

Value creation and enhancement

Case Study

Of

Red Sea Bottlers Share Company

in Eritrea

By

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(i)

CONFIDENTIALITY CLAUSE

(January 2004)

TO WHOM IT MAY CONCERN

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Due to the strategic importance of this research it would be appreciated if the contents remain confidential and not be circulated for a period of five years.

Sincerely

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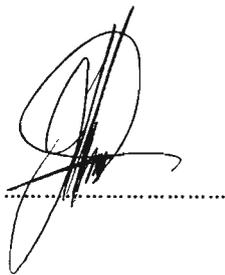
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DECLARATION

I HEREBY DECLARE THAT THIS WORK IS MY OWN WORK BOTH IN CONCEPTION AND EXECUTION, AND THAT ALL THE SOURCES I HAVE REFERRED TO OR QUOTED HAVE BEEN ACKNOWLEDGED AND INDICATED BY MEANS OF COMPLETE REVERENCES.

SIGNED:

A handwritten signature in black ink, consisting of a large, stylized letter 'S' followed by a horizontal line and a flourish.

DATE:

20/01/04

ACKNOWLEDGEMENT

I am greatly indebted to God my father, who with out him was impossible to finish my study. He was the power and wisdom of my life and my study in particular. I thank Him for all His caring.

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(iv)

DEDICATION

This work is dedicated to:-

My wife Ruth Basilius and my sons Horeb and Mimi.

ABSTRACT

The problem addressed in this research is to assess and analyse what actions lead to value creation and enhancement in Red Sea Bottlers Share Company. This research problem is broken down into three basic objectives namely: determining the value drivers of the company, evaluating how and to what extent the company is creating or destroying value, and evaluating what the management is doing in enhancing the value of the company. Company annual financial statements and other secondary documents were used to collect data for the second objective and Questionnaire was used for the first and third objectives. Seven Value drivers of Rappaport's framework are used to ascertain what managers are doing to enhance the value of the company. According to the study to increase revenue managers will increase local sales, strengthen marketing, establish local sales offices and advertise the products. Similarly to increase the profit margin building employees' morale by increasing wages and salaries, being more selective to suppliers, effectively use of resources, increasing product quality and improving production efficiency are being undertaken by managers. There is no visible attempt to reduce the tax expense. As far as the investment decision is concerned, renovating and maintaining the fixed assets has been done. There is no visible value enhancing measure in the working capital management except in inventory management. In relation to the financing decision the company is not using any long-term liability and is lacking the advantage of its gearing effect. Last, as to the growth duration of the value the company's brand name, high capital investment and established distribution channels could be mentioned as entry barriers to potential entrants and become factors of lengthening the value growth duration. Overall what the managers are doing in enhancing the company's value is positive and is to be promoted and encouraged. The main performance measurement tools recommended to determine whether the company is creating value or not are the multi-period measurement tool Total Business Return and the single period tool Economic Value Added. According to these measurements the company is creating value as per the measure of Total Business Return and destroying value as per the measure of Economic Value Added.

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CHAPTER ONE: Research Introduction

1.1 Research Topic

“VALUE CREATION AND ENHANCEMENT “

(Case study: Red Sea Bottlers Share Company)

1.2 Introduction

Financial theorists have long argued that the objective in decision-making should be to maximize firm value. Managers and practitioners have often criticized them for being too single minded about value maximization and for not considering the broader aspects of corporate strategy or the interests of other stakeholders. In the last decade, however, managers seem to have come around to the view that value maximization should be, if not the only, at least the primary objective for their firms (Damodaran, 2000).

What does value and value maximization (creation) mean after all? Pure finance theory starts from the proposition that the value of a business to its shareholders is the present value of all future cash generated, discounted using a cost of capital appropriate to the risk characteristics of the business. There is an extensive body of theory and empirical evidence to indicate that this value measure corresponds well to the market value of the company over the long run. In accordance with the simplified version of this theory, the measure of value creation in any period is the cash generated from the operational activity less the cost of capital, over the period in question. If the cash return exceeds the cost of capital, value is created for shareholders; if it is less, value is being destroyed (Research from Tillinghast – Towers Perrin, 2000). Whatever actions are taken that affects the cash flow of the company directly or indirectly affects the value of the company.

Based on these backdrops this study will be concerned with providing the following important issues:

A basic conceptual framework, which is important for the study, regarding value, value creation and its enhancement will be discussed thoroughly. Based on this frame work Red Sea Bottlers Share Company’s existing situation will be assessed. The strategies and goals, and their linkage with the value creation of the company will be discussed. The data of the company’s strategies and goals will be collected using a questionnaire to the managers. The determinants of the company’s value will be assessed.

Further, whether the company is creating value or not will be reviewed and discussed. The possible reasons for the success and failure of the performance will be assessed.

Further more, how value can be enhanced will be discussed. Keeping the conceptual presentation in mind managers will be asked using questionnaire what actions are undertaking to enhance the value of the company using Rappaport's seven value drivers frame work. As part of this the distribution of the value created will be discussed in the title of compensation and communication. At last the paper will be wrapped up with conclusion and recommendations.

1.3 Company Background

Red Sea Bottlers Share Company was established in 1964 as the National Soft Drinks Corporation in Eritrea. It started operation using second hand machinery and produced Coca-Cola, Sprite, Fanta, Orange, and Fanta Tonic. It was nationalized in 1975 and during 1975-1991 sales declined. After independence the government rehabilitated the factory and resumed production, but the obsolescence of machinery and distribution tracks were causing problems. In January 1997, the government of Eritrea and the Coca-Cola Company entered into a joint venture, creating a new company under the name of Red Sea Bottlers Share Company. Since then US\$ 13 million has been invested to build a completely new bottling facility, making it one of the most modern Coca-Cola factories in Africa. The Government of Eritrea holds 55% share of the joint venture (Hailemariam, 2001)

1.4 Literature Review

The background of the company could highlight us its journey from the state ownership, which was driven by the socialist economy to now a free market driven economy. The company's management has a great challenge to revitalize the company. The strategies and systems employed will determine its monopolistic and competitive position (at this level this company is the only soft drink company in the nation) in the future. Because, as a result of the trade liberalization as opposed to the last socialist ideology of closed system, companies are now open to global competition. The hypothesis of the study is a management that focuses and allocates the resources on maximizing the value of the firm could fill the gap of company deficiency. Hence the focus of the study is on determining the value drivers, assessing and

recommending the value creation and enhancement measures. It is not the intention of the study to compare and contrast the state owned and privatized ones.

1.4.1 Value and Value creation

The value of the company is the present value of the expected sequence of future cash flows the company will generate for the owners. This expression of value can be represented by the following mathematical equation:

$$\text{Value} = \sum (\text{cash flows})_t / (1+r)^t$$

Where, t is the number of future years, and r is the discount rate.

Based on this mathematical equation of cash flow, the value of a firm rests on four components. These four components are cash flows, reinvestment rate, growth rate and discounting rate. Value is created when a firm:

- Generate higher cash flows from assets in place, without affecting its growth prospects or its risk profile
- Reinvest more and with higher excess returns, without increasing the riskiness of its assets
- Reduce the cost of financing its assets in place or future growth, without lowering the returns made on these investments (Arnold, 2002).

1.4.2 Value Creation and Enhancement Process

In order to achieve the goals of value creation *five processes* will be needed. These are the establishment of corporate value strategies and goals, identifying value drivers, performance measurement, compensation, and value communication and reporting. These five processes are critical. They ensure that the value link from customer to shareholder is created and solidified (Black, et al, 2001).

1.4.2.1 Corporate value strategies and goals

This is where your shareholder value analysis begins. Corporate strategies define the businesses in which you are competing; they map the course for creating value across a portfolio of companies. There has to be a very close link between the strategies the firm intends to follow, with creation of shareholder value.

1.4.2.2 Identifying Value Drivers

Strategy is too abstract for most people in the company. Value drivers help make the strategy real at a level of specificity that is both meaningful and actionable. The definition of value drivers must include important aspects of the operating decisions. Value drivers are also used to understand non-financial operating measures. These operating value drivers define the strategy to people in the organization and ultimately lead to behavior changes.

Rappaport summarizes the chief relationships within the shareholder value concept in a succinct chart, which will be shown and covered in the literature review. The starting point is with the distinction between the three Operating, Investment and Financing management areas, which contribute to value creation. The major value creation factors of these individual areas are shown on the next level. These are described aptly as **‘seven value drivers’**.

Each of the individual value drivers affects one of the three valuation components of ‘Cash Flow from Operations’, ‘Discount Rate’ and ‘Debt’, which are ultimately used to derive shareholder value added (SVA) – the sole corporate purpose in the strategy presented here. As the last link in the chain, the owners ultimately gain from this added value in the form of dividends and capital gains (Credit Suisse, 2000).

1.4.2.3 Performance measurement

Successful value management requires that a mind-set of managing for value be integrated into the way decisions are made. This approach to decision making begins with the goal - managing for value- and uses measures of financial and non- financial performance to support that goal. Measures of performance must be an integral part of both the key management processes and the decisions made to improve operations or make new investments. Companies that focus on creating and building value become focused, goal oriented, and successful at building the powerful business machines that are required in today’s give no quarter competitive environment (Knight, 1998).

1.4.2.4 Compensation

For an effective value based management program to be fully implemented within a company, you need to incentivize to link your compensation system to value creation. The linkage of remuneration to value creation will promote a culture of performance and ownership that rewards shareholder value maximization and empowers employees to manage

the business as if it were their own. Such a system will ensure that interests of shareholders and employees are aligned.

1.4.2.5 Communication

This is essential for people to understand value creation and discover how the decisions they make influence the amount of value created. Communication explains what value based decision making is and is not. You can think of communication as the ongoing process of education where the education programs themselves are discrete events.

1.5 Motivation of the Study

Motivation of this study in this particular company is that the use of value based management, beyond a lip service, is the up to date business know how where all companies should pursue it. The mentioned company is one of the popular company's in the country. So it is my belief that its use of value based management will add to its popularity and business enlargement and enrichment.

1.6 Research Benefits

This research study will benefit to the management bodies of these enterprises and reader of this research document. The management will be familiar with the techniques of value measurement and their supremacy against the earning based measurements. Further, from the recommendations the possible actions that affect the current cash flows, investment positive spread units, the length of the high growth period or the cost of capital will definitely help to solve the existing management problems. Besides as a research document it will be helpful in introducing the concept of firm's value maximisation to every reader of the document.

1.7 Problem Statement

Shareholders (owners) make current consumption sacrifices, or they give up the return available elsewhere when they choose to invest their money in a firm. They do this in an anticipation of receiving more money in the future than they laid out. Hence what of interest to them are the future cash flows and the precise timing of these cash flows. Time has a money value. The money of today is worth more than that of tomorrow. Hence the management (Black et al., 1998) should align strategies, policies, performance, measures,

rewards, organization, processes, people, and systems to deliver increased shareholder value. From this basic business reality the research problem of this proposed study is to establish:

“What actions lead to value creation and enhancement in Red Sea Bottler Share Company?”

1.8 Objectives of the Study

- To determine the value drivers of the company.
- To evaluate how and to what extent the company is creating or destroying value and thereafter assess what possible reasons there are that promote or constrain value.
- To evaluate what the management is doing in enhancing the value of the company.

1.9 Research Design

“The research design constitutes the blue print for collection, measurement, and analysis of data...” (Cooper 2001:134). Accordingly the consecutive overview of the study methodology will follow. Yin (1984) compares the case study method with experiments and suggests three situations where case study is the preferred one. One from the three situations is: if we want to follow a theory which specifies a particular set of outcomes in some particular situation, and if we find a firm which finds itself in that particular situation, we can use the case study method for a critical test of theory and its applicability to the organization (Ghauri, et al 1995:89). Because this situation is similar with the study undertaken, the research methodology in this case is a case study.

Furthermore contrary to someone’s perception case study method is quite similar to historical review, but it is different in the sense that here we have a possibility of direct observation and interaction. Case study method is not synonymous with qualitative research or method. A case study may very well involve qualitative methods or even be entirely quantitative (Ghauri, et al 1995:89).

Hence the methodology of this case study is a triangulation, i.e., more than one data collection methods are used. The data collection methods that were used in this study are secondary data and questionnaire.

1.9.1 Data Collection Methods

Data is collected using different methods based on the type of data needed. The type of the data can be known from the objectives of the study. The first objective of the study is about knowing the determinants of value of the company. Managers were asked to identify the determinants of value in the company using the questionnaire and the Rappaport's seven value drivers are used as model for the analysis.

The second objective is regarding how and to what extent the company is creating value. Exhaustive study is made on the financial statements (income statement and balance sheet) using the financial ratios and value based measurement techniques. Besides, the non-financial measurement is used with a balanced scorecard technique.

The third objective is also about what managers' are doing to enhance the value of the company in the process of value creation. Based on the conceptual framework questionnaire was distributed to the managers of the company to know their efforts to enhance value to the owners of the company.

1.9.2 Data Collection Approaches

Financial data was collected from the company and Ministry of trade and Industry.

Questionnaire was distributed personally through the researcher's friend to the hand of the General and Division managers. The type of the questions was open, scaled, and closed questions. Question five and seven of the questionnaire is adapted with some modifications from the research paper conducted in the manufacturing industry prepared by Hailemariam (2001) in fulfillment of his Doctorate degree. The sample of the questionnaire is attached as an **appendix B**. The structure of the questionnaire was from general questions to more specific and then sensitive questions. Most effort was done to present the questions in the form of scale and closed type for more simplification and that respondents are able to recall what they should say. Besides in designing it due caution was made for unbalanced, forced, and small numbered categories scale of measurement, which impair validity of the scale.

1.9.3 Sampling

The case study was conducted in a single company. The numbers of respondents for the questionnaire are general manager, financial, marketing, human resource manager and other

two-division managers. The study is limited only to the general manager and the Division Managers. Therefore the target population and the sample size as well, is the whole number of Division managers and the General Manager.

1.9.4 Data Analysis

The different methods used for collecting the information to answer the research question are analyzed in the following way.

1.9.4.1 Financial Data Analysis

Financial analysis techniques are used in analyzing the financial data collected from the companies selected for this study. Based on the company income statement and balance sheet, financial ratios and value metric measurements like Total Business Return (multi period measurement) and Economic Value Added (single period measurement) are employed. Further more, performance indicating ratios are used to see profitability, asset utilization and efficiency position of the company.

1.9.4.2 Questionnaire's Data Analysis

The questionnaire results are analyzed to see to what extent the company managers' effort in enhancing value of the company is successful.

1.9.5 The Credibility of the Research Findings

Validity and Reliability tests have been commonly used to establish the quality of any empirical social research. These tests are used to establish the trustworthiness of research results or an assessment tool.

Financial statements are collected from the Company and Ministry of Trade and Industry, which could enhance the reliability of the research findings, and as much as possible the questionnaire was prepared in the way that could enhance the understanding of the respondents. Moreover, triangulation of information using multiple data sources enhances the reliability of the research findings.

“Validity addresses the issue of whether what the researcher was trying to measure was actually measured” (McDaniel, et al., 2002:299). Yin [1994] recommends the use of multiple sources of evidence and to establish chain of evidence in data collection phase. In this study,

multiple sources of evidences, such as financial and questionnaire to management will be used to enhance validity. Moreover, the variables used are derived from the literature reviewed.

1.10 Limitations of the Study

- The numbers of years of the cash flows after the privatisation are only three (1999-2001), which may not give a clear picture of the forthcoming attainments.
- In the data collection method Interview could have been more useful to come across the depth of the study but because the researcher is not able to have a personal contact questionnaire through a qualified friend is substituted.
- The cost of equity is a rough estimation where the consultants use for their study. It is not the result obtained from the known models. This is because the business environment doesn't allow doing so. This rough estimate may lead to a wrong figure in the computation of value of the company and its periodic Economic Value Added.

1.11 Structure of the Study

Chapter Two: Value determinants, when and how value created and enhanced will be discussed.

Chapter Three: The general economy of the country and industry will be touched. The performance of the company whether it is creating value or not as per the financial statements results will be critically analysed.

Chapter Four: What managers are doing in enhancing value based on Rappaport's value drivers frame work will be critically analysed as per the result of the questionnaire.

Chapter Five: This last chapter includes the study's conclusion and recommendations.

CHAPTER TWO: Literature Review

2.1 Introduction

Knowledge is power. History reveals that human beings strive to find the right way, system, style, principle, culture and so on. Every acquired knowledge and expertise of any thing on this earth at this time is the accumulated knowledge and expertise of yesterday. Therefore any person should keep in mind that nothing can be achieved cheaply. Especially in the business world the competitive environment is making life very complex for any company to sustain its existence successfully. It is not a secret that many last day giant business enterprises due to their failure to cope with the existing competitive situation are now non-existent. They are recorded in the book of history.

In most cases of the failed companies the management were not aware while they were swallowed by the contemporary more successful competitors or found to be destroying value to the investors or found themselves with no cash on hand to finance the daily activity regardless of their other business success. Thus, they were gripped in mode of surprise, just because they were not equipped with the necessary knowledge to stand on their feet.

For this and other reasons a keen management should be equipped with enough knowledge that could make it sustain against any kind of adversity. The core knowledge needed to make sure is whether the company is creating or destroying value on a daily, monthly and annual basis. If the management take notice of this fact to guarantee the smooth continuity of the business and please its stakeholders it must have a value mind set so that every attempt it takes will enhance the value of the company.

In view of this an attempt will be made to present discussion on what value is, why focus on value, and how value is created and enhanced.

2.2 Value and value creation of a company

The value of a company is the present value of the expected sequence of future cash flows the company will generate for the owners. This expression of value can be represented by the following mathematical equation:

$$\text{Value} = \sum (\text{cash flows})_t / (1+r)^t$$

Where, **t** is the number of future years, and **r** is the discount rate.

Based on this mathematical equation of cash flow, the value of a firm rests on four components. The first is its capacity to generate cash flows from assets in place, with higher cash flows translating into higher value. The second is its willingness to reinvest to create future growth, and the quality of these reinvestments. Other things remaining equal, firms those reinvest well and earn significant excess returns on these investments will have higher value. The third is the length of the asset, project or firm lifetime. Assuming the same cash flow, the longer the asset life is the more the asset value. Similarly, the longer the high growth rates in the life span of the asset the greater the value of the asset. The final component of value is the cost of capital, with higher costs of capital resulting in lower firm values (Arnold, 2002).

2.2.1 Cash flow to the firm

Cash Flow from Assets measures cash flows generated by a firm's assets. It is also known as the Cash Flow of the Firm. These cash flows will be further categorized as Operating Cash Flow, Capital Spending, and Additions to Net Working Capital.

2.2.1.1 Operating Cash Flow

This measures the cash flows generated by the firm's main operations (In effect, the ability of the firm to sell its products for more than the cost of production). Operating Cash Flow can be determined as follows:

$$\text{Operating Cash Flow} = \text{EBIT} + \text{Depreciation} - \text{Taxes}$$

The calculation begins with EBIT (Earnings before Interest and Taxes) because Interest Expense is not a cash flow that operations are dependent upon. Interest Expense reflects how the firm chooses to finance its assets, not its ability to operate them successfully. Depreciation Expense (from the Income Statement) is added back because it is non-cash expense, which was subtracted out in the determination of EBIT. Finally, the taxes that the firm actually paid in cash during the period are subtracted.

2.2.1.2 Capital Spending

Capital spending reflects the firm's net investment in fixed assets during the period. It can be

calculated as follows:

$$\text{Capital Spending} = \text{Ending Net Fixed Assets} - \text{Beginning Net Fixed Assets} + \text{Depreciation}$$

In this calculation, Depreciation Expense (from the Income Statement) must be added back because the balance for Ending Net Fixed Assets on the Balance Sheet is reduced by the Depreciation expense, which was incurred during the period.

2.2.1.3 Additions to Net Working Capital

This measures the firm's investment in Net Working Capital during the period. Net Working Capital (NWC) is defined as Current Assets minus Current Liabilities.

$$\text{Additions to NWC} = \text{Ending NWC} - \text{Beginning NWC}$$

Once the above items have been determined, the Cash Flow from the Firm's Assets can be calculated as follows:

$$\text{Cash Flow from Assets} = \text{Operating Cash Flow}$$

- Capital Spending

- Additions to NWC

A healthy firm would be expected to generate positive cash flow. However, if the firm is young and/or is investing heavily to promote growth, then a negative Cash Flow from the Firm's Assets may be excused (Mathis, 2000).

2.2.2 Expected Growth

In valuation, it is the expected future cash flows that determine value. While the definition of the cash flow, described in the last section, still holds, it is the forecasts of earnings, net capital expenditures and working capital that will yield these cash flows. One of the most significant inputs into any valuation is the expected growth rate in operating income. While one could use past growth or consider analyst forecasts to make this estimate, the fundamentals that drive growth are simple. The expected growth in operating income is a product of a firm's reinvestment rate, i.e., the proportion of the after-tax operating income that is invested in net capital expenditures and changes in non-cash working capital, and the quality of these reinvestments, measured as the return on the capital invested.

Expected Growth_{EBIT} (g) = Reinvestment Rate * Return on Capital

Where,

$$\text{Reinvestment Rate} = \frac{\text{Capital Expenditure} - \text{Depreciation} - \Delta \text{Non-cash WC}}{\text{EBIT}(1 - \text{tax rate})}$$

Return on Capital = EBIT (1-t) / Capital Invested

Or,

Expected Growth = (Earning/Net Asset Value) * Pb % * 100

Where, Pb% is the rate of retained earnings.

A measure should be forward looking and the return on capital should represent the expected return on capital on future investments. Having said that, it is often based upon the firm's return on capital on assets in place, where the book value of capital is assumed to measure the capital invested in these assets. Implicitly, we assume then that the current accounting return on capital is a good measure of the true returns earned on assets in place, and that this return is a good proxy for returns that will be made on future investments (Damodaran, 2000).

