Case Studies: Financial Management/ Corporate Finance

Rural Electrification Corporation (REC) and Stakeholders

The Rural Electrification Corporation (REC) has been operating under the ownership and control of the state government since the creation of the state in 1976. The state government privatized REC in 2015 by selling it to a local business house that has interests in pharmaceutical, FMCG, financial service and energy. Privatization was intended to pave way to the company to improve performance and raise much needed finances from the capital market. The demand for electricity has always exceeded the supply, as the state government did have enough funds to spend on capital expenditure to create the required power generation capacities. REC would be now required to make sufficient investments to increase power generation capacity in order to meet ever-increasing demand for electricity. The company's management stated that being a private sector company, it shall maximize shareholders' return. At the time of its privatization, a large private sector financial institution valued the company at Rs.5, 000 million. The issue of ordinary shares raised this money. The merchant bank division of the financial institution helped the public issue of ordinary share, par value Rs. 10 each, sold at a premium of 100 percent for Rs.20 each. The issue was oversubscribed, and on the very first day of trading, the market price of share reached a value of Rs.45. The company has been in operation for three years as a private sector company. The table below delineates selected financial and operating data of the company's operation for the period of 2015-2018. The financial data for 2015 are for the last year of the government ownership of the company. As a private sector company, REC has paid dividend in accordance with the policy stated in the prospectus. The central electricity board regulates the prices and oversees the activities of the privatized electricity company. Further demand for electricity has grown at the rate of 4 percent per annum.

REC: Operating and financial data for year ending 31 March,

(Rs. in millions)

Variables	2015 Pub. sector	2016 Pvt. sector	2017 Pvt. sector	2018 Pvt. sector

Revenue	14,500	15,250	16,500	18,500
Operating profit	710	1,120	1,500	2,250
Taxes	170	210	300	380
Profit before depreciation and tax	850	950	1,040	1,200
Profit after tax	640	900	1,500	2,210
Dividend	250	350	500	700
Wages & salaries	3,200	3,100	2,800	2,750
Total asset	2,800	3,000	3,500	4,200
Capital expenditure	500	800	1,150	1,620
Debtors	5,000	4,500	3,900	4,200
Creditors	4,600	3,600	3,200	2,900
Employees	28,000	27,500	27,300	26,500
Profit earnings ratio	-	11.50	12.80	14.35

Questions:

a- What changes, if any, do you expect in the objectives of the company after privatization and why?

b-Who are the company's stakeholder? Has the company been able to fulfill their objectives? State the additional information that you may further need to answer this question.

Torrent: Evaluation of Objectives from the Perspective of Financial Management

Torrent is the largest engineering company in India. It provides total systems to the core sectors of the Indian economy-power, industry and transportation. About two-thirds of the company's business is in power sector. It is a technology-intensive company having collaborations with reputed international companies. It ranks among 'Fortune 500' biggest industrial giants. Its operations are spread over 25 manufacturing plants and nine service centers in India. The company employs about 25,750 persons, including nearly 5,000 executives. The company was initially a totally public sector company. It has been partially privatized now. The company is committed to quality and receives orders from several countries for industrial equipments, including complete power stations, consultancy services and providing technical manpower. These countries include USA, Germany, UK, Russia, New Zealand, Thailand, Malaysia, Libya and Turkey etc. Torrent is also recognized in the world market as a renovation services and maintenance expert. A number of old boilers and TG sets from renowned international suppliers are being entrusted to the company for renovation. The company produces a wide variety of products in core sectors of the economy. The characteristics of those products vary significantly. A number of its products such as hydro and thermal sets, boilers, boiler auxiliaries, compressors, industrial turbo sets and oilrigs are long production cycle items. The company has defined its objectives as follows:

a. Growth: to ensure a steady growth by enhancing the competitive edge of Torrent in existing business, new areas and international operations so as to fulfils national expectations.

b. Profitability: to provide a reasonable and adequate return on capital employed, primarily through improvements in operational efficiency, capacity utilization and productivity, and generates adequate internal resources to finance the company’s growth.

c: Customer focus: to build a high degree of customer confidence by providing increased value for his money through international standards of product quality, performance, and superior customer service.

d: People orientation: to enable each employee to achieve his potential, improve his capabilities, perceive his role and responsibilities, and contribute positively to the growth and success of the company. To fulfill the expectations of shareholders, the company distributes dividend at 9%, having sufficient corpus of Rs. 50 million as reserve and surplus and consistent P/E ratio of 7.5 percent.

e. technology: to achieve technological excellence in the operations by development of indigenous technologies and efficient absorption and adaptation of imported technologies to sustain needs and priorities and provide a competitive advantage to the company.

