earned a significant portion of its income from roads and highways sub-sector projects. Its commitment to the government's initiative to expedite infrastructure development has improved the local road network whilst at the same time established them as a premier road and highway contractor. Going forward, MDB expects to grow further and undertake larger projects with a view of developing the Sri Lankan road networks.

Corporate Social Responsibility (CSR)

During its operations MDB has displayed its CSR in numerous ways. It has signed an agreement with the government authorities and invested more than Rs. 10 million to provide skills development training to young craftsmen in many of its engineering fields. Further, they have greatly contributed towards government housing scheme projects while working as the contractor of many mega construction projects implemented by the government over the last 8 years. MDB has provided over 30,000 employment opportunities in Sri Lanka. It has also provided more than 20,000 man hours of safety training which has reduced accidents at the workplace to a very minimum level. Accordingly the company is equipped with sufficient skilled labour for its future expansion projects.

Human Resource Management

Known to be one of the most rapidly evolving industries in the world, the construction industry is driven in equal measures by technology and people. MDB understands that its people are the fundamental drivers of its primary business model. This has been the basis on which the company has always managed its staff. The strategy has been to inculcate international standards as a benchmark to develop a stimulating environment for the employees to work in. The focus is to develop a skilled, professional workforce capable of responding rapidly and proactively to industry challenges. Having placed a great deal of emphasis on human resource management and development and employee welfare, the aim is to promote greater goal congruence in the company. The mix of skills, knowledge

and training received by the staff ensure that they are more employable and have the ability to enter any market across the globe. MDB maintains a centralised human resource function where responsibilities are cascaded down to the SBU level.

The Remuneration Committee leads MDB's human resource structure, which has ensured a cohesive framework for human resource management across the company. At the strategic level, this helps in better planning and managing the efficient deployment of human resources, while at the operational level, it has led to greater cost savings across the company.

MDB has received public and private sector awards on many occasions and also has industry professional memberships from the Chamber of Construction Industry (CCI) and the International Federation of Asian and Western Pacific Contractors' Associations (IFAWPCA).

Current Performance

During the period 2007 to 2014, MDB focused more on government projects and earned a significant growth in their financials. In the financial year 2014/15, their market capitalisation on average was Rs. 8 billion. MDB recorded Rs. 14 billion of revenue in 2015/16 representing an increase of 39%. Profit after tax increased by 84% during this year (Annexure I).

Further, MDB's sectoral growth analysis highlighted that the contribution made by number of construction projects has decreased in latter part of 2015/16. This was mainly due to the slow growth recorded in the construction industry after electing the new government in 2015 and the increasing cost of imported construction materials. The issue was discussed by the directors in their board meetings and a committee was appointed to gather information regarding this matter and came up with possible ways of overcoming future problems faced by the company.

Accordingly, the committee has provided the following facts about the current market situation in Sri Lanka and the potential lucrative investment areas for the company.

The last two quarters of the 2015/16 financial year highlighted a slight downward trend specifically in the area of civil engineering projects such as the construction of roads, bridges and housing schemes. However the committee believes that Sri Lanka's stable growth has created a conducive environment for MDB to grow and evolve its business. The focus of the government to initiate a few more infrastructure development projects will provide the necessary impetus for growth, which the company is able to capitalise. In addition, the change of government in January 2015, this led to policy reviews, resulted in a slowdown of activities. Further, the review of large infrastructure projects following the change of government has made forecasting future prospects for the industry a very

difficult task. Although the industry is expected to do well, and the committee believes that many ongoing projects will be unaffected by the review process and will continue as before, uncertainty still prevails in the industry (Annexure II).

Strategic Focus

Expansion and related or unrelated diversification remained the crux of MDB's strategic focus for the future. Its aim is to leverage on group synergies and consolidate its presence as a fully-fledged engineering solution provider in Sri Lanka. To help map out a strategic blueprint for the future, MDB was advised to get the assistance of a consulting firm, which would study the current business model and help to realign the company's strategic vision with Sri Lanka's projected growth trajectory. This would result in MDB developing its medium-term focus while reviewing its long-term strategic priorities.

