UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Postgraduate & Mid-career Development Unit

Master of Business Administration/Master of Business Administration in Finance/Master of Business Administration in Marketing/Master of Business Administration in HRM (Semester III, First -half) Examination – April 2017

MBAFI 600 – Strategic Finance

- Three (03) Hours (Additional 15 minutes for reading).
- Answer All Questions.
- This is an Open Book examination.
- Use of Calculators is allowed.

---

1. **ABC Holding PLC**

ABC Holdings PLC (ABCH) was established on 1st April 1988 as a quoted public company having at the Initial stage ABC Leisure &Spa (Pvt) Limited & ABC Manufacturers (Pvt) Limited as 100% owned subsidiaries. ABCH invested in more profitable sectors such as higher education and retail sector by establishing two more private companies, named ABC Institute of Technology (Pvt) Limited and ABC Supermarket and Food Processors (Pvt) Limited, as part of its diversification growth strategy. The company's financing policy on **Equity/Debt**is **80:20** and ABCH maintains the Weighted Average Cost of Capital as **16%** pa. The dividend payout ratio of ABCH is **20%** and this policy is continued throughout the years from the inception without anychange. The recently appointed Chief Executive Officer of ABCH, Mr. Quintus Fernando, mentioned that

"We have now consolidated our position in the market and we should not now borrow money from banks to invest in new ventures. It is an expensive financing policy. As such, we should pay off the entire debt balance of Rs. 500 Mn and keep the company debt free in the future."

Mr. Manohara De Silva, Director - investment strategies, argued that

"We should not do so, it is not a sound investment policy to implement and at least we should maintain the current **Equity: Debt** ratio as **80:20**".

Mr. Mohan Kandewaththa, Director Finance, said going public is the easiest way to raise funds for future investments, since the company maintained a stable dividend policy right through out. He mentioned that the share price of the company is currently trading at Rs.**252/-** (Par value of share is Rs.100). He argued that

"we should not change our financing and investment strategies as it was the reason for success of the ABCH Group as evidenced since 1988".

Mr. Kuma De Silva who is the current chairman of the company, mentioned that

"we have not assessed the risks recently, though we do have a formal Risk management policy in place and need to assess the risks before we step into any other ventures where we are planning to invest **Rs 1 billion** comprising Rs. 700 Mn in the Health sector and Rs. 300 Mn in the Finance sector".

The cost of equity of the ABCH is **18%.** ABCH's bankers offer concessionary rate of interest **10%**pa for long term loans obtained by them.

You have been provided with the following additional information about the ABCH and its existing subsidiaries by the Director Finance in order to support his arguments. It is observed that Group corporate tax is **30%.**

ABC Leisure & Spa: The Company is a fully owned subsidiary of ABCH. There are three Five star hotels situated in Negombo, Hambanthota and Pasikuda having sales via internet booking gateway. The room reservation is done though internet or agents on 15% commission. The company offers 10% discounted price to its customers if they book through Internet. The occupancy ratio is an average 50% to 65%, during last 12 months period and the ROIC is **18%**, while having ROE as **12%**, whereas the average sales growth is **10%** pa. The company dividend payout ratio is **75%**.

ABC Manufactures: The Company is a fully owned subsidiary of ABCH having its plant situated at the Industrial Zone in Horana. The company manufactures and exports Tires for the USA market. They do not produce for local market and the company manufactures under the international brand name called ***Titanic*** which is belonging to a USA Company called Titanic Rubber products INC. The company is having sales growth of **7%** pa while having ROIC as **17%**. The company is considering expansion of its sales to the European market. The company policy about the distribution of profit as dividend is only **40%**. Return on Equity (ROE) is **12%.**

ABC Institute of Technology; The Company is fully owned subsidiary of ABCH. It is situated in Nugegoda. The Institute was approved by the University Grants Commission- Sri Lanka to award degrees in Engineering, Management and Accountancy. The current student population is about 750 in three departments and the sustainable growth rate of the company is **8%,** and there will be a sales growth of **10% pa** for next 5 year period while having the ROIC as **20% pa**. The board of directors of the institute is planning to acquire affiliate level of the University of London.

ABC Supermarket & Food Process

ABCH acquired 75% of the share capital and the expected rate of return by its shareholders is 20%. The company has borrowed **Rs.75 Mn** maintaining the group financing policy of Equity: Debt Ratio of 80: 20. The company showed the steady progress in sales, having **8%** growth rate annually maintaining a sustainable growth rate of **5%**. The ROIC of the company is **14% pa**. There are 102 branches operating island wide, located in the prime area of the cities where they operate. A foreign investor is interested to buy the entire super market at USD 1.6 Mn. where the company's net assets are valued now at **Rs. 252 Mn.** The current exchange rate can be considered **as USD1= Rs.150.00.**

New Investments:

Health Industry: ABC Holdings is interested in investing in this industry expecting **ROIC** from ABC Health Care (Pvt) Limited a minimum of 15 % and annual sales growth to be 10%. The company promised to declare dividend to its shareholders at a minimum of 40% out of the net profit during the growth period. Return on Equity **(ROE)** will be approximately 15%. The entire capital requirement of Rs.700 Mn will be provided by the Holding company as equity. If not ROE will drop down to 12% approximately if there is Debt financing at same ratio as ABCH.

Finance industry: ABC Holding would like to invest into a medium sized Finance Company, "Dhasatha Finance PLC", acquiring 25% of its shares at Rs.300 Mn which is currently traded in the Colombo Stock Exchange. The company expects to maintain a low dividend payout ratio which is at 20% while having ROIC and ROE as 15% and 10% respectively. The sales growth is at an average of 5% annually. It was observed that WACC of Dhasatha is 20%.