Questions: Critically evaluate Torrent's objectives from the perspective of financial management, in general and shareholders in particular.

Investment Prospective of Indian Pharmaceutical Industry

The fact that the pharmaceutical sector outperformed in 2018 and recorded a gain of about 34 percent, making it an attractive destination for foreign direct investment, has attracted the notice of Mr. Joseph, a real estate dealer, who is considering parking his profits in this sector. The information he has collected on this sector is given below:

The Indian pharmaceutical industry was almost non-existent in 1980, but over time, it became a prominent provider of health care products, meeting almost all of the country's pharmaceutical needs at the beginning of the 21st century. More than 60,000 formulations are produced, and they cover nearly every therapeutic segment. Formulations are the processed medicines. The chemical industry is competitive and fragmented. companies like Orchid chemicals and Alex chemicals were basically chemical companies that turned themselves into pharmaceutical companies. The contribution of the Indian pharmaceutical industry accounts for 1.4 percent of the global pharmaceutical industry in terms of value of 10 % in terms of volume. The volume of production ranks third in the world. The year on year growth rate was 18% in 2017.

The pharmaceutical industry is highly fragmented, with over 10,500 manufacturing units in India. The top 10 companies contribute more than one-third of the market. The number of generic product manufacturer is quite large. The number of foreign players investing and expanding their bases in India is increasing tremendously. Further, India is fast becoming one of the biggest hubs for conducting global clinical trials. The industry witnessed 8 acquisitions and 17 collaborations. The government of India has given permission for 100 percent FDI in drugs and the pharmaceutical sector to establish various pharmaceutical special economic zones across the country.

The implementation of product patents has provided a thrust to innovation and research to launch new patented products the expenditure incurred on R & D by the top five companies ranges between 5 and 10 percent of revenue. The global R & D expenditure on sales is 15-20%. According to a price water house, the Indian pharmaceutical market is expected to touch US$ 84 Billion in sales by 2021. The boom is sales is expected because of a large population, increase health care expenditure, growing urbanization, rising life expectancy, and active private sector participation. According to Mckinsey, in 2025 the Indian middle class is expected to stand at 580 million, representing an annual growth of 12%. The change in lifestyle has resulted in cardiovascular diseases, diabetes. Drugs that address these complaints will continue to be lucrative and fast growing.

Besides, the domestic market, Indian pharmaceutical concentrate a lot on exports. The USFDA has stringent rules with respect to the inspection of manufacturing plants. The market leaders have problems with regard to their plants satisfying FDA rules. Even through India is the largest supplier of generic drugs, the menace of fake drug is severe. Estimates show that the fakes accounts for 15-20% of the industry. The fakes are common in cough syrups, vitamin supplements, painkiller etc. The aggressive penetration of health insurance in rural and urban areas will benefit the pharmaceutical industry. It is said that nearly 650 million people will have health insurance cover by 2021, and private insurance coverage will grow by nearly 15% annually until 2021. The industry is controlled by a complex variety of laws and policies. The National drug policy, drug price control orders, and the Indian patents act, aim to bring 350 essential drugs under price control.

Questions: With the given information can you analyze the industry with one or more analytical tool and help Mr. Joseph to invest a portion of his funds in this industry.