2.2.3 Discount Rate

Discount rate is the expected cash flows need to be discounted back at a rate that reflects the cost of financing these assets. The cost of capital (Weighted Average Cost of Capital-WACC) is a composite cost of financing that reflects the costs of both debt and equity, and their relative weights in the financing structure. The WACC is an expression of what return a company must earn if it is to justify the financial assets it uses- in other words, the opportunity cost of the assets in use. It is entirely market-driven: if the assets cannot earn that return, then investors will eventually withdraw their funds from the business. Indeed, the shareholder value approach is saying something even more serious to managers. It is not just a question of ensuring that the business earns returns that are equivalent to its WACC. If the business is to prosper in the longer terms, it has to earn more than that WACC. It is only when this condition is met that we can talk about the creation of shareholder value. (Black, et al, 2001)

2.2.4 Asset Life

For Firms that do not have finite lives it is not possible to estimate cash flows forever, we

generally impose closure in valuation models by stopping our estimation of cash flows sometime in the future and then computing a terminal value that reflects all cash flows beyond that point. A number of different approaches exist for computing the terminal value, including the use of multiples. The approach that is most consistent with a discounted cash flow model is one where we assume that cash flows, beyond the terminal year, will grow at a constant rate forever, in which case the terminal value can be estimated as follows:

$$\text{Terminal value}_n = \text{FCFF}_{n+1} / (\text{Cost of Capital}_{n+1} - g_n)$$

Where: n is number of years, FCFF is free cash flow, and g is the growth rate.

The cost of capital and the growth rate in the model are sustainable forever. It is this fact, i.e., that they are constant forever that allows us to put some reasonable constraints on them. Since no firm can grow forever at a rate higher than the growth rate of the economy in which it operates, the stable growth rate cannot be greater than the overall growth rate of the economy. In the same vein, stable growth firms should be of average risk.

Thus, in every discounted cash flow valuation, there are two critical assumptions we need to make on stable growth. The first relates to when the firm that we are valuing will become a stable growth firm, if it is not one already. The second relates to what the characteristics of the firm will be in stable growth, in terms of return on capital and cost of capital.

In summary, then, to value any firm, we begin by estimating how long high growth will last, how high the growth rate will be during that period and the cash flows during the period. We end by estimating a terminal value and discounting all of the cash flows, including the terminal value, back to the present to estimate the value of the firm (Damodaran, 2000).

There is an extensive body of theory and empirical evidence to indicate that this value measure corresponds well to the market value of the company over the long run. The measure of value creation in any period is the cash generated from the operational activity less the cost of capital, over the period in question. If the cash return exceeds the cost of capital, value is created for shareholders; if it is less, value is being destroyed (Research from Tillinghast – Towers Perrin, 2000).

2.3 Why Focus on Value?

Resources are so scarce, and managers are confronted with optimizing the allocation of scarce resources. The current economic and social environment, characterized by countless changes and evolutions (Young and O.Byrne, 2001) provides management and more particularly those in management accounting and management control functions, with new challenges. Those challenges not only reveal inefficiencies in the existing management systems but also support the need for an integrated management tool. The most important challenges and inefficiencies are briefly discussed below.

The attention for shareholder value has always been on the management agenda but in the 1960s and the 1990s the focus on shareholder value was less explicit. A McKinsey & Co research reveals that shareholder-oriented economies appear to perform better than other economic systems, and other stakeholders do not suffer at the hands of shareholders (Copeland et al., 2000). Furthermore it appears that there is a paradigm shift with regard to management objectives. In the past (and probably still even these days in some organizations) sales-growth or revenue-growth was often the governing objective. Residual income theory applied to customer or product profitability analysis reveals us that not every growth is a good thing to pursue.

This is however not the only change in management objectives, since management more and more realizes that traditional earning measures do not reflect the real value creation. Those traditional metrics are accounting based and therefore do not take into account the risk notion, neither the impacts of inflation, nor opportunity costs. Stern Stewart & Co (Stewart, 1999) calls this: the switch from 'Managing for earning to managing for value'. In addition, value is said to be one of the best performance measures because it is the only measure that requires complete information. To understand value creation one must use a long-term strategic point of view, manage all cash flows on the income statement and the movements on the balance sheet, and one must know how to compare cash flows from different time periods on a risk adjusted basis. It is therefore impossible to make good decisions without complete information, and according to Copeland (Copeland et al., 2000) there is no performance metric other than value that uses complete information (Ameels et al, 2002).

2.4 Value Creation and Enhancement Process

As it is broadly discussed in the preceding section value is the present value of the expected sequence of future cash flows the company will generate for its owners. It is not a one-moment incident. Rather it is a result of a continuous process. It is the cumulative performance of the company's daily, weekly, monthly and annually present value of the cash flow. If the present value of cash flow is more than the value invested the company creates value to the shareholders; and if the present value of the cash flow for a particular time or for the life of the firm is less than the capital invested the company is said to be destroying value to shareholders. Hence management of the firm needs to have the mindset of value creation on a daily basis on every activity of the firm to lead a successful business.

For a company to create value it must go through certain processes. Black, et al (2001) propose five-value creation processes. These are the establishment of corporate value strategies and goals, identifying value drivers, focus on future oriented performance measurements, link compensation with value creation of the company, and communicate the value concept through out the company. These five processes are critical. They ensure that the value link from customer to shareholder is created and solidified

2.4.1 Corporate value strategies and goals

This is where shareholder value analysis begins. Corporate strategies define the businesses in which you are competing; they map the course for creating value across a portfolio of companies. There has to be a very close link between the strategies the firm intends to follow, with creation of shareholder value. Strategy drives the business (or corporate) plan, which shows courses of action driven from the combination of external and internal environments the business is in. In the prevailing turbulent environment, organizations need to know their internal and external environment so as to flexibly be able to maximize their resources.

Strategy answers four questions all of which have great relevance to the process of value creation:

- What goals do you have as a corporation/company?
- What businesses are you in?
- How will you achieve your goals?
- How will you ensure that you obtain the positive returns with which to reward your shareholders?

There has to be a very close link between the strategy the firm intends to follow, and the creation of shareholder value. Unless Shareholder value is integrated into the strategy development process, a company is unlikely to meet the long-term challenge of creating value with customers and delivering it to investors.

Often strategy is taken to be exclusively a matter of markets, customers, products, technologies, and competitive dynamics. While these are essential inputs, they are not enough: the question of value creation has to be addressed for each of these areas. In other words, for a strategy to be effective, your company will have to integrate shareholder value into the formulation and development of that strategy. At this level, value is driven by three basic imperatives:

- Investing to achieve a return in excess of the cost of capital
- Growing the business and investment base
- Managing and accepting appropriate business risks

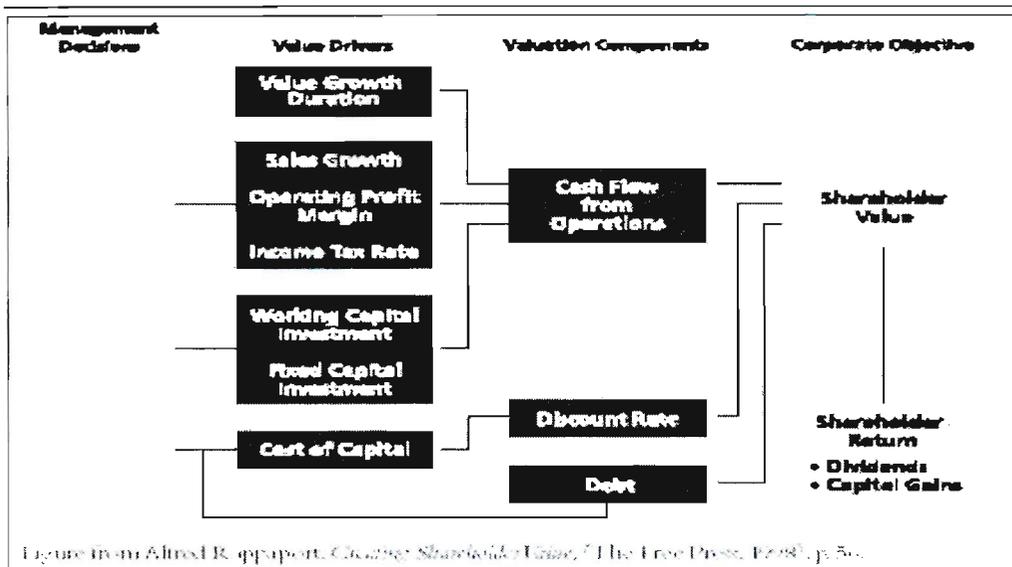
As you contemplate major strategy choices, assessments of return, growth and risk can be used effectively to weigh up the implications for shareholder value of these choices (Black, et al, 2001).

2.4.2 Identifying Value Drivers

Once resources have been established, human, intellectual and financial resources, they must be allocated to implement the strategy. Issues of resource allocation can be analysed using the seven drivers of the shareholders value model presented by A. Rappaport.

Strategy is too abstract for most people in the company. Value drivers help make the strategy real at a level of specificity that is both meaningful and actionable. The definition of value drivers must include important aspects of the operating decisions. Value drivers are also used to understand non-financial operating measures. These operating value drivers define the strategy to people in the organization and ultimately lead to behavior changes.

Fig 2.1 Alfred Rappaport's shareholder value network



Rappaport summarizes the chief relationships within the shareholder value concept in a succinct chart, shown above. The starting point is with the distinction between the three **Operating, Investment and Financing** management areas, which contribute to value creation.

The major value creation factors of these individual areas are shown on the next level. These are described aptly as ‘**seven value drivers**’ (Black, et al, 2001).

- Sales growth
- Operating profit margin
- Income tax rate
- Fixed capital investment
- Working capital investment
- Cost of capital
- Value growth duration

Whatever actions are taken at any level of an organization directly or indirectly affect value of the organization. Hence any decision is a choice for promoting or demoting companies’ performance. The decisions made are regarding the resources of the company, and every resource is worth money. The researcher could relate money as a conductor that carries electrons (coins and notes) to light lamps (owners and employees). In other words money is a medium for carrying value of the resources allocated that are later used in creating money for

owners and employees. A careful study and analysis is therefore a precondition for a sound value creating decision. As a systematic approach in decision-making process helps to arrive at a sound decision, by simplifying matters, the above seven value drivers can help a company to allocate its resources in their best contribution of creating value to the company. Following is a thorough discussion that can lead to value creation and enhancement based on the above seven value drivers.

2.4.2.1 Revenue growth

Sales may be increased in different ways. Based on the price strategy for example, there are two basic routes a firm can take to increase its revenue. It can choose to be a volume leader, reducing price and hoping to increase volume sufficiently to compensate. For this strategy to work the firm needs a cost advantage over its competitors, to prevent predatory pricing that may make all firms in the sector worse off. Alternatively, it can attempt to be a price leader, increasing prices and hoping that the effect on volume will be smaller. From a purely value maximization standpoint, we can examine which approach yields the higher value and use that approach.

Promotion can also be used as a means of increasing sales especially when a product is on its early stage. When a product is on its early stage of life cycle there is a very limited or even no awareness of the potential buyers. No one is expected to buy a product without having at least a limited knowledge of its usage. When people are informed that the launched product has a particular advantage to their life they start to buy it. Besides on a very competitive market promotion plays a great role in positioning the product through advertisement. Knowledge of a particular product may influence people to purchase.

Good service to customers may also increase revenue. To retain and add new customers a good customer service is necessary.

2.4.2.2 Improving Operating profit margin

Operating profit = gross profit – operating expenses; and Gross profit is the result of Sales less Cost of Goods Sold. Cost of goods sold (COGS for short) is the expense a company incurred in order to manufacture, create, or sell a product. It includes the purchase price of the raw material as well as the expenses of turning it into a product. Cost of goods sold (COGS) is also known as cost of revenue or cost of sales. And Operating expenses is

associated with running a business but not considered directly applicable to the current line of goods and services being sold. These include Sales and Marketing, R & D, and General and Administrative costs (including the salaries of people working in these areas).

Operating profit margin is also the ratio of operating profit to sales.

When we talk about efficiency of an operation, it comprises an efficient management of purchasing, warehousing, manufacturing, selling, and promoting and so on. This can best be analyzed using a value chain analysis. Every activity in the chain must add value to the next level, and the next to its next up to last destiny of the product. When every activity adds value to its next level, profit margin of the firm can be maximized. When inefficiency is identified in the value chain cost cutting and layoffs are some form to prune the problem. At the same time, note that these actions are value enhancing only if the resources that are pruned are not contributing adequately either to current operating income or to future growth. It is all too easy for companies, however, to show increases in current operating income by cutting back on expenditures (such as research and training) that are designed to create future growth.

2.4.2.3 Reducing the Tax Burden

The value of a firm is the present value of its after-tax cash flows. Thus, any action that can reduce the tax burden on a firm, for a given operating income, will increase value. While there is some aspects of the tax code that offer no flexibility to the firm, the tax rate of a firm can be reduced over time by doing any or all of the following (Damodaran, 2000):

- Multinational firms that generate earnings in different markets may be able to move income from high-tax locales to low-tax or no-tax locales.
- A firm may be able to acquire net operating loss carry forwards that can be used to shield future income. In fact, this might provide the rationale for a profitable firm acquiring an unprofitable one.
- A firm can use risk management to reduce the average tax rate paid over time on income because the marginal tax rate on income tends to rise, in most tax regimes, as income increases. By using risk management to smooth income over time, firms can make their income more stable and reduce their exposure to the highest marginal tax rates. This is especially the case when there are windfalls or supernormal profit taxes.

2.4.2.4 Fixed Investment Decisions

The first place to look for value is in the assets in place of the firm. These assets reflect investments that have already been made by the firm and they generate the current operating income for the firm. To the extent that these investments earn less than their cost of capital, or are earning less than they could, if optimally managed, there is potential for value creation. New investment (acquisition) also becomes a source of creating value to the firm, when the acquisitions or project's net present value is positive.

2.4.2.4.1 Poor Investments: Keep, Divest or Liquidate

Investments made may be poor for different reasons. One is the life span of the investment. Any investment has a life cycle just like human being. It goes through an early stage (introduction), growth, mature, and decline. When a given investment reaches at a stage of declining (time of death) either divest or liquidation may be a good strategy to be followed. Because at this stage the investment may earn less than what they need to break even (the cost of capital) and sometimes even losing money. Secondly there are some investments made on uncertain environment, where the assumptions made fall short of what expected. In this kind of situation too, even if it is in its early stage, either to divest or liquidate may be the right choice of action to be followed.

At first sight, Damodaran (2000) argues, it would seem to be a simple argument to make those investments that do not earn their cost of capital should either be liquidated or divested. If, in fact, one could get back the original capital on liquidation, this would be true, but that assumption is not generally true. To see why, consider three different measures of value for an existing investment. The first is the continuing value, and reflects the present value of the expected cash flows from continuing the investment through the end of its life. The second is the liquidation or salvage value, which is the net cash flow that the firm will receive if it terminated the project today. Finally, there is the divestiture value, which is the price that will be paid by the highest bidder for this investment.

Whether a firm should continue with an existing project, liquidate the project or sell it to someone else will depend upon which of the three values - continuing, liquidating or divestiture - is highest. If the continuing value is the highest, the firm should continue with the project to the end of its life, even though it might be earning less than the cost of capital.

If the liquidation or divestiture value is higher than the continuing value, there is a potential for an increase in value. The value increment can then be summarized below:

If liquidation is optimal: Expected Value Increase = Liquidation Value - Continuing Value

If divestiture is optimal: Expected Value Increase = Divestiture Value - Continuing Value

2.4.2.4.2 Reducing net capital expenditures on assets in place

The net capital expenditures refer to the difference between capital expenditures and depreciation, and, as a cash outflow, it reduces the free cash flow to the firm. Part of the net capital expenditure is designed to generate future growth, but part of it is to maintain assets in place. If a firm can reduce its net capital expenditures on assets in place, it will increase value. During short periods, the capital expenditures can even be lower than depreciation for assets in place, creating a cash inflow from net capital expenditures.

There is generally a trade off between capital maintenance expenditures and the life of asset in place. A firm that does not make any capital expenditures on assets in place will generate much higher after-tax cash flows from these assets, but the assets will have a far shorter life. At the other extreme, a firm that reinvests all of the cash flows it gets from depreciation back into capital maintenance may be able to extend the life of its assets in place significantly. This trade-off, again, is often ignored when firms embark on cost cutting and reduces or eliminates capital maintenance expenditures. While these actions increase cash flows from assets in place in the current period, the firm might actually lose value as it depletes these assets faster (Damodaran, 2000).

2.4.2.5 Working Capital Decisions

The non-cash working capital in a firm can be measured as the difference between non-cash current assets, generally inventory and accounts receivable, and the non-debt portion of current liabilities, generally accounts payable. Since money invested in non-cash working capital is tied up and cannot be used elsewhere; thus, increases in non-cash working capital represent cash outflows, while decreases represent cash inflows.

At first sight, the path to value creation seems simple. Reducing non-cash working capital as a percent of revenues should increase cash flows, and therefore, value. This, however, assumes that there are no negative consequences for growth and operating income. Firms generally

maintain inventory and provide credit because it allows them to sell more. If cutting back on one or both results in lost sales, the net effect on value may be negative.

The advent of technology and the availability of updated reliable data has made it easier for firms to plan, and reduced the need for inventory and working capital. In fact, the average non-cash working capital as a percent of revenues at major US corporations has dropped from 17.6% in 1988 to 14.5% in 1998 (Damodaran, 2000).

2.4.2.6 Cost of capital (Financing Decisions)

The cost of capital for a firm was defined earlier to be a composite cost of debt and equity financing. The cash flows generated over time are discounted back to the present at the cost of capital. Holding the cash flows constant, reducing the cost of capital will increase the value of the firm. In this section, we will explore the ways in which a firm may bring its cost of capital down, or more generally, increase its firm value by changing both financing mix and type.

2.4.2.6.1 Changing Operating Leverage

The operating leverage of a firm measures the proportion of its costs that are fixed. The extent to which a business uses fixed costs (compared to variable costs) in its operations is referred to as "operating leverage." The greater the use of operating leverage, the larger the increase in profits as sales rise and the larger the increase in loss as sales fall.

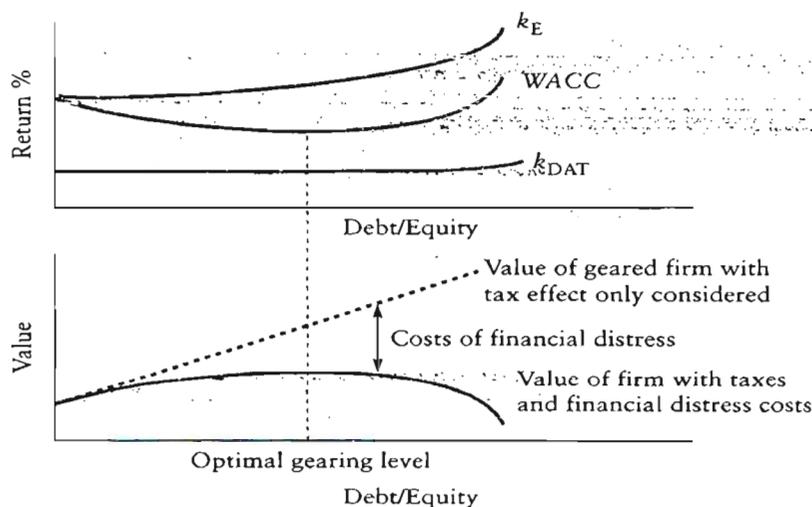
A business often can choose between a high level of fixed assets and a lower level of fixed assets. For instance, some equipment items are substitutes for labor (and labor is commonly considered a variable cost). If labor is not replaced with equipment, fixed costs are held lower, and variable costs are higher. With a lower level of operating leverage, businesses show less growth in profits as sales rise, but face less risk of loss as sales decline and reduce their cost of capital.

Similarly using outside contractors (outsourcing) for some services (fixed costs) may reduce risk of operating leverage. Moreover tying expenses to revenues; in particular with wage contracts, tying wages paid to revenues made will reduce the proportion of the costs that are fixed. (<http://www.toolkit.cch.com>)

2.4.2.6.2 Changing the Financing Mix

The second approach to reducing the cost of capital is to change the mix of debt and equity used to finance the firm. Debt is always cheaper than equity, partly because lenders bear less risk and partly because of the tax advantage associated with debt (debt is tax deductible and equity is not). Increase debt mix especially up to certain level decreases cost of capital and thereby increase value of the firm. But from certain level (optimum point) on words increasing debt mix (high leverage) may lead to financial distress. Financial distress is where obligations to creditors are not met or are met with difficulty. Risk of incurring costs of financial distress has negative effect on a firm's value, which offsets the value of tax relief of increasing debt levels. These costs become very high with very high gearing. In other words, taking on debt increases the risk (and the cost) of both debt (by increasing the probability of bankruptcy) and equity (by making earnings to equity investors more volatile). This effect is illustrated in the following graph:

Fig. 2.2 The cost of capital and the value of the firm with taxes and financial distress, as gearing increases.



Source: Glen Arnold, corporate financial management, 2nd edition, 2002:824)

Thus, firm value will increase as the cost of capital decreases if and only if the operating cash flows are unaffected by the higher debt ratio. If, as the debt ratio increases, the risk of the firm increases the firm value may decrease due to the increased cost of capital (Arnold, 2002).

2.4.2.6.3 Changing Financing Type

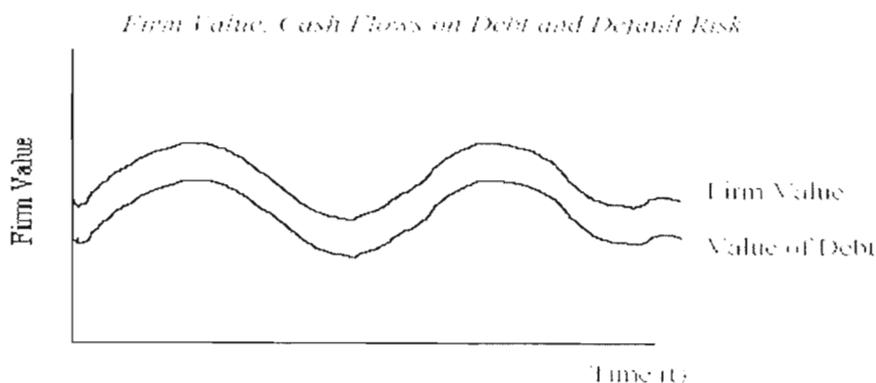
The fundamental principle in designing the financing of a firm is to ensure that the cash flows on the debt should match as closely as possible the cash flows on the asset.