As the first step, the committee suggested to use MDB's iconic presence in the industry to diversify its business into emerging market trends. MDB could perform well in the real-estate industry through the acquisition of a possible real estate company in the market. While this would be a shift in MDB's conventional business model, the committee believes that the company's engineering and construction expertise would ideally complement the real estate business model. This venture will be further facilitated by the experience of MDB's existing real estate SBU.

In addition, the committee continued to focus on strengthening the core competencies associated with MDB and its SBUs. MDB Engineers has expedited the completion of a number of projects to revamp national infrastructure, specifically focusing on the remaining part of the highway network in Sri Lanka. Meanwhile, amidst stiff market competition, MDB Piling has strengthened its presence in the local market by completing a number of projects while signing on possible high-profile projects for the years to come.

One of the committee members commented about diversification in detail. The "primary form of corporate-level strategy, concerns the scope of the markets and industries in which the firm competes as well as how managers buy, create and sell different businesses to match their skills and strengths with opportunities presented to the firm. Successful diversification is expected to reduce variability in the firm's profitability as earnings are generated from different businesses. A firm uses a corporate-level diversification strategy for a variety of reasons. Typically, a diversification strategy is used to increase the firm's value by improving its overall performance. Value is created either through related diversification or through unrelated diversification when the strategy allows the firm's businesses to increase revenues or reduce costs while implementing their business-level strategies. Other reasons for using a diversification strategy may have nothing to do with increasing the firm's value; in fact, diversification can have neutral effects or even reduce a firm's value. Value-neutral reasons for diversification include a desire to match and thereby

neutralise a competitor's market power. The decision to expand a firm's portfolio of businesses to reduce managerial risk can even have a negative effect on the firm's value."

Moreover the committee has noted that MDB's business portfolio risk should be mitigated by focusing on related or unrelated diversifications. It has been identified that the power generation sector might be a lucrative alternative for possible investment in order to minimise problems arising from the uncertainty in the construction sector. Further, the committee has noted that MDB could successfully enter into supplying thermal power to the national grid to utilise this market opportunity. Accordingly, they have gathered the facts regarding the expected developments in power generation in Sri Lanka (Annexure III). The committee is more positive towards the power generation sector.

Risk Management of MDB

MDB believes in good corporate governance practices with effective controls enabling risks to be identified and strategically managed to meet its obligations towards its stakeholders. Risk management at MDB is a continuous and developing process and plays a vital role in the development of corporate strategy and its implementation. The company firmly believes that sound risk management practices are critical for long term growth. As such, MDB's objective is to add maximum sustainable value to all activities of the organisation, taking into account the potential positive and negative factors that can affect the company's going concern. MDB takes a systematic approach to managing risks by identifying, assessing and handling both core and non-core risks. This is done through a structured system of monitoring and controlling adverse impacts and finding opportunities therein to maximise returns.

MDB's endeavors to instil in all its employees the importance of managing risk present in day to day operations. All business decisions and related activities within the company and SBUs are governed by a structured risk management system.

Risk governance applies the principles of good governance to the identification, assessment, management and communication of risks. It incorporates criteria such as accountability, participation and transparency within the procedures and structures by which risk-related decisions are made and implemented. The management believes it is paramount to have the company's risk management process open. This allows everyone within the organisation to feel a part of the continual process of risk management, its development, implementation and evaluation. The company firmly believes that most often it will be the people on the ground who are best able to see what works and what does not, and also be the first to notice any changes in the nature of risks faced by the organisation.

