Anand's Dilemma- Strateic Considerations V/s. Financial Goals

N R Parasuraman

Anand Tripthy, the CFO of Sona Hira Limited Industries[1], was sitting one early morning thinking about the planning process involved in finalising the capital budgeting proposals of the company. He also had another issue to think about relating to a subsidiary company. Barely two months back, the company had revamped the management and was looking for fresh avenues of expansion. When he was appointed, Anand Tripthy was told that funds would not be a constraint for capital budgeting proposals, since the group had tied up with an overseas conglomerate for funding arrangements. However, the return requirements were pitched higher than the present level, and Anand was asked to prepare a roadmap for future expansions.

Sona Hira Limited was established in 2007 for setting up a factory for manufacturing various types of biscuits. It was perceived in the original project report that in spite of the well-established market share of leading players such as Britannia, Parle and Sunfeast, there would be enough scope for smaller players, given the total market size. Sona Hira Limited planned to initially concentrate on two main products, cheap glucose biscuits and slightly costlier salt-and-sweet biscuits. By 2012, the company had established itself in the echelon next to the leading manufacturers and had gained considerable popularity among the public. The marketing efforts were geared to cater to the key points where transport buses stopped for breaks. Sales in the low cost canteens on railway stations also picked up.

The case writer(s) N R Parasuraman, Director, Professor- Finance may be reached at nrparasuraman@sdmimd.ac.in.

[1] Names of executives and company changed.

Table 1 :
Figures for 2012

The broad figures of the company's performance at end of 2012 were as follows:

Assets	**Rs.**	**Liabilities + Owners' equity**		**Rs.**
Bank balance	275000	Loans from banks		2700000
Machinery	2500000	Owners' equity		1500000
Furniture	1250000	Reserves		720000
Buildings	895000			
TOTAL	4920000			4920000

The Rocket Group based out of Dubai started negotiations in late 2012 for taking over Sona Hira Limited. After protracted negotiations, a consideration of Rs. 75 lakh was fixed. Since the loans had a maturity of two more years, the loans were to be taken over by the new entity, and a net consideration of Rs. 48 lakh was to be paid over to the shareholders of Sona Hira Limited. This resulted in the shareholders being happy at getting a consideration of twice their book value.

The Rocket Group had made several internal surveys and estimates in arriving at the final consideration of Rs. 75 lakh. It was perceived that the biscuits segment had a high growth potential and with the brand image of Sona Hira Limited already good, the time was ripe for foraying into other food products. The group's experience in food products' production and marketing was expected to come in handy. Diversification into other food products was to be cost-intensive and a preliminary estimate of Rs. 8 crore was thought of as the capital requirement.

Anand Tripthy came into the picture from January 01, 2013. The new venture was to get going on April 01, 2013, and here he was sitting in February 2013 mulling over the capital budgeting proposals before him.

Table 2 :
Capital Budgeting Porposals

The following proposals were before him:

Proposal	Capital outlay (Rs. in lakhs)	Sales price per unit	Sales quantity (units)	Variable cost per unit	Fixed cost	Life in years
A	150	20	300000	10	100000	5
B	80.5	15	500000	8	330000	6
C	50	12	310000	5	150000	8
D	95	8	400000	4	150000	4
E	95	14	350000	6	225000	8
F	200	10	3200000	7	215000	5

At an earlier board meeting, it was decided that frequent price changes should be avoided and except when there is an increase in production cost, the sales price should remain constant during the lives of the projects. Although it was difficult to estimate, it was thought that for estimation purposes the scrap value receipt at the end of the tenure of each of the above projects would be 20% of the outlay. The company would be under the 30% tax bracket. The assets covered in the capital outlay above would be depreciated using the straight line method (15%) on original cost per year.

Table 3 :
Interest Rates for Loans

Loans up to Rs. 4 crore were available from overseas agencies at the following interest rates:

Up to 1 crore	10.75%
For amounts over Rs. 1 crore and less than Rs.2 crore totally	11.25%
For amounts over Rs. 2 crore and less than Rs. 3 crore totally	11.75%
For amounts over Rs. 3 crore and up to Rs. 4 crore	12.5%

The balance requirements in the capital outlay would be met by new shares issued. Before the takeover, Sona Hira Limited's cost of capital was perceived to be 16%. With the expansion of operations, the new weighted average beta was estimated to be 1.3. The risk-free return in the market was 7% and the market return was 15.50%. There was a section in the board of the company which felt that a risk percentage could be added to the original 16% and that could be the hurdle rate. Looking at the above quotes for loan interest, the company's managerial consultant was of the opinion that an appropriate risk premium could be added to the cost of debt and used for this purpose.