By matching cash flows on debt to cash flows on the asset, a firm reduces its risk of default and increases its capacity to carry debt, which, in turn, reduces its cost of capital, and increases value.

In the graph below, for instance, the firm has substantial debt but never runs the risk of bankruptcy because the value of debt moves up and down with firm value. In fact, if the same firm had used an equal amount of short-term debt with fixed value to finance its operations, it would have run a much higher risk of bankruptcy.

Firms that mismatch cash flows on debt and cash flows on assets (by using short term debt to finance long term assets, debt in one currency to finance assets in a different currency or floating rate debt to finance assets whose cash flows tend to be adversely impacted by higher inflation) will end up with higher default risk, higher costs of capital and lower firm value. To the extent that firms can use derivatives and swaps to reduce these mismatches, firm value can be increased (Damodaran, 2000).

Fig.2. 3 firm value, cash flows on debt and default risk



Source: Aswath Damodaran, 2000

2.4.2.7 Lengthen the Period of High Growth

The 'Value Growth Duration' is the final value driver. As noted above, every firm, at some point in the future, will become a stable growth firm, growing at a rate equal to or less than the economy in which it operates. In addition, growth creates value only if the return on

investments exceeds the hurdle rate. Clearly, the longer the high growth lasts, other things remaining equal, the greater the value of the firm.

Note, however, that no firm should be able to earn excess returns for any length of period in a competitive product market, since competitors will be attracted by the excess returns into the business. Thus, implicit in the assumption that there will be high growth, in conjunction with excess returns, is also the assumption that there exist some barriers to entry that prevent firms from earning excess returns for extended time periods.

Given this relationship between how long firms can grow at above-average rates and the existence of barriers to entry, one way firms can increase value is by increasing existing barriers to entry and coming up with new barriers to entry. Another way of saying the same thing is to note that companies that earn excess returns have significant competitive advantages.

As it is referred in tutor2u.limited (<http://www.tutor2u.net>) barriers to entry are designed to block potential entrants from entering a market profitably. They seek to protect the monopoly power of existing firms in an industry and therefore maintain supernormal (monopoly) profits in the long run. Barriers to entry have the effect of making a market less contestable. The economist Joseph Stigler defined an entry barrier as ‘A cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry’. This emphasises the asymmetry in costs between the incumbent firm (already inside the market) and the potential entrant. If the existing businesses have managed to exploit some of the economies of scale that are available to firms in a particular industry, they have developed a cost advantage over potential entrants. They might use this advantage to cut prices if and when new suppliers enter the market, moving away from short run profit maximisation objectives - but designed to inflict losses on new firms and protect their market position in the long run. Nurturing these advantages can increase value.

2.4.2.7.1 The "Brand Name" Advantage

“Brand name is a word, name, symbol, etc., especially one legally registered as a trademark, used by a manufacturer or merchant to identify its products distinctively from others of the same type and usually prominently displayed on its goods, in advertising, etc” (<http://www.infoplease.com> - dictionary). The preference of a particular brand name depends

on its position in the mind of customers. According to Damodaran (2000) firms with more valuable brand names either are able to under price the competition, and/or sell more than the competitors. They usually end up with higher returns on capital, higher margins and much more value than their peer group.

Damodaran further explained that creating a brand name is a difficult, long term and expensive process, but firms can often build on existing brand names and make them valuable. Conversely, the managers of a firm who take over a valuable brand name and then dissipate its value will reduce the values of the firm substantially. Brand management and advertising can play a role in value creation. According to him the extraordinary success that Coca Cola has had in increasing its market value over the last two decades was attributed to the company's relentless focus on making its brand name more valuable globally more than any other way.

2.4.2.7.2 Patents, Licenses and Other Legal Protection

The second competitive advantage that companies can possess is a legal one. Firms may enjoy exclusive rights to produce and market a product because they own the patent rights on the product. The key to value enhancement is to not just preserve but to increase any competitive advantages that one possesses. If the competitive advantage that a firm has comes from its existing patents, it has to work at coming up with new patents that can allow it to maintain this advantage over time. While spending more money on research and development is clearly one way, what we said earlier about the efficiency of reinvestment applies here as well. The companies that will see the greatest increases in value are not necessarily the companies that spend the most on R&D, but those who have the most productive R&D departments not only in generating patents but also in converting patents into commercial products.

The competitive advantage that comes from exclusive licensing or a legal monopoly is a mixed blessing and may not lead to value enhancement. When a firm is granted these rights by another entity, say the government that entity usually preserves the right to control the prices charged and margins earned through regulation. In the United States, for instance, much of the regulation of power and phone utilities was driven by the objective of ensuring that these firms did not earn excess returns. In these circumstances, firms may actually gain in value by giving up their legal monopolies, if they get pricing freedom in return. One can

argue that this has already occurred, in great part, in the airline and long distance telecommunications businesses, and will occur in the future in other regulated businesses. In the aftermath, the firms that retain competitive advantages will gain value at the expense of others in the business (Damodaran, 2000).

2.4.2.7.3 Cost Advantages

Damodaran (2000) further discusses other potential barriers to entry that firms can use to enhance value. Following are a number of ways in which firms can establish a cost advantage over their competitors, and use this cost advantage as a barrier to entry:

- In businesses, where scale can be used to reduce costs, economies of scale can give bigger firms advantages over smaller firms.
- Owning or having exclusive rights to a distribution system can provide firms with a cost advantage over its competitors.
- Having access to lower-cost labor or resources can also provide cost advantages.

These cost advantages will show up in valuation in one of two ways: One is that the firm with the cost advantage may charge the same price as its competitors, but have a much higher operating margin. The other is that the firm may charge lower prices than its competitors and have a much higher capital turnover ratio. In fact, the net effect of increasing margins or turnover ratios or doing both will show up in the return on capital, and through it in expected growth. The cost advantage from economies of scale can be augmented by the fact that the high capital requirements impede new firms from entering the business. In businesses like aerospace and automobiles, the competition is almost entirely among existing competitors. The absence of new competitors may allow these firms to maintain above-normal returns, though the intra-firm competition will constrain how high returns get.

Each of the individual value drivers affects one of the three valuation components of 'Cash Flow from Operations', 'Discount Rate' and 'Debt', which are ultimately used to derive shareholder value added (SVA) – the sole corporate purpose in the strategy presented here. As the last link in the chain, the owners ultimately gain from this added value in the form of dividends and capital gains (Credit Suisse, 2000).

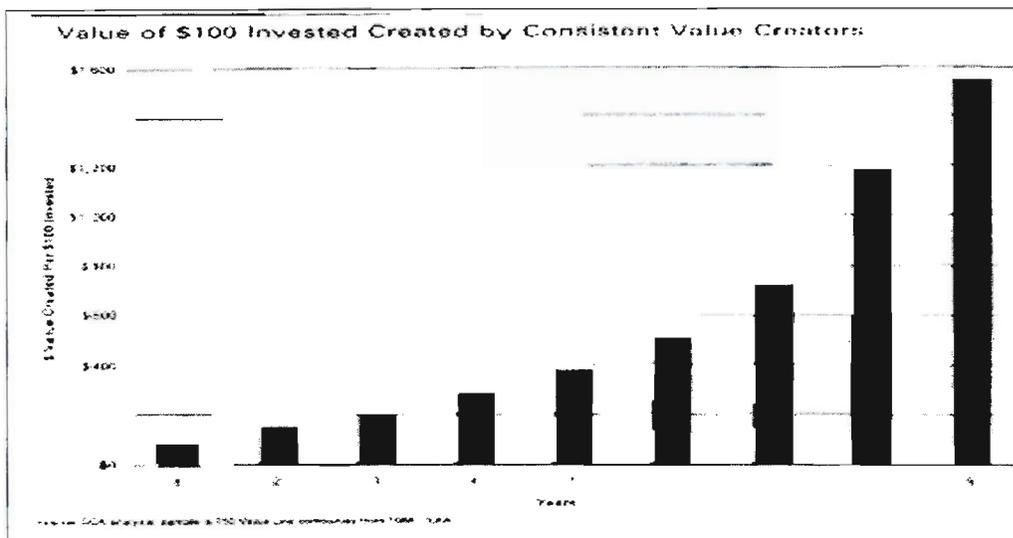
By forcing managers to evaluate business strategies based on prospective cash flows, the shareholder value approach favors strategies that enhance a company's cash flow generating ability –which is good for everyone, not just shareholders. Companies with lots of cash have more money to distribute to all of their stakeholders, not just shareholders. They also create more opportunities for employee advancement. From a broader perspective, the focus on shareholder value improves the allocation of capital, which leads to more wealth creation and more rapid economic growth.

2.4.3 Performance measurement

Successful value management requires that a mind-set of managing for value be integrated into the way decisions are made. This approach to decision making begins with the goal - managing for value - and uses measures of financial and non financial performance to support that goal. Measures of performance must be an integral part of both the key management process and the decisions made to improve operations or make new investments. Companies that focus on creating and building value become focused, goal oriented, and successful at building the powerful business machines that are required in today's give no quarter competitive environment (Knight, 1998).

To quote Robert Kaplan and David Norton, "What you measure is what you get." If earlier financial measures emphasised a more backward looking, accountancy based approach, it is now more appropriate to adopt a way of looking forward at the financial parameters within which a company is going to have to operate and survive. Shareholder value analysis, like Warren Buffet's "intrinsic value" approach, judges a company on the basis of what it can produce in the future, rather than concentrating on what it has done in the past. This way it is possible to pinpoint the elements that will contribute to the way the fundamentals of your business might develop. Companies that are on record as having embarked on, or having signed up to, shareholder value programs include such names as Coca-Cola, Pepsi Cola, Quaker Oats, Reuters, Lloyds Bank, Veba, General Electric, Briggs and Stratton, ICI, Boots, Nova Nordisk and many more. Many of the companies on this list have indeed experienced above- average share price performance-which is one good indication (Black, et al, 2001).

Fig. 2.4 Consistently value creating companies



The above figure shows how much these consistent performers created value as measured by the value of \$ 100 invested. The vertical axis is the amount of value created relative to the industry median. It is no coincidence that these companies do better. What separates these companies from the pack is that they are managed for value. One reason they consistently outperform their peers is that they are managed differently because they focus on creating value for investors (Knight, 1998).

2.4.3.1 Options for measuring financial performance

Since it is not the objective of this study to thoroughly discuss the measurement tools, just because it is desired to know whether the company is creating or destroying value a touch and narrow discussion of necessary measurement tools to the study will be made.

There are numerous ways to measure financial performance. Knight (1998) has categorized them into four logically grouped categories. Each category is related to and builds on the preceding categories:

- Income
- Cash
- Return
- Value

Income measures include operating profit (pre and after tax), and earnings per share. They are designed to measure the income generated by the company during a single period's

operations. The differences between the measures lie in the information included in calculating them.

The next category of financial performance measures is cash. Cash measures, like income measures, are designed to measure the operating results of a single period. The difference between cash and income measures is that cash measures capture the no cash charges in addition to the income. The cash based financial performance measures, most typically used are Gross Cash Flow and Earning before Interest, Tax, Depreciation, and Amortization (EBITDA). Non-cash charges to income, including depreciation, deferred taxes, and amortization, have no effect on the company's cash position. To measure the cash flow of the company in a single period, we can add back these non-cash charges.

The third category of financial performance measures is the return measures. These measures come in many different shapes and sizes. They build off the income and cash flow measures and add the dimension of return on the resources required to generate the income or cash flow. Return measures in common use today include: Return on sales (ROS), Return on equity (ROE), return on assets (ROA), return on capital (ROC), return on capital employed (ROCE), return on net assets (RONA), return on gross assets (ROGA), return on gross investment (ROGI), and cash flow return on investment (CFROI). These return measures do not measure return on the same basis. Some measure return based on sales, others on equity, and still others on assets. When measuring returns on assets, there is no single definition of what constitutes the asset base. An asset base may include all assets. An alternative approach subtracts the non-interest bearing current liabilities from the stated assets to determine the adjusted asset base. In addition, each company that uses a measure of return usually has a special twist in the definition of the assets that is peculiar to that company.

The fourth category of financial performance measures is value. Value is expressed as either a period measure or a measure at a point in time of multiple periods that defines the worth of the business. Typical period measures of value include: economic value added (EVA), economic profit (EP), shareholder value added (SVA), and cash value added (CVA). Economic value added, economic profit and shareholder value added are actually identical measures. Economical value added is primarily based on earnings where cash value added is based on cash.

Measures of value at a point in time include: stock price, net present value (NPV), Total Business Return, market value added (MVA) cash flow multiples, and cash flow simulation techniques such as spot value, plan value, and discounted cash flow simulation (DCFS).

2.4.3.2 Choosing performance measures

From the available various performance measurements, choosing which of the measures is right for your company is an important activity that can make an enormous difference in the way decisions are made. Indeed no one measure can be a fit for all measurements. One measure may perfectly fit to one firm and not for another firm. In choosing a particular measurement technique Knight (1998) proposes four factors that should be taken into consideration.

2.4.3.2.1 Accuracy of the measurement

This is how well the measure captures the fundamental economics of the business. Rarely will a single measure capture all the economics of the business. For example, if there are many non-cash charges in the course of operating the business, including cash measure as opposed to income may make sense. Because cash measures take into consideration cashes tied up in the non-cash items like inventory or debtors. If a business is capital intensive, a return measure may make more sense than an income measure because the return measure can capture the returns on the capital invested in the business. Value measures may make sense when the business confronts the difficulties of balancing growth and profitability. Focusing on return measures alone may tend to discourage growth by solely emphasizing profitability improvement. This may not be the best signal where business is highly profitable but needs to grow. Strategic measures become important when business issues do not lend themselves to single period financial performance measures. Examples include R& D expenditures and other investment, although they are incurred in a single period the company may not realize their benefits in the single period.

2.4.3.2.2 Complexity of a measurement

A complex measure doesn't mean the best measure. So often there is a tendency of some hot-blooded practitioners to recommend the contemporary complex measurements as a best fit for all businesses. They even guarantee just the use of them can create value immediately. But, a measure is only as good as the information it contains and the willingness of the management team to use it. If the measure requires information to be calculated that is not readily

available, the problem of calculating the measure may dwarf any potential benefit of increasing the accuracy. The availability or absence of division-level asset information needed for use in calculating some type of return measure provides one such example. If the unit does not keep balance sheets, the information may not be readily available. This roadblock to calculating the measure then requires alternate systems to capture the information or use of a simpler measure. The other complexity relates with the operating manager's ability to use the measure. Introducing new measure must go parallel with level of understanding of the operating managers. Despite their accuracy complex measures (relative to their users) are not usable by the incompetent users. Hence either educating the operating managers or use the simpler alternative may be an option.

2.4.3.2.3 Correlation of the measurement

The interest of shareholders must be the focus of any performance measurement system. The success of a performance measurement system at tracking and consistently reflecting shareholders' interests demonstrates how well it achieves this objective. One example of why correlation makes a difference can be seen in the highly profitable company that uses a return measure as the yardstick to judge its performance. The return measure motivates management to achieve higher returns. However, the interests of the shareholders may be better served through a combination of obtaining higher returns while investing in growth opportunities.

2.4.3.2.4 Company and Strategy Fitness of the measurement

Different industries, of course, have vastly different characteristics. Some important characteristics include the competitive economic situation, industry economics, number of competitors, asset intensity, intellectual content, and product life cycle. A combination of financial and strategic measures should address these issues of industry fit to ensure that selected performance measure serves management's purpose. The same is true for the company, except in this case we will want to analyze the company's culture to determine the effective implementation of performance measurement. Ultimately performance measurement systems must be linked to the business strategy to be truly successful in helping managers make better decisions. The business strategy should drive decision-making, and the performance measure should reinforce the strategy by sending the correct signals to managers regarding the objectives of their decision-making and resource allocation. When the business strategy calls for growth while the performance measures focus on improved returns, the inherent conflict between the two messages will undermine the effectiveness of the business

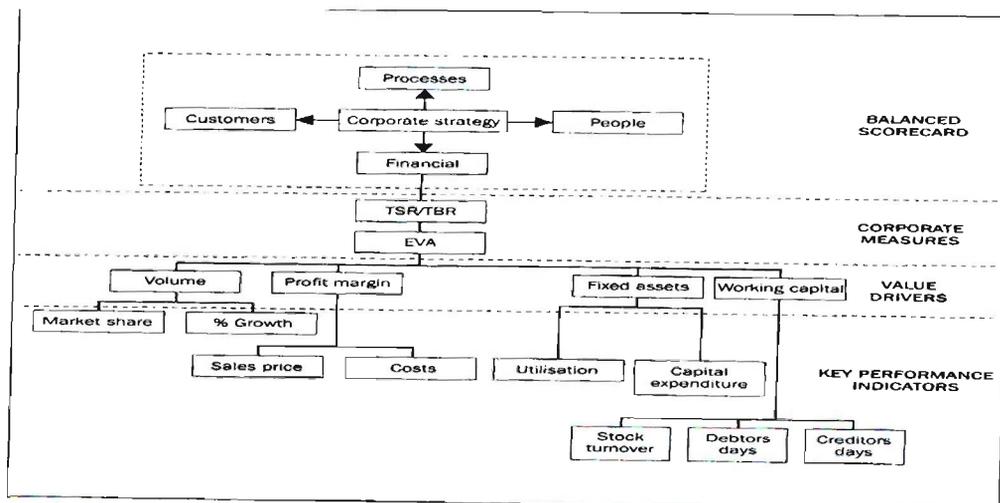
strategy. The company may achieve improved returns, but they will come at the expense of growth.

The selection, implementation, and use of a performance measure requires evaluating a series of trade-offs that involve the company, its industry, and consideration of the company's strategy from multiple perspectives. The selected performance measures should provide managers in the organization with guidance and support for good decision-making.

2.4.3.3 Value based management framework

Not departing from Rappaport's value drivers, which are the main focus of the study, Value based management framework (see Fig 2.5) is used in this section as a supporting framework. This framework expands Rappaport's framework by accommodating both customers and employees condition in the performance of the company, classifying the framework into balanced scorecard (non-financial measurement technique), corporate measures, Value drivers, and key performance indicators (financial measures).

Fig.2.5 A framework for value-based management



Source: From Warner and Hennell, Shareholder value explained, 2nd edition, 2001:100)

This framework clearly incorporates a link from the value-based metrics, to the balanced scorecard framework, through the financial perspective of the scorecard. The balanced scorecard thereby enables the value creation concept to be communicated more clearly and cascaded throughout the business (Warner and Hennell, 2001).

2.4.3.3.1 Balanced scorecard

The balanced scorecard is a tool designed by Kaplan and Norton in 1992, which is now widely used across all industry sectors. It highlights the need to look at critical success factors or outcomes required to achieve the organization's strategy and set key performance indicators for all the company perspectives including the customer, people, and internal process, as well as the financial perspective (May, 2002).

The customer perspective of the balanced scorecard focuses on how your customers view your business. In this section, customers describe the needs they are trying to fulfill when they come to you. Since your customers may also read your business plan, you should also describe how you see your customers. This will help assure them that you understand their needs and may help them understand the variety of customer needs you are trying to meet. Price, responsiveness, and product returns can be used as measures for customers' existing situation.

The next section of the business plan describes the financial resources that will be required to operate your business and the sources of those funds. This is how a financial manager looks at the business. Businesses are required to break even – i.e., to fully recover their costs without making a profit. Meeting this standard requires careful identification of costs and revenue sources.

The third section of the business plan describes internal processes. The Balanced Scorecard approach influencing this section of the business plan focuses on the internal process controls that are in place to ensure that your business line functions smoothly.

The final section, people, perspective captures the ability of employees, information systems, and organizational structure to manage the business and adapt to change. This section should describe the steps being taken to ensure continual professional development and growth of the staff. This is an opportunity to sell the knowledge, flexibility, and commitment to improving the capabilities of the staff to your customer; and to identify the areas where the business line is training and motivating its staff well and where it could use some improvement. You want to show that your business line is flexible, forward-looking and equipped to handle changing customer and technology driven needs. No of skills/employee, revenue/ employee, innovations can be used as measures for identifying the existing employee condition.

(<http://ma.mbe.doe.gov>). Ratios such as labour productivity, average remuneration per employee, and unit labour cost also could be used to further know the existing employees condition.

i. Labour Productivity (Total output/Number of employees)

Labour productivity is the size of output generated by each employee of the enterprise. This ratio gives an indication of efficiency and /or marketing capability. A high ratio reflects a good marketing strategy adopted by the enterprise.

ii. Remuneration per employee

This ratio measures the average remuneration per employee. A high ratio means high returns to individual workers and vice-versa.

iii. Unit Labour Cost (in Percent)

Unit Labour Cost is the ratio of (Remuneration / Total Output) * 100. A high ratio indicates large portion of labour cost in the total input and reflects employment of skilled and/or experienced workers, excessive overtime, reworks and high labour intensity and vice versa.

(<http://epzdanet.intnet.mu>)

2.4.3.3.2 Corporate or company wide measures

Total Shareholder Return (TSR), Total Business Return (TBR), and Economic Value Added (EVA) are used as a corporate or company wide measures in the value based management framework. A short description of these measures will be provided below:

i. Total Shareholder Return (TSR)

This represents the change in capital value of a listed/quoted company over a 1 year period, plus dividends, expressed as a plus or minus % age of the opening value. Due to its nature, **TSR** cannot be calculated at divisional (Strategic Business Unit) level and below. And also due to its nature, **TSR** cannot be observed for privately held companies. **TSR** can be easily compared from company to company, and benchmarked against industry or market returns, without having to worry about size bias (**TSR** is a percentage).

ii. Total Business Return (TBR)

This is a forward-looking measure of Cash Flow Return over Investment. **TBR** was designed

to emulate the way capital markets determine TSR. In this way one is able to 'use' **Total Business Return** also for an internal business unit, division, project or strategy. Unlike EVA it is a long-term performance measurement tool. TBR can be calculated at divisional (Strategic Business Unit) level and below and can even be observed for privately held companies.