Annexure I

MDB PLC

Income statement for the year ended 31 March

	Rs.'000	
	2016	2015
Revenue	14,025,193	10,092,371
Cost of sales	(10,902,278)	(7,986,004)
Gross profit	3,122,915	2,106,367
Other operating income	21,044	72,936
Administrative expenses	(1,274,817)	(806,656)
Selling and distribution expenses	(108,035)	(36,869)
Operating profit	1,761,107	1,335,778
Finance cost	(665,272)	(741,745)
Finance income	325,201	136,387
Net finance income/(cost)	(340,071)	(605,358)
Profit/(loss) before tax	1,421,036	730,420
Tax expense	(313,767)	(129,623)
Profit for the year	1,107,269	600,797

MDB PLC**Statement of financial position as at 31 March**

	Rs. '000	
	2016	2015
Assets		
Non - current assets		
Property, plant and equipment	4,232,778	2,604,047
Leasehold property	87,610	-
Intangible assets	511,858	511,858
Finance lease receivables	2,665,594	2,779,157
Other non-current financial assets	531,158	3,259
	8,028,998	5,898,321
Current assets		
Inventories	2,950,300	609,976
Finance lease receivables	230,079	177,028
Trade and other receivables	8,866,595	7,383,289
Other current assets	567,294	500,413
Amounts due from related parties	-	16,718
Other current financial assets	1,440,301	968,476
Cash and cash equivalents	172,003	96,616
	14,226,572	9,752,516
Total assets	22,255,570	15,650,837
Equity and liabilities		
Capital and reserves		
Stated capital	6,057,498	3,659,428
Capital reserves	669,292	501,647
Other reserves	-	4,649
Retained earnings	2,043,494	936,225
Total shareholders' funds	8,770,284	5,101,949
Non - current liabilities		
Interest bearing loans and borrowings	2,851,226	1,929,104
Other non-current liabilities	2,300	2,300
Deferred tax liabilities	113,415	94,681
Retirement benefit obligations	84,193	62,725
	3,051,134	2,088,810
Current liabilities		
Trade and other payables	3,541,679	4,482,164
Other current liabilities	155,648	46,887
Amounts due to related parties	498,724	462,342
Interest bearing loans and borrowings	5,990,064	3,367,342
Income tax liabilities	248,037	101,343
	10,434,152	8,460,078
Total equity and liabilities	22,255,570	15,650,837

Annexure II

Build Sri Lanka 2016 to unfold in May

To achieve the common goal of 'Building a new Sri Lanka', the Chamber of Construction Industry (CCI) launched Build Sri Lanka 2016 - Housing and Construction Expo, which is expected to be held from May 13 to 15, 2016, at the BMICH.

The expo expects to provide a platform to the construction industry to display their products, services, new technologies and capabilities to potential customers and the public and also highlight the recent development projects undertaken in the country with an insight into the plans of building a new Sri Lanka.

Addressing the gathering, CCI President Dr. Surath Wickramasinghe said that CCI was formed in 2001 when the construction industry was achieving negative growth. At present, the industry is progressing steadily with the projects they have in hand. "But unfortunately, now we cannot see a visible impact from the private sector towards the fast-tracking of the construction industry; it is may be because of the government is new," he said. However, he noted that the Board of Investment (BOI) has reintroduced the incentives offered to entrepreneurs and the industry in the past, and it will be a good way to kick off the development drive.

Revealing his stance on the megapolis project, which was initially submitted in 2004, then later abandoned due to the change of the government, and now expected to proceed, Dr. Wickramasinghe stated that the mega city concept is futuristic and is beneficial for the economic growth of Sri Lanka. "In my view, it should be done in phases, beginning with the smart city concept in selected parts of Colombo," he said.

Dr. Wickramasinghe also noted that the total area of the Western Province is 3,684 km², which is five times larger than Singapore. However the population of both the Western Province and Singapore are about the same, which is 5.8 million. "Therefore, sometimes I wonder whether the megapolis development concept for the total of the Western Province, which includes Gampaha, Colombo and Kalutara, can be achieved without the participation of all of our chambers" he said.

Dr. Wickramasinghe said that the proposed mega city project in the Western Province can be further fast-tracked and accelerated through developing other roads in Sri Lanka such as those to Trincomalee, Jaffna, Kandy and Galle, and perhaps a few others later on. He added that when considering the megapolis project it has to be a mix of both urban and rural.

