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KC 5 Corporate Strategy & Contemporary Issues

Section 2: Suggested Answer

Mr.Robert,
Chairman,
Apex Apparel (Pvt) Limited,
Colombo,

Dear Sir,

EVALUATION OF PROPOSALS.

At your request we have evaluated the three proposals submitted by Director Mr.Nalin. Our report along with recommendations are attached herewith for your information.

If you need further information or clarification on the content of this report you may contact us.

Thanking You,

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Director – Advisory,
Lead Consulting (Pvt) Limited.

Date.....

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1. EXECUTIVE SUMMARY

Investment in foreign country

There are two options available for AAPL either to buy a running garment factory in Vietnam or construct and operate a new garment factory in Bangladesh. The NPV calculation shows that both investments have positive NPV. NPV of Bangladesh factory is slightly higher than that of Vietnam factory. However, when it considers the initial investment required and time taken to start the operation, we suggest that it would be prudent to invest in Vietnam factory. Because it requires lesser amount of investment and less time to start operation. Further, when political and country risk is considered, Vietnam factory will be the best option given the fact that unsafe environment prevailing in Bangladesh.

It is recommended to invest in factory in Vietnam and it could probably be financed by a loan. This would provide AAPL to expand its business and thereby overcome the issues such as shortage of labor.

Listing of AAPL shares in CSE

AAPL is currently facing difficulties in managing the cash flows due to recent investments done. According to the latest financial statements, it has cash of only USD 01. Further, it can be observed that trade receivable balance is getting accumulated. This may create further problems in working capital management.

Given these facts, Director Operation has proposed that it should go for listing to raise funds required to finance the above projects.

According to the latest statistics, Sri Lankan share market is not performing well. The ASPI has come down by 10.37% over last 12 Months. The ongoing discussion of capital gain tax, raising interest rates (due to this, all bonds issued have been oversubscribed including government bonds) have been major issues behind this.

Further, IPO is a time consuming task and it will not be a best option for financing the projects at this time for AAPL. Because there is a very limited period of time to buy/construct and start operation.

Therefore it is recommended not to go for listing at this time. Instead, it should be financed by alternative method such as obtaining a loan or expediting the collection from trade debtors and using internal funds.

Review the current corporate/marketing strategy of AAPL

It is suggested to reach new emerging markets with same products. For this purpose the company is suggested to consider new emerging markets such as Brazil, India and China. Further those markets might require low cost products which might be different to products manufactured by the company at present. For this purpose it suggested to consider investing in new technology, equipment and staff.

Further AAPL has the option of diversifying by offering new products targeting new customers. For example the company can venture into retailing, consultancy and training and educational services targeting apparel sector. Company can offer many types of products targeting wide range of customers which are not in the product portfolio at present.

Having a well-designed marketing strategy for a company in this industry is utmost important due to the intense competition prevailed in the market. As a marketing tool, the social media such as face book, twitter can play a vital role without having major cost to AAPL and access to wide range of customers within shorter period of time.

However, currently AAPL is not using any of such media as a marketing tool. Therefore it is recommended to revise the marketing strategy to incorporate them and implement the same to win the competition and increase the market share.

2. INTRODUCTION

AAPL is a private limited company incorporated and domiciled in Sri Lanka. The principle activities of the company is manufacture and export of garments. The company has many subsidiary companies, joint ventures and some of them are Located in foreign countries.

The Sri Lankan apparel industry performed well over the last few years recording highest export revenue under many challenges. Sri Lankan apparel sector was on a revenue target of USD 6 Billion in 2016. Revenue of this sector was increased by 22% in the first quarter of 2016.

There are many challenges faced by manufacturers in this industry which include, shortage of labor, lack of skilled labor, increase in labor cost, increase in overhead cost compared to other countries such as Vietnam and Bangladesh etc.

However, favorable economic conditions prevailing in Sri Lanka has contributed towards the growth of this sector. Currently around 400 garment factories are operating in different parts of the country.