TBR= Terminal Value End of Period - Gross Cash Investments Begin of Period + Gross Cash Flows in the In-between Period.

(<http://www.valuebasedmanagement.net>)

iii. Economic Value Added (EVA)

B. Stewart (2002) explains what EVA is in the following way. EVA is the trademark of Stern Stewart & Co., US consultants. EVA is the financial performance measure that comes closer than any other to capturing the true economic profit of an enterprise. EVA also is the performance measure most directly linked to the creation of shareholder wealth over time.

$$\text{EVA} = \text{Net Operating Profit after Tax (NOPAT)} - (\text{Capital} * \text{Cost of Capital})$$

Put most simply, EVA is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise. As such, EVA is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return those shareholders and lenders could get by investing in other securities of comparable risk.

As Stewart (2002) (from www.sternstewart.com) further explains the capital charge is the most distinctive and important aspect of EVA. Under conventional accounting, most companies appear profitable but many in fact are not. As Peter Drucker put the matter in a *Harvard Business Review* article, "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources...until then it does not create wealth; it destroys it." EVA corrects this error by explicitly recognizing that when managers employ capital they must pay for it, just as if it were a wage.

By taking all capital costs into account, including the cost of equity, EVA shows the dollar amount of wealth a business has created or destroyed in each reporting period. In other words,

EVA is profit the way shareholders define it. If the shareholders expect, say, a 10% return on their investment, they "make money" only to the extent that their share of after-tax operating profits exceeds 10% of equity capital. Everything before that is just building up to the minimum acceptable compensation for investing in a risky enterprise.

Stern Stewart developed EVA to help managers incorporate two basic principles of finance into their decision-making. The first is that the primary financial objective of any company should be to maximize the wealth of its shareholders. The second is that the value of a company depends on the extent to which investors expect future profits to exceed or fall short of the cost of capital. By definition, a sustained increase in EVA will bring an increase in the market value of a company (Stewart, 2002).

EVA has also the advantage of being conceptually simple and easy to explain to non-financial managers, since it starts with familiar operating profits and simply deducts a charge for the capital invested in the company as a whole, in a business unit, or even in a single plant, office or assembly line. By assessing a charge for using capital, EVA makes managers care about managing assets as well as income, and helps them properly assess the tradeoffs between the two. This broader, more complete view of the economics of a business can make dramatic differences (Stewart 2002).

2.4.3.3.3 Key Ratios as performance indicators

i. Profitability Ratios

These ratios tell us whether a business is making profits - and if so whether at an acceptable rate. The key ratios are:

Ratio	Calculation	Comments
<i>Gross Profit Margin</i>	$\frac{[\text{Gross Profit} / \text{Revenue}] \times 100}{\text{percentage}}$	This ratio tells us something about the business's ability consistently to control its production costs or to manage the margins its makes on products its buys and sells. Whilst sales value and volumes may move up and down significantly, the gross profit margin is usually quite stable (in percentage terms). However, a small increase (or decrease) in profit margin, however caused can produce a substantial change in overall profits.
<i>Operating Profit</i>	$\frac{[\text{Operating Profit} / \text{Revenue}] \times 100}{\text{percentage}}$	Assuming a constant gross profit margin, the operating profit margin tells us something about a company's ability to control its

Margin (expressed as a % age) other operating costs or overheads.

Return on capital employed ("ROCE") Net profit before tax, interest and dividends ("EBIT") / total assets (or total assets less current liabilities) ROCE is sometimes referred to as the "primary ratio"; it tells us what returns management has made on the resources made available to them before making any distribution of those returns.

ii. Efficiency ratios

These ratios give us an insight into how efficiently the business is employing those resources invested in fixed assets and working capital.

Ratio	Calculation	Comments
Sales / Capital Employed	Sales / Capital employed	A measure of total asset utilisation. Helps to answer the question - what sales are being generated by each pound's worth of assets invested in the business. Note, when combined with the return on sales (see above) it generates the primary ratio - ROCE.
Sales or Profit / Fixed Assets	Sales or profit / Fixed Assets	This ratio is about fixed asset capacity. A reducing sales or profit being generated from each pound invested in fixed assets may indicate over capacity or poorer-performing equipment.
Stock Turnover	Cost of Sales / Average Stock Value	Stock turnover helps answer questions such as "have we got too much money tied up in inventory"? An increasing stock turnover figure or one, which is much larger than the "average" for an industry, may indicate poor stock management.
Credit Given / "Debtor Days"	(Trade debtors (average, if possible) / (Sales)) x 365	The "debtor days" ratio indicates whether debtors are being allowed excessive credit. A high figure (more than the industry average) may suggest general problems with debt collection or the financial position of major customers.
Credit taken / "Creditor Days"	((Trade creditors + accruals) / (cost of sales + other purchases)) x 365	A similar calculation to that for debtors, giving an insight into whether a business is taking full advantage of trade credit available to it.

iii. Liquidity Ratios

Liquidity ratios indicate how capable a business is of meeting its short-term obligations as they fall due:

Ratio	Calculation	Comments
<i>Current Ratio</i>	Current Assets / Current Liabilities	A simple measure that estimates whether the business can pay debts due within one year from assets that it expects to turn into cash within that year. A ratio of less than one is often a cause for concern, particularly if it persists for any length of time.
<i>Quick Ratio (or "Acid Test")</i>	Cash and near cash (short-term investments + trade debtors)	Not all assets can be turned into cash quickly or easily. Some - notably raw materials and other stocks - must first be turned into final product, then sold and the cash collected from debtors. The Quick Ratio therefore adjusts the Current Ratio to eliminate all assets that are not already in cash (or "near-cash") form. Once again, a ratio of less than one would start to send out danger signals.

iv. Stability Ratios

These ratios concentrate on the long-term health of a business - particularly the effect of the capital/finance structure on the business:

Ratio	Calculation	Comments
<i>Gearing</i>	Borrowing (all long-term debts + normal overdraft) / Net Assets (or Shareholders' Funds)	Gearing (otherwise known as "leverage") measures the proportion of assets invested in a business that are financed by borrowing. In theory, the higher the level of borrowing (gearing) the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends. However, gearing can be a financially sound part of a business's capital structure particularly if the business has strong, predictable cash flows.
<i>Interest cover</i>	Operating profit before interest / Interest	This measures the ability of the business to "service" its debt. Are profits sufficient to be able to pay interest and other finance costs?

Source: from http://www.tutor2u.net/business/accounts/main_ratios.htm

Value based management has to consist of more than diagrams in order to be effective. The key benefits of its introduction come when such frameworks are developed further to confirm and display the linkages between the agreed key performance indicator targets and the strategic goals. These cause effect linkages are a key feature of the balanced scorecard and can be used to embed real understanding of the value drivers through out the hierarchy. How much value does improving our key performance indicator on stock levels create? How much do we need to increase margin to achieve our economic profit and total business value goals? How much value will we derive from an improvement in the rate of order fulfilment? These are some of the questions that should be asked and answered in a value based management culture.

Analysis of this sort should result in clear decisions and action plans. It should enable the levels of achievement required to be embedded into the business, by establishing value based objectives for functions, processes, teams and individuals. This should result in greater levels of confidence that, if everyone achieves their objectives' the benefits will flow form the drivers of value up to improved total business value (Warner and Hennell, 2001).

2.4.4 Compensation

For an effective value based management program to be fully implemented within a company, you need to incentivize to link your compensation system to value creation. The linkage of remuneration to value creation will promote a culture of performance and ownership that rewards shareholder value maximization and empowers employees to manage the business as if it were their own. Such a system will ensure that interests of shareholders and employees are aligned (Black, et al, 2001).

According to Knight (1998) a company faces a real problem when:

- Compensation does not support the business strategy,
- Excellent performance is worth little more than average performance, and
- Pay packages are designed as one size fits all.

The lack of an apparent connection of compensation to the business strategy means the company is foregoing the opportunity to use pay as a way to focus employees on the results the company is trying to achieve.

In most companies labour is a large portion of the value added in companies. If companies don't offer better incentive compensation opportunities to their excellent employees, it is no wonder if that star performers are attracted to smaller more entrepreneurial companies that will recognize their contribution. Not only this, there will not be any motivation for all employees to be creative and responsible for achieving more.

The one-size fits all approach to compensation design assumes that all participants value the pay elements equally. Different people have different needs and can attach vastly different values to pay package elements. A one size fits all design does nothing to respond to the individual needs of the employees and misses the opportunity to construct categories or pay package differentiation by group that better meet the needs of both the company and the employee.

Knight further explains that Incentives have little meaning without the link to strategy. When linked to strategy, the incentives become part of the strategy's implementation. To build the link between business strategy and incentive pay, you must first establish the link between strategy and performance measures. Only then could be begun to develop the link between strategy and incentive pay using the performance measures to capture the results. A set of performance measures that correctly measures the strategy is an invaluable and necessary tool in an effective strategically driven compensation program.

According to Knight Senior management will want to begin with an understanding of the principles for the compensation strategy. One example of how the principles can be applied is as follows:

- Encourage innovative thinking and approaches to the business.
- Reward contribution, not entitlement or seniority/tenure.
- Encourage team-based behaviour.
- Provide line of sight to the team/individual.
- Focus on value based metrics.
- Recognize how each business unit contributes to value.
- Build an ownership mentality throughout the company.
- Develop an overall program with creditability.

Based on the principles described above it is possible to develop directional implications for compensation strategies as it is seen below.

Compensation principles and direction

Compensation Principles	Directional Implications
<ul style="list-style-type: none"> ◆ Encourage innovative thinking and approaches to the business and to pay ◆ Reward for contribution, not entitlement or seniority/tenure ◆ Provide line of sight to the team/individual ◆ Encourage team-based behaviour ◆ Focus on value-based metrics ◆ Build a leveraged pay system ◆ Build ownership mentality throughout the company (at the appropriate level) ◆ Develop an overall program with credibility and organization confidence 	<ul style="list-style-type: none"> ◆ Non-traditional approaches to pay ◆ Flexible systems (respond to change) ◆ Pay for the person, not the job ◆ Non hierarchical base pay structures ◆ Performance-driven pay mix ◆ Flexibility to fund/allocate incentives at the most appropriate level (Enterprise, Business Unit/country, business within Business Unit, working teams, individual) ◆ Explicitly reward integration contributions ◆ Performance measures that drive enterprise value (total shareholder return, EVA@/CFROI) ◆ Emphasis on variable pay elements <ul style="list-style-type: none"> - Extraordinary pay for extraordinary performance - Below-average pay for below-average performance ◆ Extension of variable pay throughout the organization (management incentives, team incentives, gain sharing, etc.) ◆ Simple and understandable ◆ Open communication ◆ Objective

Source: J.A. Knight, 1998

2.4.5 Value communication

This is essential for people to understand value creation and discover how the decisions they make influence the amount of value created. Communication explains what value based decision making is and is not. You can think of communication as the ongoing process of education where the education programs themselves are discrete events. Internal communication is both an opportunity to speed implementation and a tool to improve results during implementation.

Knight (1998) proposes four Rs for a communication program to be successful:

- Repetition.
- Reinforcement.
- Reception.
- Redundancy.

One-shot messages won't do it. A successful communication program requires the message to be *repeatedly* delivered. Just as in advertising, you need repetition to build awareness. The same is true for the value program. Say it once, say it twice, then say it again.

Periodic *reinforcement* is essential for successful communication. Ideally, periodic reinforcement becomes part of the management process, which accomplishes two things. First, managers receive the periodic reinforcement necessary to continue building the understanding necessary to use value concepts in their daily decision-making process. At the same time, the management processes are reinforcing the focus on value.

One of the success factors required for effective communication is how well the value concept is taught to and received by the manager. Without sufficient training, the manager will not be able to use the concept for the decisions he or she must make. Only when the application of value concepts is clearly defined, reinforced, and thoroughly re-viewed, can the manager make intelligent decisions. This is accomplished by translating the language of value into the language of operations.

Redundancy means putting the concepts of value into as many of the company's activities as possible. Redundancy will enhance the communication effort by increasing the number of times the manager is exposed to value concepts and their, application.

When it comes to implementation, it is hard to over-communicate the purpose, intent, and strategies for value- based decision-making. The greater the internal communication, the faster the implementation, and constructing a good communication program can be an indispensable tool for better implementation. Internal communication should start with each of the key management processes and then branch out into the operating decision-making. Internal communication in planning involves stating goals clearly and providing direction. As business plans are completed, the iterative communication involved in the planning process should emphasize the value consequences of the business plan.

2.5 Conclusion

The value of a company is the present value of the expected sequence of future cash flows the company will generate for the owners. Mathematically, $Value = \sum \text{Cash flow}/(r-g)$.

The value of a firm is composed of four components. The first is the firm's capacity to generate cash flows from assets in place, where higher cash flows give rise to higher value. The second is the firm's willingness to reinvest to create future growth, and the quality of these reinvestments. Other things remaining equal, firms those reinvest well and earn significant excess returns on these investments will have higher value. The third is the length of the asset, project or firm lifetime. Assuming the same cash flow the longer the asset life is the more the asset value. The final component of value is the cost of capital, with higher costs of capital resulting in lower firm values.

To understand value creation one must use a long-term strategic point of view, manage all cash flows on the income statement and the movements on the balance sheet, and one must know how to compare cash flows from different time periods on a risk adjusted basis. It is therefore impossible to make good decisions without complete information, and there is no performance metric other than value that uses complete information, and this is the main reason why management needs to focus on value management mind set.

The creation and enhancement of value goes through certain processes. These are the establishment of corporate value strategies and goals, identifying value drivers, focus on future oriented performance measurements, link compensation with value creation of the company, and communicate the value concept through out the company. These five processes are critical. They ensure that the value link from customer to shareholder is created and solidified.

Corporate strategies define the businesses in which they are competing; they map the course for creating value across a portfolio of companies. There has to be a very close link between the strategies the firm intends to follow, with creation of shareholder value. Unless Shareholder value is integrated into the strategy development process, a company is unlikely to meet the long-term challenge of creating value with customers and delivering it to investors.

Strategy is too general for a firm to limit its measurement upon it. Value drivers help make the strategy real at a level of specificity that is both meaningful and actionable. These operating value drivers define the strategy to people in the organization and ultimately lead to behaviour changes. According to Rappaport's frame work there are 'seven value drivers': Sales growth, Operating profit margin, Income tax rate, Fixed capital investment, Working capital investment, Cost of capital, and Value growth duration. Whatever actions stepped by the business management either directly or indirectly affects positively or negatively in creating and enhancing value to the firm.

From the available various performance measurements, choosing which of the measures is right for your company is an important activity that can make an enormous difference in the way decisions are made. Indeed no one measure can be a fit for all measurements. In choosing a particular measurement technique four factors should be taken into consideration: Accuracy, Complexity, Correlation, and Strategic fitness. The selected performance measures should provide managers in the organization with guidance and support for good decision-making.

For an effective value based management program to be fully implemented within a company, the company needs to incentivize to link its compensation system to value creation. The linkage of remuneration to value creation will promote a culture of performance and ownership that rewards shareholder value maximization and empowers employees to manage the business as if it were their own. Such a system will ensure that interests of shareholders and employees are aligned.

Communication explains what value based decision making is and is not. You can think of communication as the ongoing process of education where the education programs themselves are discrete events. Knight (1998) proposes four Rs for a communication program to be successful: Repetition, Reinforcement, Reception, and Redundancy. Only when the application of value concepts is clearly defined, reinforced, and thoroughly re-viewed, can the manager make intelligent decisions. This is accomplished by translating the language of value into the language of operations.

CHAPTER THREE: Company Performance as Derived From Annual Financial Statements

3.1 Introduction

The objective of this study is to know the value drivers of the company, evaluate to what extent the company is creating or destroying value, and to evaluate what the Company managers are doing in enhancing value for the company. The data for the first and third objectives is collected using a questionnaire, and for the second objective the annual financial statements of the company is used. This chapter will be dealing with the second objective that is an evaluation of whether the company is creating or destroying value both in single and multi- period time. Even though the financial statements will be the main source documents for this objective, on certain occasions when the responses from the questionnaire and other secondary sources are found to be relevant to support the findings they will be used as necessary. The financial statement of the company, where every financial data are drawn from is attached as an Appendix (A1-A6). Appendix A4-A6 statements are not reproduced as they were found but summarized from the available various documents systematically by the researcher.

3.2 Environmental Situation

Industrial development in Eritrea began during the Italian colonial period (1890 to 1941), when a large number of firms were established in light manufacturing (food and beverages) and construction materials (cement, brick, and tiles) (Cotton, et al, 2002).

Ethiopian Emperor Haile Selassie annexed Eritrea in 1962, which started the war for independence and caused a decline in industrial production. Despite the nationalization of assets in the mid-1970s under the socialist Derg regime (1974 to 1991), Eritrea still accounted for 30 percent of Ethiopian industrial production and was one of the most industrialized areas in East Africa. It is clear today that some of the commercial and industrial skills endured these phases of relative idleness (Cotton, et al, 2002).

The three-decade long battle for independence left farmland and infrastructure devastated in the early 1990s. An estimated 80 percent of the country's infrastructure had been destroyed (Bruchhaus and Mahreteab 2000). After a referendum, the country proclaimed independence

on May 24, 1993. Just a few years into the new nation's life, however, war resumed with Ethiopia in May 1998. A peace agreement was signed in Algiers in June 2000. Both sides have agreed to a border decision made by an independent Boundary Commission in The Hague in April 2002, and the physical demarcation is still in process (Cotton, et al, 2002).

Firms require a stable macroeconomic environment to lower risk and facilitate long-term financial, employment, and investment decisions. After independence, the Government of Eritrea (GOE) was quite successful in stabilizing most major macroeconomic indicators. However, many of the gains in macroeconomic stability achieved during the early years of independence were reversed during the border war. Regaining this ground will take much longer than did the initial stabilization, partly due to a continued perceived military threat from Ethiopia and partly because Eritrea's room for maneuver is now much smaller than during the post independence stabilization (Cotton, et al, 2002).

3.2.1 GDP Growth

According to Cotton, et al (2002) survey report, GDP growth averaged 7.4 percent from independence in 1993 through 1997. The border war disrupted this growth, which dropped to 0.3 percent in 1999 and became negative 11.9 percent in 2000. Growth resumed in 2001, led by recovery of agricultural production. The manufacturing sector expanded by about 50 percent from 1993 to 1997, according to rough estimates compiled by the International Monetary Fund. Then the manufacturing sector was largely stagnant during the war years 1998–2000, and most likely a large percentage of that production was related to war efforts. The private sector has tended to concentrate on services, namely imports and distribution. Manufacturing sector growth has begun to pick up slightly in 2000 and 2001. Although the manufacturing sector constitutes a small percentage of GDP, the Government of Eritrea emphasized developing it because it is central to the strategy of growth through exporting labor-intensive light manufacturing.

3.2.2 Inflation

Inflation, which was traditionally low in Eritrea (and previously in Ethiopia), was brought firmly into the single-digit range by 1996–1997. During the war years (1998–2000), inflation (end-year to end year) averaged 15.5 percent, peaking at 26.8 percent in 2000. A large part of the increase during this period was due to food price inflation spurred on by the disruption of

agricultural production, due to the Ethiopian invasion of the western lowlands in May 2000. The inflation rate then started to come down, falling to an annual rate of 7.7 percent by the end of 2001. While there are no firm numbers yet available for inflation during 2002, it would be surprising if it has not moved back into double-digit range, given the continued high defense expenditures, slow progress on demobilization, problems with financing with some of the donors, and problems on the border with Sudan (Cotton, et al, 2002).

3.2.3 Exchange Rate

In 1997, the dual exchange rate (Exchange rate of both countries, Eritrea and Ethiopia) was unified, and the Bank of Eritrea was established. This was also the year that the new currency, the Nakfa, was introduced, on par with the Birr. By early 1998, the exchange rate was stable, backed by reserves that reached nearly 5 months' of imports of goods and services, and 15 foreign exchange bureaus were trading foreign exchange.

During the war, the government kept the nominal exchange rate from depreciating in line with inflation and the real exchange rate appreciated. The parallel market for foreign currency began expanding. By 2000, foreign exchange was being rationed, pushing the black market rate to as much as twice the official rate. While this gap was significantly reduced for a while during 2001, the foreign exchange premium grew again during 2002 and was in the 60–70 percent range by October 2002 (although in an admittedly thin and volatile market). It is likely to be a harbinger of renewed inflationary pressures (Cotton, et al, 2002).

3.3 Company Background

Red Sea Bottlers Share Company was established in 1964 as the National Soft Drinks Corporation in Eritrea. It started operation using second hand machinery and produced Coca-Cola, Sprite, Fanta, Orange, and Fanta Tonic. It was nationalized in 1975 and due to the inefficient management of socialist regime during 1975-1991 sales declined. Despite its popular brand name employees were not motivated to use their creativity to change their job and the company as a whole to increase sales and profit margin. Besides due to the political situation the Ethiopian regime that was governing in those years was not investing in the company to renovate and maintain the old machinery. After independence the government rehabilitated the factory and resumed production, but the obsolescence of machinery and distribution tracks were causing problems. In January 1997, the government of Eritrea and the

Coca-Cola Company entered into a joint venture, creating a new company under the name of Red Sea Bottlers Share Company. Since then US\$ 13 million has been invested to build a completely new bottling facility, making it one of the most modern Coca-Cola factories in Africa. The new bottling line has a production capacity of 8,000 cases per day in comparison to the 1,500 cases produced by the old bottling line. The factory also added a new product-line, Krest. The company employed 175 persons in 1997. The Government of Eritrea is a majority (55%) shareholder in the joint venture.