Finally the Board decided to seek an advice from a consultant/ expert on this matter and approached you as the consultant to the board of Directors of ABCH to clarify the following.

a. Identify in detail, the existing risks of the group and the risks associated with the proposed new investments.

(08 marks)

b. Suggest appropriate risk management process for the ABCH group of companies.

(08 marks)

c. The status of the existing subsidiaries whether they create value or destroy value using strategic financial Matrix and suggest sound strategies to create shareholder value.

(15 marks)

d. Give your opinion as the Consultant about the two arguments on existing and future financing and investing policies of the company.

(08 marks)

e. Provide your professional advice on the new investment opportunities.

(08 marks)

f. State the appropriate financing and investing strategies for the proposed Rs.1 Bn investment.

(08 marks)

(Total Marks 55)

2. **Alpha Trading PLC**

Alpha Trading (Pvt) Limited was incorporated on 1st January 1985 by Mr. Edmond Sugathapala as first chairman of the company. He owns **40%** shares of the company while each one of his three brothers holds **20%** of the company share capital. They appointed Mr. Thasim who had wide experience in running a super market in Dubai as CEO of the company. The company opened its first trading outlet in Nugegoda and then expanded to Marhargama and Bambalapitiya. Mr. Edmond and three brothers decided to go public and recover their investment keeping **5%** of share capital with each of them in year 2010. The company currently has 30 super markets covering key towns such as Galle, Kandy, Mathara, Rathnapura, Nuwara Eliya, with at least one in each District. The total turnover of the company is **Rs. 5, 250 Mn** during the year ending 31.03.2017. The director finance has tabled the financial information at the monthly board meeting for discussion. He pointed out that company cash flow is not healthy at the moment though it currently generates a large amount of revenue from their **30** outlets and **90%** of the sales are on cash basis. The other Directors of the company argued that it is quite surprising to know that the company has faced such difficulty, while having large amount of sales generated from each branch. The board of directors of the main company approached you and requested to advice on the above issue. The board of directors advised the Director of Finance to provide the information required by you immediately. The Finance Director submitted the following financial information to you to carry out the analysis to identify the central issue of the company and formulate the sound financial strategies to sort out the cash flow issues as mentioned.

The company's financial policy to maintain as previous its capital structure (Debt/ Equity ratio) at 30:70, while declaring **25%** of the profit of the year as dividend. However, the analysis found that the company is having a **50** acre coconut land situated in Kurunagala, the market value of **Rs100 Mn** while the historical value of **Rs75 Mn** is shown in the balance sheet as at 31.03.2017.

The company takes an average of **60 days** to pay their trade creditors while having debtor's collection period as **15 days.** The inventory turnover ratio has been calculated as **5** as at 31.03.2017. The total net assets comprised of Receivables from associates/ subsidiary companies at **Rs. 350.5 Mn** and there was a comment from the company auditor that the company does not charge interest on the balance outstanding fromits associates and subsidiaries. The company operating margin is **20%**, where as the industry average is currently at **22%**. The company is incurring a large amount of fixed overhead, including the large amount of interest on the bank overdraft amounting to **Rs.120 Mn** for the year ending 31.03.2017. The effective rate of interest was **15%** during the financial year considered. Finance Director advised that company overdraft level utilized the same level throughout the financial year without fluctuation. Also the balance of the long term borrowing obtained by the company was 50 Mn as at 31.03.2017 at **12%** cost of debt and the applicable corporate tax is **20%** for this type of company. The Board of Directors is seeking your assistance.

a. to identify the central issues and problems faced by the company.

(15 marks)

b. to recommend the viable financial strategies to be implemented immediately to sort out those issues and problems **using supply chain strategies.**

(10 marks)

(Total Marks 25)

3. HTL Plantation PLC established in 1995 acquiring two up-country tea plantations and a low grown tea plantation from Deniyaya. The chairman, Mr. Sugath Perera who was a retired planter now seeks your assistance to calculate a reasonable value for the firm, using appropriate valuation model to offer to an interested party, who has shown an interest to buy his shares as a private placement. You have discussed the status of the company with the finance manager and obtained the following data.

Market value of the Debt was **Rs. 500 Mn** and WACC of the company is 18% while maintaining the debt: equity ratio **at 40: 60.** The company' sustainable growth rate is **6%**and the finance director requested board of directors to maintain **50%** payout ratio since there are future diversification program to invest in tourism industry which will boost the growth of the company faster than now. However majority of directors argue that the company does not want to rely on internally generated funds since there is firm offer from the bank, which will provide financial assistance to invest in the new industry at a lowest rate of **11%** for a **10 year** period of repayment with a grace period of **1 year**. Their argument was, the dividend should be declared and paid at 100% of the current year and argued that the quantum of the dividend declared has no significant impact on the firm value. The additional information has been given by the accountant in order to derive the reasonable value for the firm.

The market price of the share as at date is Rs.115/- currently trading at the Colombo Stock Exchange and the company is current ROIC is 20% while having ROE at 16% per annum.

You are required to

a. Calculate the value of the company as at 31.03.2017 using an appropriate valuation model which consists the earnings from existing levelof invested capital and reinvested income and comment on it.

(12 marks)

b. Critically examine the arguments raised by the directors against the finance director's request on the dividend policy, considering the value calculated aboveand the theoretical knowledge acquired by you from the financial management.

(08 marks)

(Total Marks 20)

****