AAPL is also a large company having nearly USD 1 billion revenue by end of 2015. The Company manufactures wide range of products and they are mainly exported to European markets and USA.

Recently, AAPL has been experiencing some issues which are common to the industry, especially shortages of labor. In addition to that, company has had liquidity problems due to recent investments done. As a result, Director of Operation (DO) has come up with three proposals to be considered by management/Directors to overcome such problems and grow the company.

3. EVALUATION OF PROPOSALS AND MAKE RECOMMENDATIONS

PROPOSAL- 01

There is huge growth potential for apparel sector in Sri Lankan with the increased demand coming from various parts of the world. This is mainly due to high quality of Sri Lankan made garments. However, many companies in this sector including AAPL has experienced with lots of problems, such as intense competition prevailing in the world market, shortage of labor, increase in the labor cost, etc. As a remedy for these problems, Director Operation (DO) of AAPL has proposed to make an investment in a garment factory in a foreign country. For this purpose he has identified two countries which are Vietnam or Bangladesh. Apparel sector of both countries are growing and there are plenty of opportunities available to invest in.

Invest in a garment factory in Vietnam

Financial Evaluation

Based on the discounted cash flow method (DCF), results are as follows, (For detail calculation, refer Annexure - 01)

	Vietnam	Bangladesh
NPV(USD)	+34.5 Mn	+37.6 Mn
Profitability Index(PI)	5.30	5.01
Payback Period	02 Years and 08 months	02 years and 08 Months

This Investment in Vietnam generates a positive NPV of USD 34.5 Mn which is USD 3 Mn (Approx) lower than that of Bangladesh factory. Therefore, investment in Bangladesh factory adds more value to the company. However, this investment in Vietnam requires only USD 6.5 Mn which is USD 01 Mn lower than investment required for Bangladesh factory. Given the financial difficulties faced by the company, reduction of the initial investment by 01 Mn will also be a big relief for the company.

According to financial information given for year 2014 and 2015, it appears that recent investments have been done by using both equity finance and loan finance. Even though equity finance is limited, still there is an opportunity for the company to raise funds through loans because the gearing ratio is still at 39%. However, raising funds through loans again increase the interest payments which will further impact on the liquidity position of AAPL.

Vietnam factory has capacity of 325,000 hours per month whereas Bangladesh factory has a capacity of 300,000 hours a month. However according to the demand forecast for next five years, the maximum demand for a month is 249, 800 hours. When it comes to the capacity of two factories, it can be concluded that investment in Bangladesh factory is worthwhile in short term because it reduces the unutilized capacity. Therefore,

Investment in Bangladesh factory is better than Vietnam factory in terms of idle capacity in short term. However we are of the view that demand for the company's products will increase and this excess capacity available could be used in the medium run.

If company invest in Vietnam factory, business operation can be started from the following day. However, factory in Bangladesh has to be built first and then start operations. Based on given information, it has only 03 months for whole construction work. During such a shorter period of time, it may not be able to build such a big factory especially in another country. In case, if AAPL fails to build it within 03 months, it will delay the start of commercial operations. It will ultimately result in loss to the company.

Additionally, other factors such as labor cost of both countries, income tax rates, operational costs and its increase, market risk and increase in hourly rates, capital allowances and demand can also be considered in evaluating the best option. However, all of those have been already taken in to account in the computation of NPV. Therefore, if there are additional information about behavior of those factors after 05th year it will be very important to consider impact of those in the NPV of the project.

When evaluating above project, it is very important to consider the other risk arising from the investment. For example country risk or political risk is a major factor. Gravity of political risk in Bangladesh is evidenced by the recent terrorist attacks happened. It may have created unsafe business environment in the country. In addition to that there were some incidents where garment factory buildings were collapsed due to low quality construction resulting many deaths.

Recommendation

It is recommended to invest in factory in Vietnam by taking in to account the current financial situation of the company. This investment generates USD 3Mn less than the other. This difference is not key determinant in this case due to the reason that, currently AAPL is experiencing difficulties in managing cash flows. That means financing the project may not be easy task. Therefore, less investment will be better. Other very important factor is the time taken to start the project. It is very clear that, within 03 months it would be very difficult to construct the factory and start operation. Risk of construction failure is very high as evidenced by recent incidents. If so, cost of failure will also be very high.

