

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

**KC5 - Corporate Strategy and Contemporary
Issues**

JULY 2016

Answer Guide:

(Following points should not be considered as the only model answer for the case given. They will help students to develop an answer for the case study)

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Executive Summary

- Students should briefly identify the business environment and given strategic options
- It is expected to justify the most suitable business options by referring to pros and cons of each option with financial and non-financial viabilities
- Students' conclusion and recommendation based on quantitative and qualitative justifications

Body of the report

1. **Environmental analysis for MDB by considering different strategic options**
(Mainly PEST can be used for Environmental Analysis. Porter's five forces model also can be accepted)

(i) PEST Analysis

Political	Economic	Social	Legal
New government policies on construction and hydropower sector	Currency depreciation	Negative impression of the apartment concept among local community	Legal barriers to approval for construction projects
MDB's network with government ministries	Unstable economic condition	Tendency to move to skilled labour in the country.	Constrained environmental laws on construction projects e.g. approval from the environmental authorities
Discontinuation of some construction projects initiated by previous government	Negative impact by inflation	Urbanization and increasing demand for shelters.	Outdated legal systems in the country resulting in red tape e.g. Forest Act
Unnecessary government influence for private sector projects	Continuous increase in labour cost	Perception on resistance to change people shelters	

(ii) **SWOT Analysis**

Strengths	Weaknesses	Opportunities	Threats
Over 35 years of business experience	Highly geared company	Proposed construction projects by the government e.g.- Megapolis	Continuous increase of material prices
Diversified into sub areas of the industry	Staying for a long period of time in the same industry	Government policy to discourage coal power	High competition in the construction industry
Experienced and skilled labour force	MDB's business structure (SBU model) of operation restricts expansion. Failure of one SBU negatively affects the whole MDB	Government contacts of MDB	High labour turnover in the construction industry
Existing advanced technology	Less return on Investment of MDB (5%)	Power buy back agreements by CEB	Recent government changes negatively affected construction industry in Sri Lanka
Prestigious brand name in the market (e.g. won several awards)	Inexperience in hydropower industry	Tax incentives	Depreciation of currency
Close rapport with the government	Guaranteed income from the proposed hydropower projects	Progressively increasing real estate market in Sri Lanka	Foreign construction companies involvement for government construction projects
Continuous profitability from operations	Highly capital intensive in both projects	Government is making more effort to get the support of the international community.	Unstable economic conditions negatively affect foreign direct investments
Financial and technical support from MDB's parent company	Current problems in KLC such as High level of labour turnover, Loss of key management personnel, Unfavourable trade union actions will negatively affect MDB	Continuous development of the northern part of the country.	Unfavourable weather conditions.
Expected non related diversification mitigate the risk			Tendency to move into the renewable energy sector

2. Strategic formulation and evaluation for the proposed business models

Students are required to identify strategic options and apply suitable business models

- Students are required to identify two business options (Hydropower project – Non-related Diversification and Acquisition of KLC – Market Development) and justify with facts to position the two projects in two different strategies
- Students should identify Hydropower project as a non-related diversification and the Acquisition of KLC as Market Development.
- Students should justify his/her answer by referring to pros and cons of diversification and market development using Ansoff Growth Matrix.

****** It should be noted that the models such as SAFS (Suitability, Acceptability, Feasibility, and Sustainability), **BCG Matrix and Ashridge Parenting –fit matrix** are also considered as optional answers for strategic formulation and evaluation for the proposed business models.

Diversification

Advantages of Diversification to power generation

- Increase the earning capacity
- Mitigating the market risk, provide better risk control through no longer being reliant on a single market and Spread risk by avoiding having all eggs in one basket
- Maximum utilization of excess resources
- Increasing scope of the company and its market
- Stretching corporate parenting capabilities into markets and products
- Control of inputs, leading to continuity and improved quality
- Control markets by guaranteeing sales and distribution
- Take advantage of existing expertise, knowledge and resources in the company
- Provide movement away from declining activities

Disadvantages of Diversification to power generation

- Less expertise in the power generation sector
- May result in slowing growth in its core business
- High initial investment in the power sector
- Unexpected unfavourable weather condition may decrease the expected level of sales.
- Tendency to move into the renewable energy sector

Acquisition of KLC can be considered as a Market Development since the MDB is already in the construction and real estate sector having MDB Development unit as a separate SBU. MDB's intention is to acquire KLC and expand the business of real estate sector.

Market Development

Advantages

- Enjoy synergistic benefit
- Expansion of the market and possibility to beat the competition
- Less operational and market risk
- Enjoy economies of scale since MDB is currently in the real-estate sector
- Forming a new company will help to obtain business projects from Megapolis development plan
- Experience of Labour force and already provided training for existing employees by MDB will help to work in KLC
- Prestige of the company by receiving awards and having membership in professional organizations in the construction industry
- Fast growth in earnings
- Utilization of current infrastructure facilities of MDB

Disadvantages

- Market risk to MDB in relying on one sector.
- Problems currently encountered by KLC
 - Poor corporate governance practices
 - High level of labour turnover
 - Loss of key management personnel,
 - Unfavourable trade union actions
 - An unethical use of a trademark which led to a litigation problem

Additionally following points also should be considered in the acquisition of KLC

- MDB must consider what value it can add to the acquired business. This may include management, technology and distribution.
- A common core of unity must exist between the businesses in terms of markets, products and technology.
- MDB must put a quality management team quickly into the acquired business.
- MDB must retain the best management from both businesses.