Portfolio Management and Investment Avenue

Mr. John, a bank professional, feels that it is the appropriate time to siphon-off a portion of his savings to the equity market to beat the soaring inflation. He is very keen on analyzing the relative attractiveness of the stocks. He studies the financial highlights of various companies and selects X, Y and Z companies. In present chaotic scenario when the economy is on a diminish path, he looks forward to an upsurge in consumer spending and wants to invest in the one of the three companies given below. He is very particular about the current financial position of the company. He also believes that no company should be considered for investment unless it has a good current financial position and general reserve. The present prices of the companys' share in Mumbai stock exchange are respectively 450, 435 and 250. You are asked to examine the data as laid out in the table below and help him to choose an appropriate company to invest. Enumerate the additional information that you might need to conclude the answer.

Ratio (%)	X		Y		Z	
	2016	**2017**	**2016**	**2017**	**2016**	**2017**
Current ratio	2.1	2.5	2.0	2.26	2.71	2.53
Acid test ratio	1.27	1.42	1.38	1.50	1.90	1.76
Cash	13	13	34	29	34	34
Receivables	38	36	24	26	33	32
Inventory	4	4	9	10	2	3
Net sales to inventory	3.90	3.77	4.45	4.23	5.65	5.25
Net sales to working capital	3.29	2.97	3.10	2.81	2.87	2.85
Retain earning	33.93	34.90	40.50	42.50	43.50	42.50

Capital Budgeting of Penguin Limited

Penguin limited is a highly profitable organization, it has a proposal for manufacturing car air-condition. The company has just tested the market for its new product. The test indicates that air-condition may capture about 35 percent share of the market. The new product can be manufactured in existing facilities, which could also be used to meet expected increase in one of the company's existing products. The project would involve cost of plant of Rs. 500 lakh (or 55 million), installation cost of Rs. 100 lakh and working capital of Rs.125 lakh. The annual capacity of the plant is to manufacture 20,000 sets.

The price per set in the first year would be Rs. 12,000. The fixed cost per annum would be 290 lakh (including depreciation) and variable cost to sales ratio is expected to be 65 percent. The company would have to incur promotion expenditure of Rs.120 lakh in the first year. Written down depreciation rate for tax purposes is 25 percent. Working capital requirement is estimated to be 25 percent of sales. The company expects that the plant's capacity utilization over its economic life of 7 years will be as follows:

Year	1	2	3	4	5	6	7
Capacity Utilization	40	40	50	75	100	100	100

The terminal value of the project is expected to be 20 percent of its original cost. Assume that depreciation is charged on the assets as per the current tax laws in India. The executives of the company are not unanimous on accepting the project. The production manager considers the location as a strategic advantage that could meet the demand economically in the market.

Questions:

1. Decisively evaluate the funds from operation assuming corporate tax of 35 percent.
2. Calculate the project's net present value by considering target rate of return of 15 percent and profit from the sale of the asset is taxed as ordinary income.

Impact Assessment of net cash flow from Modernization

The general manager of the engineering division of Max engineering limited is considering the replacement of six-year-old equipment. The company has to incur excessive maintenance cost of the equipment. The equipment has a zero written down value. It can be modernized at a cost of Rs. 1, 20,000 enhancing its economic life to 5 years. The equipment could be sold for Rs. 20,000 after 5 years. The modernization of the equipment would help in material handling and reducing labor and maintenance costs. The company has yet another alternative. It can buy a new machine at a cost of Rs. 3, 00,000 with an economic life of 5 years with a terminal value of Rs. 60,000. The new machine is expected to be more efficient in reducing costs of material handling, labor and maintenance and repair etc. The terminal value of new equipment may depend on the cash flows, which could be generated much beyond the assumed analysis or horizon period. The company may make a reasonable assumption pertaining the cash flow growth rate after the horizon period. The annual costs are as follows:

Particular	Existing equipment	Modernization	New equipment
Wages & salaries	40,000	30,700	11,800
Supervision	20,000	9,500	7,000
Maintenance	28,000	8,000	2,500
Power	20,000	18,000	15,000
Total	1,08,000	66,200	36,300

The company has a tax rate of 50 percent and a required rate of return of 10 percent. Presume straight line depreciation for tax purposes, and tax on the sale of equipment at the existing corporate tax rate. Depreciation is calculated net of the expected salvage value.

Questions:

1. Calculate the net cash flow from modernization and new machine installation.

2. Should the company modernize its equipment or buy new equipment? Make your assumptions explicit.