However the capacity of Vietnam factory is higher by 25,000 hours (Approx) per month compared with Bangladesh factory. If can't be considered as a serious issue, because unutilized capacity is dependent on the fluctuation of demand for the product in future which has not been taken in to account.

On the other hand country risk and political risk is also higher in Bangladesh when compared with Vietnam. Further, investment of one US dollar gives USD 5.30 of return for Vietnam factory. But, it is just USD 5.01 from Bangladesh factory.

Considering all these factors, it is recommended to invest in Vietnam factory.

PROPOSAL - 02

Listing AAPL on Colombo Stock Exchange

While considering the foreign investment, Director of Operation (DO) has proposed to get the company listed in Colombo Stock Exchange (CSE) to raise more funds required for the project. This may be very important at the current situation because company is facing difficulties in managing cash flows due to recent investment done.

The major concern is the prevailing stock market condition of Sri Lanka and investor sentiments. Specially, the downturn depicted in the latest statistics from share market will hardly motivate potential investors for share investments. Thus it is doubtful whether it will fully subscribe. According to recent statistics, ASPI (All Share Price Index) has come down by 10.37% in last twelve months. Further, future forecast of ASPI also shows downward trend. Additionally, Investors could be more concern about the capital gain tax to be introduced by government. Moreover the raising interest rate depicted in latest statistics would also be a major issue for the boom in share market. The trend is that, more going for bond investment which yield around 8%-12% income to investors. During last 12 months, CSE (Colombo Stock Exchange) had facilitated around 8- 10 debenture issues. Almost all have been oversubscribed. However there were only one IPO open for investors. Therefore, if share market is not performing well there is danger of not meeting up capital requirements. Further, an issuance of prospectus will result in additional cost and will take time. Further AAPL would not be able to wait longer period to make such an investment.

Further, in Sri Lanka, none of the companies in the apparel sector is listed on CSE which can be considered as opportunity for AAPL.

Advantages of listing AAPL

- Ability to better strength their internal structure & become more attractive to potential strategic investors.
- Enhance corporate visibility, Prestige, brand image, public profile & creditability.
- Greater access to fund since company can return to public market for additional capital & access alternative financing on favorable terms from private investors as well.
- Provide a more liquid & diversified share capital base.
- Will facilitate further growth of the company.

Disadvantages of listing AAPL

- High distracting and time consuming due to need for periodic reporting and investor relation.
- High cost due to ongoing and initial expenses

- Limits on management's freedom to act including need for approvals of board or shareholders on major matters.
- Potential loss of control & privacy since there is a need to reveal high sensitive information in public reports.

Recommendation

It is recommended not to go for listing of equity shares. Because this might not be the right decision to take now. One major reason is the unfavorable market condition prevailing in the country which may not attract investors to invest in equity shares. On the other hand, AAPL won't have enough time to do an IPO and utilize the funds for the investments. If investments are delayed, AAPL would not be able to achieve its target NPV.

PROPOSAL - 03

Change in/revise the corporate/marketing strategy of AAPL

AAPL has the option of reaching new markets with the same apparel products they manufacture. For example the company can partner with retailers in emerging economies such as Brazil, India and China to supply their products. AAPL can use the demand from these countries to increase production and attain higher economies of scale. Further the company will face lower risks compared with the current strategy because it will generate revenues from many countries. It's unlikely that all these economies will hit an economic downturn at the same time. In addition to these, AAPL can use these countries to promote their own brand products easily because majority of consumers in these countries are middle income level customers and their demand will match with the medium range priced products of the company.

However this strategy requires new investments to increase the production capacity. AAPL will also require to make necessary adjustments to the own brand products based on the local preferences of customers. Further buyers of these destinations could be demanding the products at a lower rate than the buyers from the US and EU. Therefore profitability could be less compared to the current sales with US and EU.