The company has been producing Coca-Cola, Fanta, Sprite and Fanta Tonic for more than thirty years. Coca-Cola sales are the major source of revenue of the company. Recently the company has introduced two new products known as Krest Soda Water and Krest Tonic water to increase sales. However, consumers are not accustomed to these new products and though it is at its early stage, customers' demand for these new products is lukewarm (Hailemariam, 2001).

3.4 Value of the company

Value of a company is the present value of the expected sequence of future cash flows the company will generate for the owners. This is mathematically expressed as:

$$\text{Value} = \sum (\text{cash flows})_t / (1+r)^t$$

For infinite period (perpetuity) with growth

$$\text{Value} = \sum (\text{cash flows}) / r-g$$

Where, **t** is the number of future years, **g** is the growth rate, and **r** is the discount rate.

3.4.1 Cash flow to the firm

The cash flow needed to compute the value of the company should have been the forecasted future expected cash flow. As the researcher was not able to find such data in the company an attempt will be made to draw a meaning on historical data found that have a sustainable trend.

Due to the huge investment the company incurred in the year 1997 it could be assumed as if the company has started its operation on this year, year of privatization and the establishment

of joint venture. Invested Capital of 1996 was only 28 million in Nakfa and in 1997 it jumped to almost 131 million Nakfa and about 214 million in the year 2001. This is a phenomenal change that could lead us to focus on the performance of post privatization and especially the years 1999-2001 which have a relatively sustainable trend and where the researcher has able to get pertinent data for computing the cash flow.

As a result of the major investment incurred in the year 1997 the company's capital spending becomes so low relative to depreciation expense in the years 1999-2001. This is because the major investment is so soon for the company to incur additional expenditures again. This condition has resulted in generating very high cash flows in these particular years compared to profit of the company for the same years. As years passed capital expenditures both for maintenance and new investments will be required to sustain the assets life, therefore it is less likely to assume the perpetuating of these cash flows for the life of the company. In spite of this fact because the researcher was not able to get the normalized cash flows that could nearly estimate the value of the company he is using the average cash flows of these three years as the company's sustainable cash flows.

Table 3.1 Annual cash flows in Nakfa

Year	2001	2000	1999
Profit after tax before interest	11,003,055	6,164,726	1,855,227
Add annual depreciation	12,902,437	11,491,340	12,302,482
Less Capital Spending	5,383,968	7,558,041	2,705,203
Less Change In Stock	56,443	9,198,567	-3,995,418
Annual Cash Flow	18,465,081	899,458	15,447,924

Source: Ministry of trade and industry

Note: Nakfa is an Eritrean country currency

The annual cash flows for the years 1999-2001 are exhibited in Table.3.1. And the average of these cash flows = $(18,465,081 + 899,458 + 15,447,924)/3 = 11,604,154$

3.4.2 Expected Growth

The expected growth in operating income is a product of a firm's reinvestment rate and the return on the capital invested.

Table 3.2 Returns and retained earnings of the company for the years 1997-2001 in Nakfa

Year	2001	2000	1999	1998	1997
Profit after tax and interest	10,441,872	5,856,490	1,762,466	(1,963,446)	3,117,007
Retained Earnings to date	19,214,389	8,772,517	-	-	-
Unappropriated profits to date	-	-	2,916,027	1,153,561	3,117,007

Source: Ministry of trade and industry and other researcher's document collected from the company (anonymous).

As it is depicted on Table.3.2 the company is investing all its return in the company. In other words there is no any payment made to the shareholders in any form. Thus it can be assumed that the reinvestment rate is 100%.

Return on the capital invested can also be drawn from the financial statement and is exhibited below.

Table 3.3 Return on Invested Capital in Nakfa and Growth Rate

Year	2001	2000	1999
Profit before interest and tax	18,664,394	12,548,281	5,144,088
Equity Capital	140,815,593	129,824,149	123,856,656
Long term liability	-	-	-
Current Liabilities	73,569,869	55,996,049	45,293,130
Invested Capital	214,385,462	185,820,198	169,149,786
Return on Invested Capital (RIC)	5.5%	3.4%	1.4%
Sustainable Growth rate	5.5%	3.4%	1.4%

Source: Ministry of trade and industry and other researcher's document collected from the company

Note: Invested Capital = Capital/ Equity + Long term Liability + Short Term Liability

RIC = Return (Profit before interest and after tax) divided by Invested Capital

Growth rate = reinvestment rate (retention rate) * Return On Invested Capital

As it is revealed in Table 3.3 Return on capital and growth rate are increasing.

The Country's economic growth according to Cotton (2002) survey report on the stable condition was 7.4%. It is believed that any firm's growth after the high growth time horizon will not be greater than the Country's economic growth. If in the early stage the firm showed

higher growth rate than the economy the use of two-stage valuation method would be advisable. But the firm's average growth rate of the years 1999-2001 is only 3.4% that is much less than the prevailing economic growth. Therefore it is the researcher's assumption to use this figure as a sustainable growth rate for the company in computing its value.

3.4.3 Discount rate

The cost of capital (Weighted Average Cost of Capital-WACC) is a composite cost of financing that reflects the costs of both debt and equity, and their relative weights in the financing structure. The WACC is an expression of what return a company must earn if it is to justify the financial assets it uses, in other words the opportunity cost of the assets in use. The cost of capital used for Red Sea Bottlers Share Company is an estimate of consultants in Eritrea. There is no capital market and thus, computation of cost of capital using the usual methods of capital asset pricing model and others are not possible. The consultants use the banks' lending rate as a proxy and adjust it for industry risk in evaluating cash flows. The industry-lending rate of banks in Eritrea to state-owned enterprises is 8.5% [IMF, 1998] and then they add additional risk premium depending on the industry. The cost of capital estimate of the beverage industry is 9%. In addition, the financial manager of the company was consulted whether he thinks this rate is excessive or too low (Hailemariam, 2001).

The discounting rate is so crucial in the computation of value for the company. The estimation of the company's Discounting rate used by the consultants doesn't have any scientific background. To date the major valuation methods used in computing Cost of Capital are the Capital Asset Pricing Model and Dividend Model. None of them is used in this estimation, and there is no way for the researcher to estimate the cost of capital using these Models for the same reason mentioned above. But looking at the risk profile of the company may help in reaching at certain conclusion. If we see the business risk of the company it is almost stable; it doesn't have any cyclical problem. Because its products are a kind of necessity they are consumed regardless of the customers' financial position. To the surprise of all, even in the past three wartime years the company was able to sell its products at a profit. Furthermore the company is a monopolist company and it has an opportunity to allocate its price that could result an acceptable profit. Besides if we turn back to its financial risk the company doesn't have solvency problem, this could be justified looking its cash flow statement depicted in Table 3.1. In all the three years (1999-2001) the company has shown positive cash flows. Moreover, the company's unemployment of long-term liability minimizes its financial risk.

Due to this less risk position of the company the additional risk premium allocated to the company may be assumed as a reasonable rough estimate in computing the discounting rate. Therefore the researcher is comfortable with the existing cost of capital to use it as a rough estimation for discounting cash flows of the company.

3.4.4 Asset Life

The fourth element of the value of the company is its asset life. Through renovations and regular maintenances the life of the asset or the company is assumed to remain for infinite time.

The above elements of value are narrow and limited to give as an accurate estimate of the firm's value. But for deriving some meaning a rough estimation could be computed using the average cash flow and average growth rate as sustainable cash flows and growth rate for the infinite period of time.

Calculation of Value

$$\text{Value} = \frac{\sum(\text{cash flows})}{r - g}$$

$$\begin{aligned} \text{Cash flow} &= \text{average of the annual cash flows} = (18,465,081 + 899,458 + 15,447,924) / 3 \\ &= \text{Nakfa } 11,604,154 \end{aligned}$$

$$\begin{aligned} \text{Sustainable Growth rate} &= \text{average growth rate of the years from 1999 on words.} \\ &= (5.5\% + 3.4\% + 1.4\%) / 3 \\ &= 3.4\% \end{aligned}$$

$$\text{Discount rate} = 9\%$$

$$\text{Asset life} = \text{infinity}$$

$$\text{Value} = 11,604,154 / (0.09 - 0.034) = 11,604,154 / 0.056$$

$$\text{Value} = \text{Nakfa } 207,217,036$$

$$\text{Invested Capital} = \text{Nakfa } 169,149,786$$

$$\begin{aligned} \text{Total Business Return} &= 207,217,036 - 169,149,786 \\ &= \text{Nakfa } 38,067,250 \end{aligned}$$

3.5 Performance measurement

Measures of performance have a role to play in the process of value creation and enhancement. If a company is using a measurement performance which couldn't capture the business realities decisions made on these results may definitely lead to a wrong direction.

Therefore choosing the right measure for a company is one of the crucial points in making a sound decision in planning and allocating resources of the company which eventually affect directly or indirectly value of the company. To know what performance measurement tools Red Sea Bottlers Share Company is using at present six questionnaires were distributed to the General Manager and the other five division managers. All of them have checked all the measurements used by the company in the questionnaire from the given multi choice type of question. Taking the field of specialization into consideration it is the researcher's assumption to take the responses stated by the financial manager. According to him the following measurement tools are used in the company:

- Profit Before Interest and Tax
- Net Income after interest and tax
- Earning Per Share
- Return On Total Assets
- Return On Capital Employed
- Cash flow Analysis
- Return On Equity

As it can be clear from the above lists of single period value measurements, Economic Value Added or its proxy Shareholder Value Added tools are not used in the company.

3.5.1 Choosing performance measurements

In choosing a particular measurement technique the following factors should be taken into consideration.

3.5.1.1 Accuracy of measurement techniques

Over the years 1999-2001 Red Sea Bottlers Share Company annual capital spending is much less than its annual depreciation (see Table 3.1). This kind of situation has led the company to generate cash much more than its annual earning as discussed in the preceding section. From this capturing the annual earning seems to be relevant. Besides, the company is a capital-intensive company. Hence a return over investment measure may make more sense than an income measure to capture the returns on the capital invested in the business. Moreover, the company spent large amounts for renovation and maintenance in the year 1997. The result of this investment is not seen early. Thus strategic measures become important when business measures do not lend themselves to single period financial performance measures. One of the financial strategic measures (measure at a point in time of multiple periods) is Total Business Return of the business (multi period discounting cash flow).

On top of that as a matter of fact investors must be guaranteed to gain their required rate of return. In addition to all measurements taken from the time the company has got out of its early stage a single period measure of value must be incorporated into the business. One of the single period measures of value is Economic Value Added. Economic Value Added measure may be selected as a single value measure technique to Red Sea Bottlers Share Company which could help the business to clearly show whether it created value or not on a single period basis. When the single period return surpasses the required rate of return (cost of capital) the company would create value and vice versa.

3.5.1.2 Complexity of the measurement

As per the response collected from the financial manager a return measure and Cash Flow analysis are already used in the company. As EVA is not more complex than the two measures assuming the company has an estimate of its financing cost (Cost of capital), for this measure is almost similar with return measures except this incorporates the cost of capital as its part, it is recommended for the company to introduce this value based measurement technique to see whether it is creating or destroying value on a regular basis.

3.5.1.3 Correlation of the measurement

The main criteria in selecting performance measurement tool for a given company should be the shareholders interest. The success of a performance measurement system at tracking and consistently reflecting shareholders interests demonstrates how well it achieves this objective. The selected measurement tools, mainly the single and multi period value measurement tools are one of the main popular value based management techniques recommended in keeping the interest of the owners of the company. This is because they incorporate the cost of capital as the main part of their measurement component. If any investment return is found less than the return required by the owners the decision will not be viable and vice versa.

3.5.1.4 Company and strategic fitness of the measurement

Measurement tools in the company should take into consideration the company's focus on growing to have a strategic fitness. When the business strategy calls for growth while the performance measures focus on improved return, the inherent conflict between the two messages will undermine the effectiveness of the business strategy. Red Sea Bottlers Share Company has already invested a huge capital in maintaining and renovating itself. Therefore measurement techniques selected must reflect and go with its existing strategy. The return

measures and the value measures (Both the single period and multi period) may be helpful in capturing the business economics that go parallel with the business strategy.

3.5.2 Value based management framework

Value based management framework (see Fig. 2.5) as it is discussed on the second chapter, is an expansion of Rappaport's value drivers framework. This framework makes the value drivers more clear and measurable both quantitatively and qualitatively, and accommodates customers and employees condition in the performance of the company. Hence an attempt will be made to see Red Sea Bottlers Share Company financial and non-financial performance measurements using the value based management framework.

3.5.2.1 Balanced Score Card (Non-financial Measure)

3.5.2.1.1 Customer Perspective

The customer perspective of the balanced scorecard focuses on how your customers view your business.

Hailemariam (2001:157) interview with managers of beverage industry revealed that not much is done to attract customers except in Red Sea Bottlers. The General Manager of Red Sea Bottlers in the interview stated that:

In 1994, we have visited our customers at their shops to enquire if they have complaints regarding our products and services. Our customers were amazed and told us that they did not see any producer who asks for comments. If a customer brings back to the factory any of our products unopened due to production defects such as dirt and others; we give the customer three bottles of soft drinks free and write him a letter of appreciation. We are also giving out as incentive refrigerators and light bulbs to our customer's demand. Now, since we are using new machinery, we will be able to provide our customers with the amount of soft drinks they request. We give attention to our customers.

According to Hailemariam (2001:157) the management of Red Sea Bottlers is selling Coca-Cola products to wholesalers and retailers at low price. However, the distributors are overcharging the final consumers. The company general manager stated: *the government of Eritrea is following a free market policy and thus, there is no restriction to what price our customers should charge on our soft drinks products. There is collaboration among the shopkeepers and they try to maintain their profit margin high. They do not like fair competition and if a person sells a soft drink at a lower price, all other shopkeepers ostracize*

him as a radical. Our aim is to make our products available, affordable, and acceptable to the customers. Due to this motto, we are planning to open kiosks and to place containers at different places in the city.

Red Sea Bottlers Share Company's goal to make its product *available, affordable, and acceptable* to the customers is the first step to see the company's intent to satisfy its customers. Further, whether the goal is really communicated to its end users can be seen from the price responsiveness, and product returns. Thus the increase in sales of the company from time to time may be taken as a good indication of its ability to retain its existing customers and attract new customers. All the initiatives taken by the company to attract its customers is to be encouraged and promoted.

As it is explained in the study of Hailemariam (2001), the company is having a problem with the wholesalers. The channel of distribution the company is pursuing is an indirect one, which is through the wholesalers. The end users don't have a direct contact with the company. That is why the distributors are getting a chance to impose their own price for the end users. Therefore, if the company is not able to distribute itself directly to the end users it must be able to change the existing atmosphere of the wholesalers using different motivational techniques. The free market policy should not be raised as an excuse for the management of the company to throw the responsibility on the wholesalers and the Government. Managerial capability lies on coping with the existing environment. One of the many things this company could bring the wholesalers in harmony with its policy is to give a frequent training to the major distributors, allow them to get a reasonable benefit, and give them an incentive on a regular basis could be mentioned. If an immediate action to resolve the problem is not taken, this problem can create a problem on the price responsiveness of end users, which ultimately impair sales of the company.

3.5.2.1.2 Financial Perspective

The next section of business plan describes the *financial resources* that will be required to operate your business and the sources of those funds. This is how a financial manager looks at the business. This section will be discussed in detail on the financial performance measures next to the balanced scorecard.

3.5.2.1.3 Internal Perspective

The third section of the business plan describes *internal processes*. This measure focuses on the internal process controls that in place to ensure that your business line functions smoothly. Red Sea Bottlers Share Company attempt to renovate the company may be considered a strategic move to make the company operation continue smoothly. How far the goal is achieved could be seen using the financial measures in the next sections.

3.5.2.1.4 Employee Perspective

The final section is about *employees* of the company. How far the company ensures continual professional development and growth of staff? Indeed, this is an opportunity for the company to sell the knowledge, flexibility, and commitment to improving the capabilities of its staff to its customer. How far the company invested on its employees could be analysed by number of skills/employees, revenue/employees, and innovations. An analysis of the company employees' condition will be seen using ratios such as labour productivity, average remuneration per employee, and unit labour cost.

i. Labour productivity

Labour productivity is the size of output generated by each employee of the enterprise. Red Sea Bottlers labour productivity (as seen in Table 3.4) for the years 1999, 2000, and 2001 are Nakfa 139,351, 186,557, and 252,632 respectively. The data shows that labour productivity of the employees is improving from year to year. This may indicate efficiency and /or marketing capability imbedded into the employees of the company.

ii. Remuneration per employee

This ratio measures the average remuneration per employee. A high ratio means high returns to individual workers and vice-versa. The labour cost per employee of the company as shown in Table 3.4 is increasing from year 1999 on wards with a large number. This high increase may indicate the appropriation of high returns to individual workers from year to year.

iii. Unit Labour Cost (in Percent)

In Table 3.4 it is revealed that the unit labour cost ratio is increasing from year to year. This increase may indicate the company's additional employment of skilled and/or experienced workers, excessive overtime, and/ or reworks.

Table 3.4 Employees Remuneration and productivity

	Years		
	2001	2000	1999
Remuneration in Nakfa	9,161,961	6,470,341	3,121,351
No of employees	367	357	337
Revenues in Nakfa	130,893,990	95,361,404	64,951,240
Production out put	92,716,055	66,600,833	46,961,290
Labour productivity in Nakfa	252,632	186,557	139,351
Labour Cost per Employee in Nakfa	24,964	18,124	9,262
Labour cost per output in percent	9.9%	9.7%	6.6%

Source: computed from financial statements found in Ministry of Trade and Industry.

Note: Numeration or labour cost doesn't include benefits given to employees.

Labour productivity = production output / no of employees

Labour cost per employee = Remuneration / no of employees

Labour cost per output in % = Remuneration / Production out put

From the data on Table 3.5 and 3.6 it can be understood that the ratio of temporary workers to permanent workers is 50%, 47%, and 47% for the years 1999, 2000, and 2001 respectively. And the ratio of temporary workers wages and salaries to permanent workers is 29%, 22%, and 27% for the years 1999, 2000, and 2001 respectively. There is a big gap between the ratio of the numbers temporary/permanent workers and their wages and salaries of them.

Table 3.5 Number of employees

Year	Number of employees			Total Number of employees
	Management staff	Support Personnel, Technical & production workers	Temporary workers	
1999	49	118	170	337
2000	59	129	169	357
2001	62	131	174	367

Source: Ministry of Trade and Industry

Table 3.6 Wages and salaries

Year	Wages and Salaries in Nakfa			Total wages and salaries
	Management staff	Support Personnel Technical and production workers	Temporary workers	
1999	828,272	1,302,656	890,423	3,121,351
2000	1,952,223	3,092,379	1,425,739	6,470,341
2001	2,505,667	4,224,326	2,431,968	9,161,961

Source: Ministry of trade and industry

Though the company has an advantage of reducing remuneration and some other benefits given to permanent workers there is a risk of retaining permanent skill to the company. In other words it would be difficult for the company to impart the necessary skill and expertise needed on the employees to sell knowledge and innovation to customers. Besides this large number of temporary workers may be a treat for the permanent workers in accepting whatever request the company asked them. In short because the bargaining power of employees for promotion, increasing wages and other benefits will be weakened due to the engagement of the large number of temporary workers, this could be a source of dissatisfaction for the permanent employees. Hence the company should be able to strike the balance between reducing its cost and keeping its permanent workers morale and retaining necessary skill and expertise for the company.

In general from the above ratios the trend of employees' situation seems to be improving in productivity, skill, and wages and salary. However the ratio of temporary workers to permanent workers seems to be large which eventually may hamper the value creation ability of the permanent workers of the company. Therefore it seems logical for the company to revise its policy of the employees' combination to keep the necessary skill, expertise and satisfied workers.

3.5.2.2 Financial performance measurements

In our discussion of the previous section we came to understand that Red Sea Bottlers selected performance measurement techniques to capture the economics of this business based on the selecting criteria-accuracy, complexity, correlation, and strategic fitness-for both multi period and single period are Return measures, Economic Value Added and Total Business Return metrics.

3.5.2.2.1 Total Business Return

In the first section of this chapter the Total Business Return of the company is roughly estimated to be **Nakfa 38,067,250**.

In Table 3.2 it is shown that the earning gained annually was reinvested in full. The 100% reinvestment rate increased the growth rate of the company. If the company changes its reinvestment policy, the growth rate will be affected. Let's for example assume that the reinvestment rate is 60%. The growth rate of the years 1999, 2000, and 2001 would be

0.6(0.014), 0.6(0.034), and 0.6(0.055) respectively. The average computation of these numbers would give rise to 2%. Substituting this number in the value formula would result -3,376,158. Thus the Total Business Return of the company became negative.

Table 3.7 sensitivity analysis for different reinvestment rates

		Sensitivity Analysis using different Reinvestment rates					
Return rates On Invested capital for their respective years		35%	40%	50%	60%	70%	80%
1999	1.4%	0.5%	0.6%	0.7%	0.8%	1%	1.1%
2000	3.4%	1.2%	1.4%	1.7%	2%	2.4%	2.7%
2001	5.5%	2%	2.2%	2.8%	3.3%	3.9%	4.4%
Average		1.2%	1.5%	1.7%	2%	2.4%	2.7%

Source: computed based on Table 3.3.

Note: the average shows an average growth rate, which is the result of the average rate return on invested capital multiplied by the reinvestment rate.

Using different growth rates an estimate of Total Business Return can be computed using the general formula of value.

Table 3.8 Total Business Returns for different Sustainable Growth Rates

Average Growth rates	1.2%	1.5%	1.7%	2%	2.4%	2.7%
(r-g)	7.8%	7.5%	7.3%	7%	6.6%	6.3%
Value of the cash flows	148,771,205	154,722,053	158,961,014	165,773,628	175,820,515	184,192,920
Invested Capital In Nakfa	169,149,786	169,149,786	169,149,786	169,149,786	169,149,786	169,149,786
Total Business Return	-20,378,581	-14,427,733	-10,188,772	-3,376,158	6,670,729	15,043,134

Source: Computed based on tables 3.1, 3.2 and 3.7

Assuming the cash flows are sustainable, and the return rate of the invested capital is in average 3.4% and the asset life is infinite the Total Business Return of the company for different reinvestment rates is shown on the above table. As it is shown in Table 3.8 the company creates value when reinvestment rate is greater than 60%. When reinvestment rate is 60% and less, the company destroys value and value of the cash flows less the invested capital gives rise to the negative result. Therefore in making decisions the company should be aware of its reinvestment policy in its effect of value creating or destroying to its investors. Growth rate has a great impact in the value of the company.