However, Dr. Wickramasinghe also said that there are smaller mega cities with a population of less than 10 million and out of these the best economic growth is achieved in cities with a population between 1.5 - 5 million. He also noted that the global trends indicate that by 2025, there will be 27 mega cities out of which 21 will be in developing countries.

CCI Sri Lanka General Manager Kapila Liyanaarachchi said the expo, which is held for the 12th time, is organised for the benefit of the stakeholders and those involved in domestic housing construction, who can obtain knowledge on materials and modern technological equipment.

Explaining the concept of building a new Sri Lanka, he said that with the present government's vision on the proposed megapolis project where Colombo, Gampaha and Avissawella would become one city, all the roads would be inter-connected. He said that cities such as Kandy and Galle would become satellite cities, which would be connected with highways under this project. "Even if you look at Kaduwela to Fort there will be a monorail system," he added.

Kapila also said that the Port City Project is a necessity and it should be continued. "The chamber believes the city should be expanded. It's not only the land side, but the sea side also needs to be acquired," he stated. Moreover, the fifth edition of the construction industry trade and business directory for 2016/17 was also launched at the expo.

Extracted from: www.daily.mirror.lk

Annexure III

Power generation in Sri Lanka

Demand for electricity generation is expected to grow by around 6 percent in 2016 due to increasing economic activities and prevailing low tariffs. With increased low cost power sources, particularly coal power, the average electricity generation cost is expected to remain low. Further, a supply shortage of electricity is expected in 2016 due to problems of coal power generation. The financial performance of the Ceylon Electricity Board (CEB) is expected to remain favorable if coal power generation operates at its full capacity and normal weather conditions prevail during 2016. The power generation cost will be well-adjusted during the remaining period of 2016 as international oil prices are expected to remain at low levels mainly due to the increase in supply caused by higher production in the OPEC member countries and easing of sanctions against Iran.

The gradual transition to a lower-middle income country with a GDP per capita income together with greater urbanisation and the emergence of an urban economy oriented around manufacturing and services has pushed Sri Lanka ahead of many of its South Asian counterparts. Strongly appended to these developments, the demand for power and energy too has seen an explosive growth in the past few years.

At present, 40 percent of Sri Lanka's total energy requirement is for the use of households. A further 40 percent is taken up by the manufacturing industry and the remainder is taken up by the commercial sector. In addition Sri Lanka is also the only country in the region that has improved its infrastructure capabilities and electricity generation capacity to feed the growing demand for power. Approximately 94 percent of the country's households have already been provided with electricity and the government remains committed to raising this to 100 percent. Having set a goal to achieve 100 percent electrification, the government has continued to encourage the private sector to act as licensed Independent Power Producers (IPPs). At present, Sri Lanka's power generation sector consists of IPPs with varying capacities, who contribute nearly 550 MW per annum of the country's total energy requirement. Most of the major hydro potential in Sri Lanka has been developed and they are delivering valuable low cost electricity to the country. Hydroelectricity generation has played a major role in power generation in Sri Lanka since the commissioning of the first hydroelectric power plant in 1950.

Sri Lanka is an island nation with substantial wind energy resources. The Wind Energy Resource Atlas compiled by the National Renewable Energy Laboratory (NREL), has identified three major regions in Sri Lanka as having good-to-excellent wind resources.

They are:

1. North-western coastal region from the Kalpitiya Peninsula to the Mannar Islands and the Jaffna Peninsula in the north.
2. Central highlands in the interior of the country – largely in the Central province
3. Parts of the Sabaragamuwa and Uva provinces.

It is estimated that there is nearly 5,000 km² of windy areas in Sri Lanka with good-to-excellent wind resource. About 4,100 km² of the total windy area is on land. The windy land represents about 6% of the total land area (65,600 km²) of Sri Lanka. Additional studies are required to accurately assess the wind electric potential, considering factors such as the existing transmission grid and accessibility