AAPL has the option of offering new products to the existing markets. For example, the company can start producing new products such as hand bags, accessories, shoes and perfumes to its existing markets targeting the same customers. The company can benefit from increased revenues and profits as a result of offering new products. AAPL will not incur a significant amount of cost to promote the product initially because it can promote the products to its existing buyers without incurring much additional expenses. Further, this will strengthen the brands of the company due to availability of higher number of type of products.

However this strategy will divert focus of the company from its core products to some extent. This can compromise the quality of existing products and can result manufacturing products which are not up to the expectations of existing buyers. Further

these new products will not be able to manufactured using existing staff and equipment. Therefore company will have to invest in new production facilities and staff to produce new range of products.

AAPL has the option of diversifying by offering new products targeting new customers. For example the company can venture into retailing, consultancy and training and educational services targeting apparel sector. Company will offer many types of products targeting wide range of customers which are not in the product portfolio at present. AAPL can benefit from diversifying its risk because their revenues and profits will generate from several sectors as a result. Company can explore the opportunities in different sectors and grow with time to a large conglomerate in long run. However this strategy could result AAPL losing its focus on its current business and risking the future earnings from it. Investing in new sectors will restrict the resources available to invest in apparel sector as well.

AAPL is currently producing different types of products especially to European and USA markets. Therefore marketing strategy of the company is very important and it plays a vital role.

Currently, AAPL has no social media presence and undertaking its promotional activities in a traditional manner. This is not suitable with the present situation in the environment. The company can leverage social media to uplift its own brands.

Initially, AAPL should identify the social media platform (Face book, Twitter, etc) where majority of the target customers actively engage in. Then, the company should create relevant corporate profiles (Ex. Facebook page for “Splash”) on the selected platforms. As the next step, company should inform about these social media presence using their current marketing method. For example, display a link to the Facebook page of “Splash” after a T.V advertisement. Company can create an awareness of the new social media presence and invite them to engage with them doing this. Further, AAPL can use online advertising to attract customers to the relevant social media as well. As the next step, company should add content connecting with customers, similar to a friend connecting with another. The company should take feedback from customers and appreciate the feedbacks and reply to them. Further, AAPL should keep the customers engaged with the social media profiles and encourage them to share and communicate about the brand with their friends and followers. For example, AAPL can have a competition inviting customers to post their favorite photo wearing a Dynamic branded sportswear. In the long term the company can spread the brand among a wide range of potential customers by using its existing customers as messengers.

Therefore it is recommended to review the corporate strategy specially the marketing aspects of it as explained above in relation to social media.

4. CONCLUSION

When considering the recommendations derived from the above analysis, the company should invest in the factory in Vietnam. However, IPO should not be launched. Therefore, investments should be financed either by a loan or internal funds such as collecting outstanding trade debtors. Further, AAPL should revise its marketing strategy to incorporate social media as a marketing tool and implement the same to reach new customers.

Company should consider going for listing once economic conditions are favorable for the share market.

ANNEXTURE (1)

Investment in Vietnam		Y0	Y1	Y2	Y3	Y4	Y5
Initial Investment		(6,500,000.00)					
Revenue			6,237,600.00	6,571,644.00	6,827,112.54	7,155,447.14	7,499,878.76
DL	325,000.00		(1,772,727.27)	(1,817,045.45)	(1,862,471.59)	(1,909,033.38)	(1,956,759.22)
Factory OH			(750,000.00)	(825,000.00)	(907,500.00)	(998,250.00)	(1,098,075.00)
Capital Allowance			(72,000.00)	(72,000.00)	(72,000.00)	(72,000.00)	(72,000.00)
Taxable profit in Vietnam			3,642,872.13	3,857,598.55	3,985,140.95	4,176,163.76	4,373,044.55
Tax in Vietnam	25%		(910,718.18)	(964,399.64)	(996,285.24)	(1,044,040.94)	(1,093,261.14)
Taxable profit in SL			2,732,154.55	2,893,198.91	2,988,855.71	3,132,122.82	3,279,783.41
Tax in SL	15%		409,823.18	433,979.84	448,328.36	469,818.42	491,967.51
Add: Capital Allowance			72,000.00	72,000.00	72,000.00	72,000.00	72,000.00
NCF		(6,500,000.00)	2,394,331.37	2,531,219.07	2,612,527.35	2,734,304.40	2,859,815.90
							52,132,060.68
		(6,500,000.00)	2,394,331.37	2,531,219.07	2,612,527.35	2,734,304.40	54,991,876.58
DCF	10.76%	1	0.903	0.815	0.736	0.664	0.600
Discounted CF		(6,500,000.00)	2,162,081.23	2,062,943.54	1,922,820.13	1,815,578.12	32,995,125.95
NPV			34,458,548.97				