3. Evaluation of financial viability of the given business alternatives Investment in Hydropower project

Students should evaluate the project using the two possible scenarios given with the cost of capital being 11% and 13%.

Years	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
(Rs. Million)								
Capital expenditure	(591)	(660)	(679)					
Revenue				337	350	379	393	431
Operational and maintenance expenses				(38)	(40)	(41)	(43)	(45)
Working capital increase				(88)	(11)	(12)	(14)	(15)
NCF	(591)	(660)	(679)	211	299	326	336	371
TV								371/.11 3,373
Discount Rate 11%	.90	.81	.73	.66	.59	.53	.48	.43
DCF	(532)	(535)	(496)	139	176	173	161	1,610
NPV	696							
Discount Rate 13%	.88	.78	.69	.61	.54	.48	.42	.38
DCF	(520)	(515)	(469)	129	161	156	141	371/.13=285 4 (2854+371)* .38 = 1,226
NPV	309							

Acquisition of KLC

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
(Rs. Millions)						
Expected Net Operating Profit After Tax (NOPAT)	320	345	350	366	370	375
Depreciation	45	52	54	56	59	61
NCF	365	397	404	422	429	436
TV						436/.12 3,633
DF @ 12%	.89	.80	.71	.64	.57	.51
NCF	325	318	287	270	245	4069
PV	289	254	203	172	139	2075
Total PV	3,132					
(-) Debt of KLC	(820)					
	2,312					
Value per Share	2,312/210					
	Rs.11.01					

Offer price given by KLC is Rs.15- Rs. 20. Accordingly value of a share is in in between the range. Therefore it is possible and not worth to acquire KLC.

** Students are allowed to use adjusted weighted average cost of capital of MDB for business valuation purpose with suitable assumptions.

4. **Propose corporate governance practices human resource and risk management strategies for MDB**

Risk Management

- MDB should methodically address the risks attaching to their activities with the goal of achieving sustained benefit within each activity and across the portfolio of all activities.
- The focus of good risk management is the identification and treatment of these risks.
- Its objective is to add maximum sustainable value to all the activities of MDB and it helps the understanding of the potential upside and downside of all those factors which can affect MDB.
- It increases the probability of success, and reduces both the probability of failure and the uncertainty of achieving MDB's overall objectives. Risk management should be a continuous and developing process which runs throughout the MDB's strategy and the implementation of that strategy.
- It should address methodically all the risks surrounding the organization's activities past, present and in particular, future.

Different risk aspects of MDB

Following points can be used by students to elaborate their answers

Financial Risk Interest rates Foreign Exchange Credit risk Liquidity and cash flow Accounting controls Information systems	Operational Risk Recruitment Supply chain Regulations Culture Board composition
Strategic Risk Competition Customer changes Industry changes Customer demand Mergers and acquisition	Hazard Risk Public Access Employees, Properties Product and services Contracts Natural events Supplier Environment

Corporate Governance

- MDB's corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources.
- It should be consistent with the rule of law and support effective supervision and enforcement.
- MDB's corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations.
- Its corporate governance framework should typically comprise elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition.
- What works well in MDB, for one investor or a particular stakeholder may not necessarily be generally applicable to all investors and stakeholders that operate in another context and under different circumstances.
- As new experiences accrue and business circumstances change, the different provisions of the corporate governance framework of MDB should be reviewed and, when necessary, adjusted.

Proposed MDB governance structure

- Internal Governance Structure
Consists of the committees, systems and processes that inculcate a culture of good governance and ensuring the sustainability of the organization.
- External Governance Structure
Consists of applicable laws, regulations and best business practices complied with by MDB.
- Assurance

The supervisory module of MDB's Corporate Governance framework that ensures the integrity of operations.

Human resources practices

- Training for new areas of business
- High level of labour turnover
- Loss of key management personnel,
- Unfavourable trade union actions

5. Strategic prioritization, recommendation and conclusion

The following points were given based on the above calculations only. Students should justify their conclusion and recommendation with their own qualitative, quantitative or/and financial and nonfinancial information.

- Hydro Power project is financially viable due to positive NPV at both the scenarios at the rate of 11% as well as 13% providing positive NPV of 696 and 309 respectively. Further students should notice that the payback is more than 5 years. (Students can refer to advantages and disadvantages of Diversification to support his/her answer.)

- Moreover according to facts given, management is more interested in diversification since they are in the construction industry for over 35 years.
- On the other hand, acquisition of KLC is not financially viable since the offer price is in between Rs.15 to Rs.20 and the value per share is Rs.11.
- Also KLC has several organizational problems such as poor corporate governance practices, high level of labour turnover, loss of key management personnel, unfavourable trade union actions and unethical usage of a trademark which led to a litigation problem.
- Furthermore the total investment in Hydropower is approximately Rs.1,930 million which is to be invested over 3 years while total investment in acquisition of KLC is Rs.2,312 million which is required to be paid at the time of acquisition as lump sum payment. This will lead to high gearing in MDB and negatively affect overall capital structure of the firm.
- By considering financial and non-financial facts discussed above, it is more beneficial to MDB to invest in the Hydropower project.
- But students can justify their answer with qualitative facts to acquire KLC even though the offer price is higher than the value per share. Specially referring to merits of market development strategy and core competencies of KLC.

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