Certain observations are worth mentioning. On the general situation of the company's environment it is observed that the company is found under unstable condition with high inflation rate. The high inflation rate may have inflated the cash flows of the company where eventually inflate the value of the company.

On the other hand the unstable condition may have certain negative implications in producing and selling the product (further discussion of constraints for enhancing value is given in the next chapter). For example lack of foreign exchange and labour instability may have a negative impact in creating and enhancing value to the company. Thus in a stable condition the company could have improved its cash flows.

Table 3.9 Return on Invested Capital for the years 1993-1996

Years	1993	1994	1995	1996
Return On Invested Capital	25%	24%	23%	22%

Source: computed from the financial statement of the company

Another observation is its history before privatisation regarding return on investment as shown on Table 3.9. In the years 1993, 1994, 1995, and 1996 the company was earning high returns for a given invested capital. The company was creating value every year for the return is much greater than the required rate of return, 9%. In the time of post privatisation, though gross profits and operating profits are increasing annually with increasing rate, the return is decreasing highly when we compare it with pre privatisation annual performance. This is because of the unstable condition of the country and its great capital expenditure for renovating the company after it is privatised on the year 1997. When the returns divided to the large amount of capital the rate become so small. But it can be assumed that because the investment is on its infant stage it is more probable to believe that the company's return will grow higher and higher up to certain years. The trend shown on Table.3.3 may also support the argument for the company's return is increasingly growing. If the rate of return increases with the existing trend it is more probable to believe that the company will create value to its investors on an annual basis in the near future.

3.5.2.2.2 Economic Value Added

By taking all capital costs into account, including the cost of equity, EVA shows the Nakfa (Eritrean Currency) amount of wealth a business of Red Sea Bottlers has created or destroyed

in each reporting period. In other words EVA is a profit the way the shareholders of the company define it. The shareholders of this company for example expect 9% return on their investment, they make money only to the extent that their share of after tax operating profits exceeds 9% of cost capital. Everything before that is just building up to the minimum acceptable compensation for investing in a risky enterprise.

EVA = Net Operating Profit after Tax (NOPAT) – (Capital * Cost of Capital) Or

EVA = (Return on Capital Invested – Cost of Capital)* Invested Capital

Table 3.10 Economic Value Added of the Company's report

	2001	2000	1999
Invested Capital	214,385,462	185,820,198	169,149,786
ROA	9%	7%	3%
ROE	8%	5%	1%
RIC	5.5%	3.4%	1.4%
Cost of Capital	9%	9%	9%
EVA	-7,503,490	-10,405,931	- 12,855,384

Source: Computed from the financial statements of the company

ROA = Return On Asset (Profit before interest and tax divided by total Asset)

ROE = Return On Equity (Profit after tax and interest divided by total Asset)

RIC = Return (Profit before interest and after tax) divided by Invested Capital (computed from financial statement of the company)

Invested Capital = Capital/ Equity + Long term Liability + Short Term Liability (see table 3.3)

Economic Value added of the company for the given years are shown on Table 3.10 above. In all the years the company is destroying value. The reason for this, as it is explained in the preceding sections, is a result of high maintenance costs and high depreciation expense (as the result of high invested capital) and the country's unstable condition. As a result of high capital investment after privatisation it is expected to use a low asset utilisation in the early stage due to less coverage of its potential customers. By the time the company is able to extend its distribution channels nation wide in the customers' convenience, such as installing Vending machines in Schools and other strategic areas, sales will increase and its asset utilisation will also increase, which ultimately increases the return over invested capital. The history of the organisation can give us a further justification for strategy to create value. Up to the year 1997 the company was creating value with a large number. If we see Table 3.9 the return on investment for the years 1993-1996 is great. And the trend of its return, as it is seen in Table 3.10, in the years 1999-2001 is also promising. Therefore though at this stage the company is

destroying value due to the discussed reasons it is more likely to believe that in the near future the company will push its earning growth by increasing its asset utilisation.

While the company is creating value using the multi-period measurement technique, it is destroying value using Economic Value Added (single period) measurement technique. This may seem a puzzling phenomenon, but it is not. The company was able to draw a good amount of cash flow return on the years 1999-2001 as it is discussed in the section of '*cash flow of the firm*'. The annual cash flow return over invested capital can be calculated as follows.

Table 3.11 Annual Cash in Flow over Invested Capital

Years	2001	2000	1999
Cash flow in Nakfa	18,465,081	899,458	15,447,924
Invested Capital in Nakfa	214,385,462	185,820,198	169,149,786
Cash flow/Invested Capital	8.6%	0.5%	9.1%

Source: Computed based on tables 3.1 and 3.3

The annual cash flow return over the invested capital is shown in table 3.11. The average of these figures is 6.1%, which is almost double of the return (profit before interest and after tax) over invested capital (3.4%) depicted in Table 3.3. Besides, the multi-period measure incorporates the growth rate of the company. This growth rate increases the value of the company (by decreasing the denominator). Red Sea Bottlers cost of capital is 9% and less the growth rate (3.4%) equals 5.6%, which is less than the average cash flow return 6.1%. This is why the company is able to create value using the multi-period measurement technique.

From the above discussion it is clear to see that the company desperately needs to use a single period measurement technique that could accommodate the cost of capital. According to this study EVA is proposed to be supportive in knowing whether the company is creating or destroying value on a periodic basis. Indeed, the measuring instrument by itself is nothing but helps in identifying the problem of the company to come forth to the management's attention. The knowledge of value status on a regular basis is so crucial for the company to know where and how it is heading and therefore reconsiders its resource allocations to consistently create value

3.5.2.2.3 Other performance indicator ratios

i. Profitability Ratios

Profit margin: is the ratio of operating profit (earning before interest and tax) to sales. The company's profit margin can be calculated from the profit and loss statement.

Table 3.12 Operating profit and Profit Margin of the company in Nakfa

Years	2001	2000	1999	1998	1997
Turnover	130,893,990	95,361,404	64,951,240	23,685,662	24,679,789
Cost of sales	91,090,490	66,335,396	46,598,063		
Gross profit	39,803,499	29,026,008	18,353,177		
Operating expenses	21,139,105	16,477,727	13,209,089		
Profit before interest & tax	18,664,394	12,548,281	5,144,088	1,579,461	5,299,279
% age increase or decrease in profit	49%	144%	226%	-70%	
Profit Margin in % age	14%	13%	8%	7%	21%

Source: Ministry of Trade and Industry (The last two rows are computed from the given data)

Gross profit and Operating Profit, as shown in Table.3.12, has increased annually with a large amount from the year 1998 onwards up to 2001. Similarly, Profit margin has grown from the year 1998 onwards. This may show the company's increasing ability to control its production and operating costs.

Return on Asset: Return on Asset for the years 1997-2001 as it is shown on Table 3.13 is 4%, 1%, 3%, 7%, and 9% respectively. These shows what returns management has made on the resources made available to them before making any distribution of those returns. The increasing trend may show the management ability to use its resources more effectively.

Table.3.13 Financial Performance Indicators of the firm

	2001	2000	1999	1998	1997
Turnover	130,893,990	95,361,404	64,951,240	23,685,662	24,679,789
PBIT	18,664,394	12,548,281	5,144,088	1,579,461	5,299,279
NIAT	11,003,055	6,164,726	1,855,227	(1,963,446)	3,117,007
Equity Capital	140,815,593	129,824,149	123,856,656	122,001,429	114,021,460
Total Asset	214,385,462	185,820,198	169,149,786	153,565,797	130,699,965
ATO	61%	51%	38%	15%	19%
ROA	9%	7%	3%	1%	4%
ROE	8%	5%	1%	-2%	3%

Source: Ministry of trade and industry and other researcher's document collected from the company

ATO = Asset Turn Over (total turnover divided by total assets)

ROA = Return On Asset (profit before interest and tax divided by total asset)

ROE = Return On Equity (Net Income after tax divided by Equity)

PBIT = Profit Before Interest and Tax

NIAT = Net Income After Interest and Tax

ii. Efficiency Ratios

Asset Turn Over (ATO): The asset turn over of the years 1997-2001 as it is shown in Table 3.13 is 19%, 15%, 38%, 51%, and 61% respectively. This tells us that the company's sales generated by each Nakfa's worth of assets invested in the business. The data are showing an increasing trend, which is a good indication for the company's utilisation of its assets.

Stock Turn Over: The stock turn over shows to what extent the company has tied up cash in the form of stock. As it is shown in Table 3.14 the stock turn over is increasing from year to year. This shows that the company is improving its inventory management.

Table 3.14 Stock Turn Over of the Company annual report

	Years		
	2001	2000	1999
Cost of Sales	91,090,490	66,335,396	46,598,063
Stock (Inventory)	22,156,981	19,555,407	14,927,902
Stock turn Over	4.1	3.4	3.1

Source: Ministry of Trade and Industry

CHAPTER FOUR: Actions that lead to value creation And enhancement as derived from the Questionnaire

4.1 Introduction

In the preceding chapters the conceptual framework and Red Sea Bottlers Share Company's performance evaluation based on its financial statement was provided in detail. In this chapter what the company managers are doing in creating and enhancing value as it is collected from their response of the distributed questionnaire will be critically analysed. As necessary, data from the financial statement of the company and other secondary sources could be used. The analysis will be able to give the managers of the company enough information for the research objectives of the study to support them on their decision making in creating and enhancing the value of the company. The flow of the chapter follows that of the literature review. The questionnaire is attached as an Appendix B on the last part of the paper.

4.2 Value creation and enhancement process

4.2.1 Strategies and Goals of Red Sea Bottlers Share Company:

The first question of the questionnaire was regarding the company's goals and strategies. Three of the six respondents have given their responses. As the General Manager's response summarizes all the other responses the long run objective and strategies of the company as the General Manager states are:

Long run Objectives:

"To benefit and refresh every one it touches."

Strategies:

- Accelerating the growth of its carbonated soft drinks business
- Selectively broadening its family of beverage brand to divest profitable growth.
- Growing system profitability and capability together with its bottling partners.
- Serving customers with creativity and consistency across all channels.
- Directing investments to the highest potential markets across the world.
- Driving efficiency and cost effectiveness everywhere.

In addition to the above company wide strategies managers of the company were asked to list their division's strategies and goals. Except the General Manager (Which is logical) all other managers have given their responses. The summary of their response is as follows:

Table 4.1 Strategies and Goals of the Company at divisional level

Division Managers	Strategies and Goals
Financial Manager	<ul style="list-style-type: none"> • Planning and control of financial activities of the company • Ensure that internal controls are in place to adequately protect company assets and records • Develops a wide range of operational and financial reports essential for management decision • Prepare the annual business plan of the company and monitors and reports progress against the plan • Prepare financial statements and management accounting reports • Ensures that management information systems provide accurate, realistic and timely reports for management decisions.
Marketing Manager	<ul style="list-style-type: none"> • Promoting sales volume by keeping the consumers satisfaction through provision of merchandising materials (objective) • Deliver products to the consumers through route sales, strategic sales depot and distributors (strategy)
Human Resource Manager	<ul style="list-style-type: none"> • Selecting and recruiting the right personnel • Allocating of human resource as per budget plan • Develop strain employees to upgrade their knowledge, skill, and ability to perform their jobs. • Control and ensure that safety rules are in place • Provide safety, health and others to keep employees safe and healthy.
Other Division Manager	<ul style="list-style-type: none"> • To implement the Coca-Cola quality system and thereby to refine our system process and procedures throughout the supply chain so as to consistently provide our consumers and customers with the highest quality products and services.
Other Division Manager	<ul style="list-style-type: none"> • Produce quality product that satisfies customer • Create awareness of quality between professionals and floor workers • Create hygienic condition of surrounding and personnel • Strict follow up of standard procedures

The company wide and divisions goals and strategies are well defined by both the general Manager and the other division managers. Nonetheless it is not difficult to see where the company management is focusing. Quality, Cost, employees' condition, and Customers Satisfaction could be seen from their response. The overriding goal of shareholder value maximization is not seen in any one of them. As a matter of fact the primary focus should have been the shareholders interest; this is because they are owners of the venture. In the outset of the paper it was made clear that the shareholders of the company are the

Government of Eritrea (with 55% share) and Coca-Cola Company. Though it is improbable to expect the Government withdraw its capital in the situation where value is destroyed annually, this may not be the case for foreign investor whose sole purpose of investing is required return on his invested capital. The company management must keep in mind always that the foreign investor had sacrificed other second best alternative opportunities to earn his required rate of return over his invested capital on a regular basis. Therefore more than any thing the company must be able to guarantee the required rate of return for its investors. And the value principle is a good measure as to what extent the firm is creating or destroying value, which should be the main goal of the firm's existence. All the goals and strategies mentioned by the managers could be considered as part of the value system, but if they are taken alone without a due consideration of value creation this lack of knowledge could lead to disastrous position. Therefore the primary objective should have been to earn a return that exceeds the required return (cost of capital) by the investors and simultaneously distribute benefits to all the stakeholders according to their contribution.

4.2.2 Identifying Value Drivers

To evaluate every activity of the company up to the operational level the above strategies may be too general and abstract. Value drivers help to make the strategy real at a level of specificity that is both meaningful and actionable.

To know the main determinants of value creation in Red Sea Bottlers managers were asked to list out what they believe the main value drivers of the company. From the six respondents only four of them have given their response to this particular question. The summary of their responses follows.

Managers	Value Drivers
General Manager	➤ Beverage innovation
	➤ Superior delivery infrastructure
	➤ Efficiency
Marketing Manager	➤ Brand Name
	➤ Marketing capability
Other Division Manager	➤ Quality
Other Division Manager	➤ Incentive schemes
	➤ Training staff
	➤ Upgrading existing technology

Looking at the responses of the managers there is no any similarity amongst them. It is the researcher's judgment that there could be a tendency to give emphasis more to their own division. If we see the marketing manager for example the two mentioned value drivers are related to the marketing division. So, based on this assumption it seems logical to take all the lists as value drivers of the company. Therefore the company should capitalize more on these drivers, which helped to lead a successful business.

Rappaport's seven shareholder value drivers frame work will be used as a model to assess what managers are doing in enhancing value and constraints they are facing, as evidenced by questionnaire.

The question regarding the seven value drivers was question number seven of the questionnaire, and the responses of the managers will be provided below in three parts designated Table 4.2, 4.5, and 4.6. The format is adapted with some modifications from the research paper conducted in the manufacturing industry prepared by Hailemariam (2001) in fulfillment of his Doctorate degree. On the table what respondents are doing on promoting the value of the company is exhibited on a five-scale measure: Strongly agree, agree, neutral, disagree, and strongly disagree.

4.2.2.1 Revenue Growth

Looking back to the financial statements the revenues of the company as it is exhibited in Table 3.12 for the years 1997-2001 are Nakfa 24,679,789, 23,685,662, 64,951,240, 95,361,404, and 130,893,990 respectively. Similarly, the percentage increase or decrease for the years 1998-2001 is -4%, 174%, 47%, and 37% respectively. Except in the year 1998 that incurred 4% revenue decrease (due to the large restructuring expenses) from the year 1999 up to 2001 there is an increase in revenue.

In addition to those information managers were asked using the questionnaire what measures they use in promoting or enhancing the value of the company's revenue.

The respondents are six in number but except in two strategies subsection 5 (strengthen marketing) and subsection 7 (increase advertising) where all have given their response, in all the other points the number of response is less than six.

Table 4.2 What managers are doing in enhancing value in Operations of the firm

Operations	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
1. Increase local sales	5				
2. Increase exports					2
3. Drop product price	1		1	2	1
4. Increase product price			2	1	
5. Strengthen marketing	5	1			
6. Establish local sales offices	3	1	1		
7. Increase advertising	5	1			
8. Increase number of employeec		1	2	1	
9. Cut wages					3
10. Increase wages	1	3			
11. Being more selective to suppliers	3	1	1		
12. More effective use of resources	3	2			
13. Increase product quality	5				
14. Change of product mix	1	2		2	
15. Improve production efficiency	4	1			

As it is exhibited in the table, five out of the six respondents have agreed on their present attempt of promoting local sales. Increase in revenue if not followed by proportional increase in cost of sales will enhance the value of the company and thus those revenue-enhancing strategies should serve to add value. The high capital expenditure made to renovate the company surely necessitates an increase of sales.

Two out of the six strongly disagree on promoting export sales, and the other four respondents were silent. This may seem that there is no any attempt and intent in increasing export sales. This strategy needs an attention from the management of the organization for different reasons.

- The population of Eritrea (especially urban dwellers) may be shallow to create a large market for expansion in the long run.
- Eritrean Government encourages and promotes export market
- Because Coca-Cola is a known brand in the world neighbor countries may become a good market for increasing sales with less promoting expenses.

In the study of Hailemariam (2001) Coca-Cola Company has awarded a franchise to Red Sea Bottlers Share Company sell Coca-Cola products in Eritrea only. Selling in the neighboring

countries would be a breach of the franchise agreement. The Coca-Cola Company can make an exception if there is large demand in the neighboring countries which is unmet by the local company.

If the reason for neglecting export is the franchise agreement of the company, a further study may be needed to revise the agreement or assess new markets, which doesn't breach the agreement.

The response to drop or increase the product price for increasing revenue doesn't seem a strategy taken by the firm. Most of them are inclined to disagree to take neither of the strategies.

When we observe on what situation the company is found this strategy doesn't seem sound. Inflation rates for the years 1997, 1998, 1999, 2000, and 2001 are 4%, 9%, 9%, 19%, and 15% respectively. In this kind of situation with increasing inflation rate increasing selling price seems to be reasonable strategy to adjust the purchasing power of money. But the management should take notice of the effects on customers' position on the sales volume. The increase in price should supersede the decrease in sales volume otherwise price increase could be a cause of decreasing the value of the company. If the company is not able to create value its existence will be at stake and this definitely will affect every stakeholder of the company. Therefore for the welfare of the shareholder and other beneficiaries of the company the management should be able to flexibly handle the situation the company faces to create value and make the company sustain every adverse situation.

Almost all of them have strongly agreed on their effort of strengthening marketing and increase advertising in promoting revenue of the organization. Besides, four out of the six had agreed on their establishment of local sales offices to facilitate their sales. Managers' effort of increasing sales by increasing advertisement, strengthening marketing activities, and establishing local sales offices are all good strategies in promoting sales.

4.2.2.2 Profit margin

As it is shown in the third chapter Table 3.12, profit margin for the years 1999-2001 are 8%, 13%, and 14% respectively. The company's profit margin is growing. This is a good indication of the company's performance. The discussion as per questionnaire's findings on

what managers are doing in enhancing profit margin of the company in anticipation of increasing the value of the company will follow based on Table 4.2.

The company agrees in motivating its employees to promote sales and thereby increase profit to the organization. This can be seen from the response of the managers on the issue of employees' wages. They seem to agree in increasing wages for employee rather than decrease and have more profit at the expense of their employees' morale. This is a valid strategy to keep the employee morale in the situation where the purchasing power is reducing as a result of a continual inflation rate.

Other strategies like being more selective to suppliers, effective use of resources, and increase product quality, are followed by the company in improving its operation. The use of these strategies could be helpful in increasing the value of the company.

Some of the respondents also support a strategy for changing the product mix of the company. This strategy also makes sense for a good reason. The market determines what can be sold. The production department should produce what the company can sell, not what it can produce. On the other hand, the marketing department can contribute to increased sales of a marketable product and contribute to the shift in product mix toward items of higher contribution. Recently the company has introduced two new products known as Krest Soda Water and Krest Tonic Water. Sales Volume of these two products relative to the other products is shown below.

Table 4.3 Sales Volume of the company products

Years	Volume in Cases				
	Coca-Cola	Fanta	Sprite	Krest Tonic	Krest Soda Water
1999	1,978,682	691,897	333,444	51,197	38,747
2000	2,302,548	888,448	278,633	47,552	33,635
2001	2,763,450	933,392	388,354	57,616	35,819

Source: Ministry of Trade and Industry

Note: one case equals 24 numbers of bottles.

As it is exhibited in Table 4.3 sales volume of Krest tonic and Krest Soda Water is so low comparing to other product sales. These two products are introduced in 1997 with privatization of the company. Though these products are on their infant stage to the market

there is no visible increase of the sales on the years 1999, 2000, and 2001. It almost is constant and very low especially when we compare it with the sales of Coca-Cola. The main reason for these products failure to penetrate the market may be that mineral water is a highly popular brand in the country. It is not easy to break the loyalty of customers to this brand for its especial flavor and popularity. For the company to increase users of these new products it must be able to deliver a differentiated value to the potential users. Other wise withdrawal from these products and capitalize on the high contributing lines would be an advisable strategy. Or an acquisition of the mineral enterprise could be another possible strategy to expand its monopolistic position. If not, these products may use resources unnecessarily and ultimately contribute to value destruction.

They all agree in their effort to improve the efficiency of the company's operation to increase the profit margin of the company. Besides they all agree in producing quality product to both retain their existing customers and attract new customers. This can also be confirmed from the study conducted by Hailemariam (2001): In order to increase sales, the company management is aiming at delivering Coca-Cola products to the consumer efficiently and bringing the products to the nearest place possible to the consumer. In addition, the management is planning to put ten vending machines in different places of Asmara with Coca-Cola products so that anybody can buy and consume the products easily. Furthermore, the management has a plan of distributing cold Coca-Cola products using wheelbarrows in places where there are many consumers, such as the market areas. This will help consumers to get Coca-Cola products at their convenience. All these plans are expected to increase the sales and profit margin of the company.