Investment in Bangladesh		Y0	Y1	Y2	Y3	Y4	Y5
Initial Investment		(7,500,000.00)					
Revenue			6,237,600.00	6,571,644.00	6,827,112.54	7,155,447.14	7,499,878.76
DL	300,000.00		(1,227,272.73)	(1,257,954.55)	(1,289,403.41)	(1,321,638.49)	(1,354,679.46)
Factory OH			(600,000.00)	(675,000.00)	(759,375.00)	(854,296.88)	(961,083.98)
Capital Allowance			(120,000.00)	(120,000.00)	(120,000.00)	(120,000.00)	(120,000.00)
Taxable profit in Bangladesh			4,290,327.27	4,518,689.45	4,658,334.13	4,859,511.77	5,064,115.32
Tax in Bangladesh	27.5%		(1,179,840.00)	(1,242,639.60)	(1,281,041.89)	(1,336,365.74)	(1,392,631.71)
Taxable profit in SL			3,110,487.27	3,276,049.85	3,377,292.24	3,523,146.03	3,671,483.61
Tax in SL	15%		466,573.09	491,407.48	506,593.84	528,471.90	550,722.54
Add: Capital Allowance			120,000.00	120,000.00	120,000.00	120,000.00	120,000.00
NCF		(7,500,000.00)	2,763,914.18	2,904,642.37	2,990,698.40	3,114,674.13	3,240,761.07
							57,286,180.53
Total Cash Flows		(7,500,000.00)	2,763,914.18	2,904,642.37	2,990,698.40	3,114,674.13	60,526,941.60
DCF	10.94%	1	0.901	0.813	0.732	0.660	0.595
Discounted CF		(7,500,000.00)	2,490,286.68	2,361,474.25	2,189,191.23	2,055,684.93	36,013,530.25
NPV			37,610,167.33				

Assumptions used.

- There is no double tax agreement between Sri Lanka and above two countries.
- 10.76% and 10.94% were used as the WACC of the vietnam project and bangladesh project respectively.
- After 05th Year, net cash flows are growing at the rate of 5%.

Computation of WACC for the purpose of NPV

Investment in Vietnam

$$\begin{aligned} \text{WACC} &= \frac{e}{e+d} K_e + \frac{d}{e+d} K_d (1-t) & \text{WACC} &= \frac{198.6}{198.6+128} 14.95\% + \frac{128}{198.6+128} 5\%(1-15\%) \\ & & &= \underline{10.76\%} \end{aligned}$$

Cost of Equity

$$\begin{aligned} K_e &= r_f + \beta (r_m - r_f) \\ &= 8.65\% + 1.26 (13.65\% - 8.65\%) \\ &= \underline{14.95\%} \end{aligned}$$

Investment in Bangladesh

$$\begin{aligned} \text{WACC} &= \frac{198.6}{198.6+128} 15.25\% + \frac{128}{198.6+128} 5\%(1-15\%) \\ &= 10.94\% \end{aligned}$$

Cost of Equity

$$\begin{aligned} K_e &= r_f + \beta (r_m - r_f) \\ &= 8.65\% + 1.32 (13.65\% - 8.65\%) \\ &= \underline{15.25\%} \end{aligned}$$

Assumptions used.

- WACC has been computed based on current capital structure.