Anand held discussions as to the way the projections had been drawn up for the above projects. He wished to conduct a sensitivity analysis, changing sales price, sales quantity, variable cost and fixed cost up and down by 2% . He also wanted to have a scenario analysis done with all parameters going 3% more favourably and 3% less favourably. Anand wished to assume preliminarily that Sona Hira Limited operations would continue in the same scale and return as in previous years. On examination he found that given the capital outlay of nearly 50 lakh, the project was returning Rs.11 lakh pre-tax profits.

While Anand Tripthy was clear on how to tackle the individual issues, he was concerned about how the whole thing could be reckoned logically in a sequential manner.

The second issue that was confronting him that morning related to the following situation:

Anand stared at his subsidiary company's financial statements. This subsidiary belonged to the Rocket Group and was brought under the control of Sona Hira Limited. Sipping hot coffee, he realized that he would have to make substantial improvement in the working capital performance of the company to improve the bottom line in the short run. As the group CFO he was feeling the heat of the pressure on the bottom line of the subsidiary HAR Engineering more than ever before. He wanted to embark upon a series of meetings from early next week to improve the position.

HAR Engineering's core business of supplying engineering spare parts to leading manufacturers had stabilised over the last two years.

However, growth opportunities had dried out and increasing costs were putting heavy pressure on the bottom line. The only way out in the short run was to optimise the working capital and thereby improve margins. Anand realized that each and every aspect of working capital had slipped to a level of high inefficiency, as was borne out by the following ratios:

Table : 4
Key Ratios

Ratio	HAR Engineering	Industry
Current ratio	3.82	1.51
DSO	103.29 days	51 days
Days Inventory	79.16 days	40 days
Cash to Sales ratio	2%	0.89%

The company's production was fully automated, but Inventory holding was way higher. Anand examined for the umpteenth time the broad position the company was in.

Table 5 :
Broad Profitability

Profit after tax	14.31
Capital employed	126.40
Net worth	77.78
Current assets	132.34
Quick assets	80.30
Working capital	33.40
Current ratio	3.82
Quick ratio	1.66
Current liabilities	54.60
Sales	239.94
DSO	103.29

Anand knew that there would be stiff resistance from the production team regarding inventory level reduction. A supplier who was ready to accede to a JIT system was demanding a higher rate for the goods. About 75% of the inventory could be handled this way by agreeing to an increased amount. The amount needed to be finalised.

Anand wished to schedule a discussion with the bankers for effecting internet transfer facilities to all the branch accounts. On account of previous overdraft facilities availed by the company, the bank was not willing to make free transfers to all the branches in the past. This needed to be overcome so that the cash holding can be brought down to 40% of the present level.

Further, the discussion with the Sales and Marketing Department had broken down. Anand pointed out the need to bring down the DSO to sane levels, but he had to hear about a number of constraints in doing so. Perhaps a discount scheme would need to be introduced. It appeared that many customers wanted a reduction in the sale price. In lieu of that, if a discount could be offered for payment earlier, it could serve to reduce the working capital commitment.

Since there were deadlocks in discussion with the production and sales teams, he would need to brief the CEO on the cost-benefit analysis of each area of working capital and the extent to which the net returns could go up with optimisation at various levels. He set out to do the preliminary workings.

Specifically, Anand pondered over several issues. He wondered what the considerations a company should have in taking over another company for a price which is substantially higher than the book value. He tried to see if the concepts of Real Options come in here. In any case, how would the company expect to recoup the excess payment made. He set out to work on the procedure involved in drawing up of the capital budget. He perceived that banks quote different interest rates for different levels of loans. He wondered how a cost of debt could be calculated. He wondered how the ideal level of capital deployment chosen, given multiple projects and differing profitability. His board member wanted to know what evaluation measures give a correct ranking among several projects.

His CEO had phoned the previous company and asked him to be prepared for certain probing questions on risk management.

He would need to be prepared as to the way to interpret results after a sensitivity analysis, and the specific circumstances where a Monte Carlo simulation is called for.

Next, he turned to the specific issues relating to the subsidiary company. He examined in his mind as to how the quantum of working capital needed is measured. Anand's assistant gave him a host of ratios, and he wanted to make meaning out of these.

Anand recalled a professor asking him in college as to why is it more important to compare working capital ratios with the industry averages than our own past averages?

He knew that his CEO and Board will be interested in the specific issues regarding reducing inventory levels, and as to whether these reductions will result in reduced sales as well. Anand knew that reducing DSO would involve protracted discussions with the marketing team. The immediate question will be as to how this will impact sales. Lastly, he would need to be clear as to whether the changes made could be sustained over long periods.

Ultimately, Anand knew that the question came down to increasing profits and returns and also as to whether changes made in working capital can be sustained over long periods.