4.2.2.3 Income tax rate

The value of a firm is the present value of its after tax cash flows. Thus, any action that can reduce the tax burden on a firm, for a given operating income, will increase value.

Table.4.4 Annual Tax rate of the company

Year	2001	2000	1999	1998	1997
Profit Before Tax	17,958,287	12,378,899	4,574,568	1,579,461	5,299,279
Tax	6,955,232	6,214,173	2,719,341	383,985	2,018,219
Tax rate	39%	50%	59%	24%	38%

Source: Ministry of trade and industry and other researcher's document collected from the company

Income and municipal tax rate for the company especially for the year 1999 reached at its climax, 59%. From the year 1999 onwards there is a decline of the tax rate as it is shown on Table 4.4. This may be because of Government policy change. Whatever the reason it is a good indication for the company's performance.

4.2.2.4 Fixed Capital Investment Decisions

On the investment decisions, we do have two categories. One is related to the fixed assets and the other is related to the working capital. Strategy options that could be needed to promote investment are presented in a form of measurement scale as the second part of Question Seven of the Questionnaire. Similar to Table 4.2 the summary of what managers' are doing in enhancing value on investment decisions is presented in Table 4.5, and the format is adapted with some modifications from the research paper conducted in the manufacturing industry prepared by Hailemariam (2001) in fulfillment of his Doctorate degree.

As it is exhibited in the table all of them have attempted the question. The response is similar almost in all strategy options except in the case of account receivables and account Payables. The financial manager response to these options was, 'not available'. The marketing manager didn't give his response for these particular options. All the other respondents have responded as if the company is using the two accounts, account receivable and account payable, as an instrument of working capital management decisions. Taking financial know how into consideration the response of the financial manager is taken as a valid response to these strategy options. This could further be confirmed from the financial statements. As to the researchers knowledge there is no clear account for account receivable or account payable in the balance sheet of the company financial statement. Therefore the analysis will be made assuming the company is not using these instruments in its working capital management.

As to the measures taken on fixed assets or on the capital expenditures, as it is exhibited on Table 4.5, almost all respondents have agreed on what they are doing to enhance the value of the company by investing in equipment, upgrading the existing technology, disposing of unprofitable assets and control of capital expenditures.

Table 4.5 What managers are doing in enhancing value in Investment decisions of the firm

Investments	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
1. New investment in equipment	2	2			
2. Upgrade technology	3	2			
3. Dispose of unprofitable assets	4	2			
4. Control of capital expenditures	3	2			
5. Reduce collection period of receivables	N/A				
6. Increase payment period of payables	N/A				
7. Implement cash control	2	3			
8. Change in inventory policy		2	1	1	

This could further be supported from the interview conducted by Hailemarim (2001) with the financial and general managers of the company. They both confirmed that due to the introduction of new machinery the company will be able to minimize both operation and labor costs which were resulted from the old machinery. Besides the new bottling line with high-tech waste water treatment established in the factory will help the company to save a lot of money.

In the fixed capital investment decisions the company may be able to increase its value by increasing cash flows to either in the short run or in the long run. Divesting, liquidating or disposing inefficient operating machineries may create immediate cash flows that are able to increase the value of the company. Where as changing inefficient machinery or equipment with new or introducing new equipment to upgrade the capacity of the company though an immediate cash creation is not possible due to its capital spending for the long run these expenditures may become a good source of cash flow to the company, provided that the decision was made on a sound study. As it is revealed from the managers' response the company is following a good strategy in upgrading the existing technology, disposing of unprofitable assets and control of capital expenditures. Though at the early age consumes a lot of money and return per unit of capital is low for the long run this may not be so.

4.2.2.5 Working Capital Investment

From the financial manager response the company sale is made on cash only. Thus, there is no credit policy. At face value, this may be taken as a good strategy for increasing cash flow

to the company, because the company is found free of tied money and free from the risk of bad debts. But generally firms use credit to increase sales. If eliminating credit is deterring sales to grow as it should be, sales on cash may not be increasing cash flows but rather decreasing cash flows. Though high credit is not advisable for it becomes the cause of creating bad debts and excess tied up capital, an accepted credit is advisable to increase sales to the company. In fact the company has already introduced new machinery with high capacity. To utilise the high capacity of the investment the company need to employ credit policy to increase sales.

Similarly the company is not using account payable. However looking back at the financial statement (Appendix A2) there is a large amount of current liability. Looking at this information it is the researcher's assumption that the company is financing its purchase transactions using the short-term loan. Unlike to this interest bearing loan, the use of account payable as a non-interest bearing instrument has an advantage of generating cash flow once. However if the company has no problem in getting short-term loan on time of need it can comfortably use it for the annual interest expenses is not so remarkable as it can be seen in the financial statement Appendix A5.

Third element of the working capital is inventory. From the respondents it is known that inventory is not a problem. Whatever the case a minimum inventory level is advisable to release tied up cash flows, but this should not deter sales of the company.

4.2.2.6 Cost of Capital (Financing Decisions)

Holding the cash flows constant, reducing the cost of capital will increase the value of the firm. Changing operating leverage, financing mix and type can reduce cost of capital. In this section a discussion will follow with respect of changing the financing mix.

Managers' suggestions for enhancing value of the company by changing the financing mix was presented on Question seven part three of the Questionnaire. These responses are reflected in Table 4.6. Similar to the first two parts of this Question from the six respondents in average only three of them have commented on the given financing strategy options.

In spite of the fact that the company has not undertaken a long-term loan as evidenced from the financial manger and financial statement of the company, three of the six respondents agreed in their suggestions as an instrument of enhancing the company’s value.

Two out of the six respondents agreed to increase short term as an enhancing instrument, one was neutral and the other one disagreed to increase this instrument as increasing the value of the company. Similarly one out of the six respondents agreed to decrease the short-term loan to increase the value of the company and another one was neutral in decreasing the short-term loan in enhancing value of the company. This could be seen from the following table.

Table 4.6 What managers are doing in enhancing value in financing decisions of the firm

Financing					
1. Undertake long-term loan	1	2			
2. Increase short-term loan	1	1	1	1	
3. Decrease short term loan		1	1		

To understand the reason why the company is not using long-term liability as a financing instrument, questions number 8 and 9 were asked to managers using the questionnaire. Question number 8 was a yes/no question if the company uses long-term loan as a financing instrument. Two of the six respondents answered ‘YES’, one said nothing, and the other three (including the financial manager) said ‘NO’. Question number 9 asked the reason to those responded ‘NO’ to question number 8. Only the financial manager has responded to this question. According to him because the company has enough cash on hand it was not necessary to engage in debt.

From the data collected the researcher was not able to identify the company’s attempts to minimise the cost of capital by changing both financing mix and type. This may be justified more from the fact that the company is not using long term liability as a financing instrument due to its believe that it has excessive cash on its hand which enables her financing its needs.

Generally debt is considered cheaper than equity partly because it is less risky. But if investors have no opportunity to invest in the second best alternative the general argument of debt is cheaper than equity loses weight. To the knowledge of the researcher there is no solid ground to believe that equity is more expensive than debt in the country. The only valid

argument could be the tax deductibility. Debt is tax deductible unlike equity. The use of long-term debt, due to its tax relief, may increase value to the company. Thus, the management of the company should direct its attention of the financing mix to enlarge the value of the company. In Table 4.4 it was observed that the company is paying a lot of money for income and municipal taxes. Any instrument that enables to decrease its tax expense may increase value assuming there would not be any adverse effect that could nullify the advantage. The use of the long-term debt therefore could help to decrease the taxable income, which ultimately increases value for the company.

4.2.2.7 Value Growth Duration

Red sea bottlers Share Company is using the following measures to keep the high growth value duration to stay long enough.

Brand Name: This Company is a joint venture of the Government and Coca-Cola Company. Coca-Cola is a known brand that has unshakeable position in many users of the product.

Besides the company is the sole soft drink company and industry. There is no other soft drink company in the country. This **monopolistic position** of the company may give it to decide what ever price of the product that can produce a reasonable profit.

On top of that the company has **cost advantages** in many cases that can be a good entry barrier for potential entrants, such as:

- Economies of scale
- The distribution system established on years

Every attempt on the seven value drivers positively or negatively affects the value of the company. Each of them affects one of the three valuation components: cash flow from operations, Discount rate, and debt, which are ultimately used to derive shareholder value added. As it can be seen from the above discussion in most cases the company is found in the right truck in adding value to the owners.

4.2.3 Constraints encountered in enhancing value

Managers were asked what their company and/or division short-term targets are in Question

number 4 of the questionnaire. Two out of the six respondents didn't give their response. The response of the four respondents is summarized below.

Table 4.7 Short-term targets of the company divisions

Managers	Short term targets
Financial Manager	<ul style="list-style-type: none"> ➤ Prepare financial reports ➤ Prepare management accounting reports ➤ Prepare report progress against plan
Marketing Manager	<ul style="list-style-type: none"> ➤ To monitor the level of consumers satisfaction related to the services provided ➤ To expand the distribution channels to every corner of the country ➤ To promote sales volume
Human Resource Manager	<ul style="list-style-type: none"> ➤ Filling budgeted vacancies ➤ Training employees as per training gap analysis ➤ Collect surveys to match with market benchmarks
Other Division	<ul style="list-style-type: none"> ➤ To attain targets set in annual business plan of the company for the year 2003 based on the capacity of equipment and sales demand

In their effort of enhancing the value of the company the managers mentioned certain constraints that resulted in not meeting the required targets. Some of these constraints as they were collected from the questionnaire distributed to the general managers and division managers are the following. (The Question is adapted with some modifications from the research paper conducted in the manufacturing industry prepared by Hailemariam (2001) in fulfillment of his Doctorate degree).

Constraints for not meeting the required targets

Managers	Constraints
General Manager	<ul style="list-style-type: none"> ✓ Irregularity in electric energy supply ✓ Inflation ✓ Unavailability of hard currency
Financial Manager	<ul style="list-style-type: none"> ✓ Irregularity in electric supply ✓ Lack of hard currency
Marketing Manager	<ul style="list-style-type: none"> ✓ Disturbances of materials supply ✓ Lack of cash ✓ Frequent breakdowns of machineries ✓ Irregularity in electric energy supply ✓ Lack of getting a loan ✓ Transportation problem

Human Resource Manager	✓ Irregularity of production operation
	✓ Lack of hard currency
Other Division Manager	✓ Lack of hard currency

From the above summary of the managers' response lack of foreign currency was mentioned in all of them. This may show us that this problem is so severe it came to the knowledge of all managers. In the study of Cotton, et al (2002) was also mentioned as the main problem of the country. The cause of this was definitely the devastating war in the country starting in the year 1998. One of the main problems that could result from the unavailability of hard currency is purchase of raw materials and spare parts for the machinery. These two primary activities in the value chain of the company have a great impact in decreasing the profit margin of the company. Therefore this constraint is so crucial in the performance of the company, which may have decreased value of the company.

As the second constraint the General Manager has mentioned inflation as one of the company problems in achieving its target. This problem could also be confirmed from the study of Cotton, et al (2002) as it is discussed in the General situation part of Chapter three. Similar to the above problem this constraint is also the result of the broken war in the country. Inflation is taking place when the purchasing power of money decreased. When one unit of Nakfa, which was able to buy a particular good yesterday is short of buying it today the currency is said to have inflated and lose power of purchasing. The main problem of having inflation is, the cost of import will be high that could lead to the increase of the product price of the company. But this could damage the response of the consumers to the increased price. Besides employees wages and salaries will be influenced and the company will be needed to adjust simultaneously otherwise because of the decreasing purchasing power employees' condition could be impaired. Furthermore managing the fluctuations of the daily, monthly and annually inflation is also not easy. Therefore all these problems could have contributed in decreasing the performance of the company, which might have reduced the value of the company.

Irregularity of electricity supply was also mentioned as a constraint by three of the respondents. This problem is also a big problem if especially the down load is frequent. The

production process is only possible in the presence of electric power. Any interruption has an immediate impact in the performance of the firm.

All other constraints have also an impact in the performance of the company directly or indirectly where eventually decrease its value.

The information of what managers are doing in overcoming these constraints would have a valid contribution to the analysis; unfortunately the researcher didn't include such question in the questionnaire.

4.2.4 Compensation

In order to empower and impart the sense of ownership in its employees' a company needs to introduce incentive schemes in its business. To know to what extent Red Sea Bottlers Share Company is motivating its employees using an incentive schemes two questions were forwarded for the managers in a questionnaire. The first question (Question number 11) was whether the company has incentive scheme or not? And the second question was what type of incentive scheme the company is currently employing. All the six respondents assure that the company is currently employing an incentive scheme. Because the response of the General Manager and Marketing manager summarises all other responses to the second question of what type of incentive schemes the company is currently using their response is followed.

According to the general manager the following incentives are used.

- Improve employee benefits and facilities
- Refine recognition mechanism for exceptional performance
- Volume bonus and sales commission
- Production and quality achievement

Similarly the marketing manager listed out the following incentives.

- Commission to the sales force
- Donation of Coca-Cola product monthly and on holiday
- Bonus once in a year.

According to the study made by Hailemariam (2001) on the beverage industry where Red

Sea Bottlers Share Company is one of the three companies composed in this industry employees are highly paid in comparison to the employees in other industries in Eritrea. However, the living standard is increasing and employees complain that the wages they receive are not enough. Employees also get incentives such as bonuses, monetary, as well as non-monetary, and other social benefits. Based on the collective agreement of the companies and their labour union, employees are entitled for a bonus depending on the accounting profit of the fiscal year.

Employee performance and thereby value of the company will be affected if the basic salary and other benefits are not good enough to make employees of the company satisfied. The basic reason for an employee to be employed is to earn money so that he is able to sustain his life and family. Therefore the up and down of his salary and other benefits has direct relationship with the up and down of his life and family. In the above paragraph it is observed that the basic salary of the beverage industry of which Red Sea Bottlers is one is relatively higher than other industries in the country. This definitely has a positive influence to impart a positive behaviour for the employees to love their company and as a result will be willing to commit themselves in the company. This has a direct influence in increasing the value of the company.

On the other hand whenever the purchasing power of money is decreased due to inflation, the company should be able to adjust the wages and salaries to equalise the standard of living. Employees should not be victimised by the prevailing inflated market. The value of their salary should remain constant to keep their morale untouched. When we see the interview made by S. Hailemariam employees are complaining about the high standard of living resulted by inflation. This may show that the company is not adjusting the wages and salaries parallel with the prevailing condition. Indeed this may have a negative influence on the performance of the employees, which eventually impact the value of the company.

In addition to the basic salary companies give incentive to the best performers to encourage employees to work hard and perform maximum. The company gives bonuses, sales commission, and product gifts on holidays. If employees have a share from the profit of the company, it is more probable to believe that these people will perform well and increase the value of the company. Giving bonus is a good incentive to the company's workers as a whole. But this has a less effect on the individual performance for it is not aimed to reward the best

performers. Hence it has not a significant role to act as an incentive scheme. Similarly the gifts on holidays have the same implications. Every one of the company employees will be granted a gift on holiday regardless of his performance. This has no direct relationship with the performance of the worker and therefore will not have a visible impact on the result of the company's performance. On the other hand sales commission may be taken as a good incentive scheme. This is because it has a direct relationship with the number of sales. If the sales person sells more he will be rewarded more and if less rewarded less. Hence he will be motivated to work hard to earn more. This system has definitely has a direct impact on the result of the company. Sales force will strive at most to increase sales, which eventually increase the value of the company. Just as the sales commission, it is recommended that all the departments introduce incentives, which reward the high performers of their place. For example production division could set monthly targets that are only achievable by good performers. And therefore the Division will reward those who beat the target. An incentive should be linked with an individual performance so as to influence the overall performance of the company.

To further use employees potential in the company, the incentive of the company should not be limited in money. One of the dynamic understandings on the psychology study is people's need of recognition. Employees need to be recognised, to belong, to be accepted, and be seen as the greatest asset of the company and so on. Therefore as part of incentive the company management should be able to empower their workers by incorporating the social aspects of their employees in the working environment of the company.

Promotion and how it is executed has a motivating impact for employees. Keeping this in mind on what basis an employee is promoted was asked (Question number 13) to Red Sea Bottlers Share Company managers using the questionnaire. According to the responses of the General Manager, Financial Manager, and Human Resource Manager, Promotion to employees is based only on merit. While the other division mangers include seniority in addition to merit in promoting an employee. If length of working experience couldn't add in the knowledge and skill of a particular employee the length of time in the job in itself is nothing more than the people without the working experience. Therefore the use of merit as basis for promotion has a stronger power of motivating employees to invest time and energy in them-selves to display their capability in the work area.

Every employee has an inner drive to walk to the next upper ladder. The highly motivating environment may help every individual employee to realise his dream in where he is employed. If the job he is currently placed is the source of frustration when alternative options are found he will be the first candidate to leave the firm. In addition to that, the biggest asset in this planet is the mind of human being. What ever changes displayed in our planet is the result of combined minds of our world. Though some individuals are able to penetrate the intense environment, most need motivating environment to trigger their creative abilities. Therefore for employees' improvement, every one of them should be promoted when they are deserved to be.

4.2.5 Communication

The knowledge of goals and strategies up to the operational level is crucial to the success of the business. This is only possible in using a good channel of communication to bring every message on the heart of the different managerial levels and company wide employees. To assess the company's communication channel a questionnaire was distributed to the General Manager and Division Managers. In response to the question by which all the management levels are made aware of the strategies and goals of the company the general manager said:

“Monthly senior management meeting is held. Action plans are discussed in the meeting. Each senior manager forward and discuss his action plans. Based on the outcome of the meeting decisions, actions are taken to investment decisions made.”

In addition to the response of the general manager the other division managers has also provided some measures used as means of reaching all the management levels. Such as:

- Budget plan is prepared and distributed to every department and the department communicates to its lower levels.
- Training is given at different levels of management and technicians even by sending them abroad.
- Weekly and monthly meeting of employees
- Cross sharing of experiences with sister companies.

On top of that the communication channels used to up date employees as the managers responded are:

- Each senior manager has plans at certain period to hold meeting with their respective employees
- Written instructions, information or any procedures are posted at each departments
- When necessary the Human Resource Manager or the General Manager holds meeting with all employees.
- Frequent meeting is done amongst Human Resource management or General Manager with Trade Union leaders.
- Short term training to employees is given
- Performance appraisals.

One of the greatest gifts human beings have is their ability to communicate easily. Communication is a medium for transferring ones message to another. Whoever wants a message to be done he must be able to communicate it understandably. The company sets goals to be achieved and set strategies to achieve its targeted or spelled goals. The achievement of the goals will be highly dependent on the performers understanding of the goals and strategies. If this is so the company management must ensure that the goals and strategies are well understood in all levels of the company operations. This activity is not a one-day event. As far as the company continues to operate the employees should have enough knowledge where they are going. To make this simple the company should be able to lay a solid communication channels or systems.

Red Sea Bottlers Managers response to the questionnaire in brief show that the ways by which they make their employee communicate their goals and strategies is through regular meetings with different level of company managers, general meeting with employees as necessary, posted instructions and procedures, and short term and long term training.

Indeed these all are very important in communicating the company's programs to its employees, and in addition to that monthly, quarterly or annual publications would also help to promote communication to the company employees.

As the last question of the questionnaire the company managers' were asked in a five-scale measurement whether they strongly agree, agree, neutral, strongly disagree, disagree that at every level of the organization is a sufficient degree of understanding of how actions and

decisions affect value of the company. All the respondents have given their response to this question. Three of the six respondents have strongly agreed and the remaining three have also agreed to sufficient understanding of all levels of the company what actions and decisions could affect the value of the company. All managers have similar response to this particular question. This may show their confidence in transferring their future action plans through the established communication channels to all levels of the firm. As this is to be encouraged and promoted, to build more in the strength of the company and be ready to any uprising internal and external environmental challenges the company's management should think of updating the existing systems and introducing more efficient systems of communication in the company.

CHAPTER FIVE: Conclusions and Recommendations

5.1 Conclusions

The purpose of this study was to come with an answer to the research question of-

“What actions lead to value creation and enhancement in Red Sea Bottlers Share Company?”

In answer to the research question the following objectives were determined to achieve at the end of the day where the management will be able to see its position and be able to have full information in making a decision.

- Determine the value drivers of the company.
- Evaluate how and to what extent the company is creating or destroying value and thereafter assess what possible reasons there are that promote or constrain value.
- Evaluate what management of the company is doing in enhancing the value of the company.

In light of these objectives the conclusions will follow

5.1.1 Value of the company

The value of a company is the present value of the expected future cash flows of the company that could mathematically be expressed as: $Value = \sum \text{Cash flow}/(r-g)$.

The cash flows of Red Sea Bottlers Share Company for the years 1999-2001 are Nakfa 15,447,924, 899,458, and 18,465,081 respectively. Averaging the flows the result will be equal to Nakfa 11,604,154. Similarly the growth rates of the company for the years 1999-2001 are 1.4%, 3.4%, and 5.5% respectively. Averaging the three years growth rate will give rise to 3.4%. As there is no capital market in Eritrea, the cost of capital used for the company is estimate of Consultants in Eritrea. According to their estimate the cost of capital for the company is 9%. The fourth element of the value of the company is its asset life. Through renovations and regular maintenances the life of the asset or the company is assumed to remain for infinite time. Plugging all these elements in the Cash Flow Discounting formula the value of the company will be roughly estimated to be Nakfa 207,217,036 and because the invested capital in the year 1999 was Nakfa 169,149,786 the company has created an extra Total Business Return of Nakfa 38,067,250.

This has to be treated with suspicion for it is based on some uncertain assumptions.

5.1.2 Financial and Non-Financial Performance of the company

Value-based management framework, which is derived from Rappaport's value drivers' framework, is used to accommodate both customers and employees condition in the performance of the company. This framework classifies the non-financial and financial measurements into balanced scorecard, corporate measures, value drivers, and key performance indicators. The qualitative measures could give us the general customers' and employees' condition towards creating value of the company.

5.1.2.1 Non-Financial measures

A balanced scorecard is used to capture the non-financial business economics. In the customer perspective of the balance card the company's goal to make its product available, affordable, and acceptable to the customers could be assumed as a first step to see the company's intent to satisfy its customers. The increase in sales of the company from time to time could also be an indication that it is pleasing its customers. Besides its distribution of fridges to its customers freely and hearing the customers complaint by visiting them in their place could also be a good attempt in motivating customers. But the imposition of high product prices by the wholesalers to the retailers could be a problem in the price responsiveness in the future.

The internal process of the company operation is the question of how smoothly it will continue. Its privatisation and creation of joint venture with Coca-Cola Company is a turning point to the company. After the venture its high capital expenditure both to renovate and maintain its existing position could be mentioned as its sound strategy in its continuation smoothly in the future.

As to the employees section of the balanced scorecard the labour productivity of the company for the years 1999-2001 is found to be Nakfa 139,351, 186,557, and 252,632 respectively. The data shows that labour productivity of the company is improving from year to year. This may indicate efficiency and/or marketing capability imbedded into the employees of the company. Remuneration per employee is also increasing from year 1999 onwards with a large number. This high increase may indicate the appropriation of high returns to individual workers from year to year.

The ratio of temporary workers to permanent workers is 50%, 47%, and 47% for the years 1999-2001 respectively, and the temporary workers wages and salaries to permanent workers

is 29%, 22%, and 27% for the same years. Though the company has an advantage of reducing remuneration and some other benefits given to permanent workers there is a risk of retaining permanent skill to the company, and this large number of temporary workers may be a cause in decreasing the bargaining power for the permanent workers in requesting their right. Thus this could a source of disagreements between these two classes of workers and the source of dissatisfaction for the permanent workers and eventually affect negatively to value of the company.

5.1.2.2 Financial measures

Due to the major investment incurred in the year 1997 the company's capital spending becomes so low relative to depreciation expense in the years 1999-2001. This is because the major investment is so soon for the company to incur additional expenditures again. This condition has resulted in generating very high cash flows in these particular years compared to profit of the company for the same years. As years passed capital expenditures both for maintenance and new investments will be required to sustain the assets life, therefore it is less likely to assume the perpetuating of these cash flows for the life of the company. In spite of this fact because the researcher was not able to get the normalized cash flows that could nearly estimate the value of the company he is using the average cash flows of these three years as the company's sustainable cash flows. The total business return (multiple period measure) computed using this assumption is positive with a Nakfa balance of 38,067,250.

Overcoming the constraints in the future, which are mainly resulted from the unstable condition of the country and the underutilization of the assets, may have a normalizing effect to the future cash flow of the company that could possibly strengthen the company's position of creating value in its multi period measure.

EVA shows the Nakfa (Eritrean Currency) amount of wealth a business of Red Sea Bottlers has created or destroyed in each reporting period. As Return On Invested Capital for the years 1999-2001 are 1.4%, 3.4%, and 5.5%; cost of capital that the investors require from their investment is 9%, the Economic Value Added for the years 1999-2001 are - 12,855,384, - 10,405,931, and -7,503,490 respectively. It is clear from these data that the company is destroying on these three years. This is because of the unstable condition and high depreciation expenses resulted from the high investment in the year 1997.

While the company is creating value using the multi-period measurement technique, it is destroying value using Economic Value Added (single period) measurement technique. This is because the company was able to draw a good amount of cash flow return compared with profit before interest and after tax on the years 1999-2001. The main cause for the difference of measures was that depreciation expense is much greater than the annual capital spending in these three years. The annual cash flow return over invested capital is 6.1%, which is almost double of the return (profit before interest and after tax) over invested capital (3.4%). Besides, the multi-period measure incorporates the growth rate of the company. This growth rate increases the value of the company. Red Sea Bottlers cost of capital is 9% less the growth rate (3.4%) equals 5.6%, which is less than the average cash flow return 6.1%. This is why the company is able to create value using the multi-period measurement technique.

As to the key performance indicators profitability ratios and efficiency ratios are used in evaluating the company's performance. Profit margin and return on assets are growing increasingly. Besides the Asset Turn Over (measures of asset utilization) of the company shows an increasing trend, which is a good indication for the company's utilization of its assets. More over Stock Turn Over of the company is increasing from year to year which shows its improvement stock management.

5.1.3 What managers are doing to enhance value of the company

The existence and continuity of a given company is dependent on its ability to create value in its daily, monthly and annual activities. Having this in mind any company should follow the following processes to create and enhance value of its business. These are the establishment of corporate value strategies and goals, identifying value drivers, focus on future oriented performance measurements, link compensation with value creation of the company, and communicate the value concept through out the company.

The company wide strategies and divisions strategies and goals of the company do focus on cost efficiency, quality, customers' satisfaction, and employee conditions. Though these points are important the primary focus of the management should have been on the value maximization of the company owners. It is not only these people are owners and deserve priority but also for the stakeholders better off the company should be able to achieve a periodic return that could exceed its cost of capital. Otherwise its existence would be at stake.

The value drivers of the company as per the managers' responses are beverage innovation, superior delivery infrastructure, efficiency, brand name, marketing capability, quality, incentive schemes and training. It is these drivers that are helping the company to lead a successful business in the country. Therefore it is a wise decision for the company to capitalise more on these determining factors to establish more on its core competency to secure its leading position.

To evaluate what the managers are doing in creating and enhancing the value of the company in every activity of the firm, Rappaport's value drivers' framework was used as a model. According to Rappaport's frame work there are 'seven value drivers' namely sales growth, operating profit margin, income tax rate, fixed capital investment, working capital investment, cost of capital, and value growth duration. Whatever actions taken by the business management either directly or indirectly affects positively or negatively in creating and enhancing value to the firm through these seven value drivers.

Revenue of the company is growing by 174% in the year 1999, 47% in the year 2000 and by 37% in the year 2001. Even though inflation rate had increased by the percentages 9% for the year 1999, 19% for the year 2000 and 15% for the year 2001 the growth is still remarkable.

Profit margin is also increasingly growing from year to year. It is 8%, 13%, and 14% for the years 1999-2001 respectively.

The third element of the operating decisions of Rappaport's value drivers, Income Tax Rate for the years 1999-2001 are 59%, 50%, and 39% respectively. As the annual percentage shows it is not small, but its decreasing trend may be a good indication that the company is doing something to minimise its tax expenses.

The company management is trying to increase the local sales and thereby profit to the company by increasing advertisement, strengthening marketing activities, and establishing local sales offices in their attempt in enhancing value of the company. But from the questionnaire respondents declined to use export sales as a strategy to increase sales of the company. On the other hand Managers also declined to decrease or increase product price as a strategy to increase sales of the company, though the inflation rate of the sales is increasing from time to time. But this doesn't seem advisable. To keep the purchasing power of the

money the company should be able to increase the price of the product parallel with the rise of inflation in the way customers will not be deterred from decreasing sales. Managers' response to the employees' wages is to increase rather than decrease. This is a valid strategy to keep the employee morale in the situation where the purchasing power is reducing as a result of a continual inflation rate.

The company had recently introduced two new products after privatisation. The sale of these two products is not promising. The sales volume relative to other products is very low, not only that Krest Soda Water is declining from the year 1999 and Krest Tonic is not growing too. This may be because there are other competitive products in the country like Mineral Waters, which are highly popular.

With regard to the fixed capital investment decisions the company is upgrading the existing technology, disposing of unprofitable assets, maintaining inefficient machineries and expanding the company at large. Though at the early stage these decisions consume a lot of cash and return per unit of capital is low, in the long run this invested and maintained capital may be a good source of cash to the company provided the expansion strategy is employed on a sound strategic decision.

The company's sales are made on the base of cash only. On face value it could be argued that sales on cash saves the company from bad debts and tying up capital, but it also inhibits it from increasing sales. The purchase of its raw materials is made on the base of short-term loan rather than non-interest bearing, account payable. The use of account payable as a non-interest bearing instrument has an advantage of generating cash flow once. Looking at the interest expenses is so small relative to the liability assuming there is no problem in getting the loan the company can stay with existing system.

Stock turnover is increasing from year to year which is a good sign of the company's improving inventory management.

Holding the cash flows constant, reducing the cost of capital will increase the value of the firm. Changing the financing mix can reduce cost of capital. The company is not using long-term loan at present as a financing instrument. The reason for not using of this financing instrument is that the company has enough cash on hand to finance its need. As income and

municipal tax expenses are so large long-term liability because of its tax deductible nature could have minimized these expense and ultimately increase cash inflow to the company.

Value growth duration is the last (seventh) element of the value drivers. This is about elongating the period of time in which returns will exceed the costs of capital. The company has certain acquired potentials that could help in lengthening its value growth duration. The Coca-Cola brand name can be mentioned as one that have a long history in the country and have a place in every customer's heart as the one with no substitute. Besides its monopolistic position and high capital investment could be great entry barriers. Moreover the long rooted distribution channels and acquired knowledge through long time experience could also be an entry barrier. These barriers on the other hand are helpful in increasing its value growth duration.

Red Sea Bottlers employees' basic salary is relatively higher than the other enterprises in the country. This has a positive impact in attracting and keeping employees in the company. Despite this fact, employees complain about their lack of coping with inflating living standard. This may be because of the company's inability of adjusting the wages and salaries parallel with the increasing inflation rates. In addition to this the incentive schemes employed in the company are annual bonuses, Holiday gifts from the company product, and Sales commission. The first two are poor incentives, due to their lack of linking the employees' performance with the gifts. Bonus and Holiday gifts are given to all regardless of the employees' performance, while sales commission has a great role in improving employees' performance, because the more the sales person sells the more he is rewarded.

Red Sea Bottlers Managers response to the questionnaire shows that the ways by which they make their employees communicate their goals and strategies is through regular meetings with different level of company managers, general meeting with employees as necessary, posted instructions and procedures, and short term and long-term training. In addition to these the use of publications may have a wide coverage in bringing other stakeholders to the attention of the company.

5.2 Recommendations

Having seen the conclusions the researcher's first recommendation is regarding Red Sea Bottlers Share Company strategies. It has listed certain strategies that could be used a road

map to follow in creating a better off business. From all the points mentioned as strategies there is no mention of securing its shareholders returns. All the strategies mentioned are very good, but it needs to incorporate the mindset of adequate return for its investors. Otherwise it could face a problem when its investors get dissatisfied with the return they expect. Every management member and operational employees must have the mindset owners' value maximization. The management ability of ingraining value in its business will have a dramatic influence in bringing every member to be responsible and empowered to do something. Every member could bring a change in the organization, which could turn it into unbelievable performer. This has a positive implication for all stakeholders too.

The second recommendation will be regarding what the managers are doing in enhancing the value of the company on the operating decisions (Revenues, Profit Margin, and Income Taxes). The company managers are using certain means to enlarge sales and profit margin, and in most cases are doing well. But their response in sales export and product price needs to be revised. As the population of the country, especially urban dwellers could be shallow to the company especially in the long run one of the main strategies the company should think is to export to the neighbour countries, provided the franchise agreement could be reconsidered or access a place to where the franchise is not breached. The product price is also another point. The country inflation rate is increasing form time to time. In this situation to keep the purchasing power of the sales revenue, increase in product price is advisable. Indeed it should not be to the extent of freezing the customers' responsiveness to price but anyway it should be taken as a good alternative.

As part of what managers are doing in enhancing company value on its operation the third recommendation will be on its product mix. After privatisation the company has introduced two products in the product line. These are Krest Tonic and Krest Soda Water. The financial data for these products shows that the sales volume of both is so low and no increase is shown in the years 1999-2001. Krest Soda Water is especially decreasing starting from the year 2000. It is the researcher's suggestion that further study should be made to see if these products have a potential demand to at least bring the investors required rate of return. Otherwise it would be recommended to cut-off the lines and think other options. One alternative option the company could bring to its attention is the introduction of different sizes of the known Coca-Cola brands. This strategy may be helpful to decrease the product price and be able to attract more consumers especially those of price sensitive due to the package

reduction on the big sized container. Besides the company's use of only glass bottle container for all its brands could be reconsidered. The use of plastic bottles and tins could be used as an alternative provided it is possible to minimise cost than that of the glass container.

The fourth point is regarding its investment decision on working capital. Depending on the questionnaire and the financial data the researcher has on hand it is assumed that the company's sales made on the base of cash only. When sales are made on cash they have an advantage of avoiding both bad debts and tying up of capitals. But generally credit is used to increase sales for the organisation. When we see Red Sea Bottlers it has expanded its capacity so much, and this definitely need different mechanisms to create sales to better utilise the invested big amount of capital. One way could be introducing a reasonable credit policy with a minimum bad debts expectation and minimum debtor's turnover to motivate the potential customers to buy more.

The fifth point concerns with reducing the cost of capital. The company at present is not using a long-term liability. But the use of this financing instrument is helpful in reducing the taxable income due to its nature of tax deductibility. From the financial data it could be known that the company is incurring a lot of tax expenses. Decreasing these expenses by using a long-term liability could be a source of creating value to the company.

The sixth point the researcher needs to recommend is on the company's measurement techniques used. The first recommended measurement tool that is used for a multi-period measure is Total Business Return. Provided the estimation is made on a normalised cash flow and sound discounting factor this measure can be a useful tool in showing the status of the company in its future life from a point of time. And this knowledge is so important to not only doing something in the future, but also creating the future. The second point is with the single period measure. From the managers response it was able to know that the single period measurements used in the company are income and return measurements, not value measurements like Economic Value Added measure. To know whether a given organization is creating value or not, is only possible when returns are compared with the cost of capital. Therefore Red Sea Bottlers Share Company should introduce Economic Value Added measurement technique to follow its annual financial position on a regular basis. Its profit and return measurements could lead the company to take a wrong decision, which would result a disastrous effect. If we refer the existing status for example the company is earning a large

amount of profit in the years 1999-2001, but using EVA it is found destroying value in all these three years with a large amount of money. Therefore the use of appropriate measurement techniques is recommended in capturing the business economics of the company.

The next point is regarding the employees' condition in the company. As basic wages and salaries are the main concerns for the employees, it could be argued that the employees of this company are comparably paid more than the other most enterprises in the country. This has a good impact in the morale of the employees. However employees do complain about their wages and salaries for their inability to cope with the inflating standard of living. When the company believes that the purchasing power of its employees wages and salaries is diminishing it should make an adjustments with the increasing inflation rates. When we come to the incentive schemes the focus should be made on the ones that could directly link with the individual performance. In other words the best performers should be rewarded more than the others. Just like sales commissions department goals or targets could be laid off to reward those who perform the best. In the production division (assuming no reward is being given to production target beaters at present) for example targets achievable by high performers would be set as a target. And those who meet the target will be rewarded. Further more as the questionnaire distributed was limited to the managers only to what extent employees are motivated or pleased with the company's situation need to be further studied from the employees' side.

The last point is regarding the communication of goals and strategies to the overall company. The means used to communicate the goals and strategies to all managerial levels and general employees are acceptable. But with its strategy of expansion the use of publications could help much more than anything in creating awareness of the company's paces in all employees, customers, and the community at large.

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APPENDICES

Appendix A1 Profit and Loss account in Nakfa

Red Sea Bottlers Share Company (Privatized in January, 1997)										
(Profit and Loss account)										
	Years				Privatized Year					
	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Turnover	173,530,530.00	131,186,190.00	95,361,404.00	64,951,240.00	23,685,662.00	24,679,789.00	27,751,255.00	24,786,255.00	20,896,553.00	16,605,537.00
Profit Before Tax	8,425,254.00	17,939,251.00	12,378,899.00	4,574,568.00	1,579,461.00	5,299,279.00	10,229,317.00	10,365,649.00	9,238,704.00	7,484,416.00
Tax	2,864,586.00	6,947,807.00	6,214,173.00	2,719,341.00	383,985.00	2,018,219.00	3,940,934.00	3,994,103.00	4,195,904.00	3,763,152.00
Profit after tax	5,282,635.00	10,441,872.00	5,856,490.00	1,762,466.00	(1,963,446.00)	3,117,007.00	6,288,383.00	6,371,546.00	5,042,800.00	3,721,264.00
CPI	197.80	169.15	147.66	123.81	113.56	103.74	100.00	107.65	104.90	105.80

Appendix A2 Balance Sheet in Nakfa

Balance Sheet										
Fixed Assets	79,668,334.00	91,317,244.00	100,616,038.00	104,247,618.00	106,239,637.00	8,166,757.00	1,789,424.00	2,318,917.00	1,134,539.00	1,238,548.00
Goodwill	1,278,308.00	1,591,363.00	1,904,420.00	2,217,473.00	2,530,528.00	2,843,583.00	-	-	-	-
Project Account	-	-	-	-	-	46,318,295.00	-	-	-	-
Deffered Expenditure	-	-	-	-	-	-	-	-	-	-
Current Assets	130,161,519.00	121,476,855.00	83,299,740.00	62,684,695.00	44,795,632.00	73,371,330.00	30,720,967.00	28,229,208.00	21,993,960.00	15,078,481.00
Current Liabilities	66,648,399.00	73,569,869.00	55,996,049.00	45,293,130.00	31,564,368.00	16,678,505.00	17,025,244.00	16,261,462.00	8,148,248.00	9,404,530.00
Net Current Assets/Liabilities	63,513,120.00	47,906,986.00	27,303,691.00	17,391,565.00	13,231,264.00	56,692,825.00	13,695,723.00	11,967,746.00	13,845,712.00	5,673,951.00
Capital/equity	144,459,762.00	140,815,593.00	129,824,149.00	123,856,656.00	122,001,429.00	114,021,460.00	15,485,147.00	14,286,663.00	14,980,251.00	6,920,379.00
Deffered income	-	-	-	-	-	-	(4,485,930.00)	(3,382,959.00)	2,079,583.00	1,406,631.00
Capital/equity	144,459,762.00	140,815,593.00	129,824,149.00	123,856,656.00	122,001,429.00	114,021,460.00	10,999,217.00	10,903,704.00	12,900,668.00	5,513,748.00
Total Asset	211,108,161.00	214,385,462.00	185,820,198.00	169,149,786.00	153,565,797.00	130,699,965.00	28,024,461.00	27,165,166.00	21,048,916.00	0
Financed By										
Share capital	107,340,400.00	107,340,400.00	107,340,400.00	107,340,400.00	107,340,400.00	107,340,400.00	722,239.00	722,239.00	722,239.00	722,239.00

Grant	-	-	-	-	-	-	-	675,531.00	580,018.00	580,018.00	574,918.00
General Reserve	13,146,182.00	13,146,182.00	13,146,182.00	13,343,415.00	13,343,415.00	3,400,000.00	-	-	-	-	(1,106,083.00)
Legal Reserve	1,392,655.00	1,114,622.00	565,050.00	256,814.00	164,053.00	164,053.00	9,601,447.00	9,601,447.00	1,232,937.00	-)
Retained Earning	22,580,525.00	19,214,389.00	8,772,517.00	-	-	-	-	-	-	10,365,474.00	5,322,674.00
Un appropriated profit	-	-	-	2,916,027.00	1,153,561.00	3,117,007.00	-	-	-	-	-
Share Holder's Funds	144,459,762.00	140,815,593.00	129,824,149.00	123,856,656.00	122,001,429.00	114,021,460.00	10,999,217.00	10,903,704.00	12,900,668.00	-	5,513,748.00
Long-Term Loan	-	-	-	-	-	-	-	-	-	-	-
Capital/equity	144,459,762.00	140,815,593.00	129,824,149.00	123,856,656.00	122,001,429.00	114,021,460.00	10,999,217.00	10,903,704.00	12,900,668.00	-	5,513,748.00

Appendix A3 Investment Spending in Nakfa

3. Investment Spending											
Machinery and Equipment	2002	2001	2000	1999	1998	1997(8 months)	1996	1995	1994	1993	
Building and other											
construction works	142,022.00	2,128,804.00	2,285,427.00	2,643,670.00	59,102,284.00	46,318,295.00	14,774.85	64,223.27	125,060.37	-	
Vehicles	41,153.00	26,000.00	10,658,766.00	7,960,005.00	35,160,774.00	-	13,958.85	-	-	-	
Others	-	529,235.00	-	148,331.00	8,757,658.00	-	-	1,347,419.96	-	967,390.81	
	-	-	-	-	-	-	5,448.50	32,499.95	20,139.79	47,467.04	

Source for Appendix A1-A3: annual financial statement of Red Sea Bottlers Share Company (indirectly)

Appendix A4 Inventory in Nakfa

Year		1999	2000	2001
Finished Goods	Beginning	824,727	1,187,953	1,453,391
	Ending	1,187,953	1,453,391	3,078,956
	Difference (Change)	363,226	265,438	1,625,565
Raw Materials	Beginning	13,451,550	11,057,862	16,943,311
	Ending	11,057,862	16,943,311	9,564,375
	Difference (Change)	-2,393,688	5,885,449	-7,378,936
Spare Parts	Beginning	623,403	2,710,308	5,757,988
	Ending	2,710,308	5,757,988	7,515,941
	Difference (Change)	2,086,905	3,047,680	1,757,953

Appendix A5 Profit and Loss Statement for post privatization in Nakfa

(Profit and Loss account)						
Years	2002	2001	2000	1999	1998	1997
Turnover	173,530,530	130,893,990	95,361,404	64,951,240	23,685,662	24,679,789
Cost of sales		91,090,490	66,335,396	46,598,063		
Gross profit		39,803,499	29,026,008	18,353,177		
Operating expenses		21,139,105	16,477,727	13,209,089		
Profit before interest & tax		18,664,394	12,548,281	5,144,088		
Interest		706,107	169,382	569,520		
Profit Before Tax	8,425,254	17,958,287	12,378,899	4,574,568	1,579,461	5,299,279
Tax	2,864,586	6,955,232	6,214,173	2,719,341	383,985	2,018,219
Profit after tax	5,282,635	11,003,055	6,164,726	1,855,227	(1,963,446)	3,117,007

Appendix A6 Annual cash flows in Nakfa

Year	2001	2000	1999
Profit after tax before interest	11,003,055	6,164,726	1,855,227
Add annual depreciation	12,902,437	11,491,340	12,302,482
Less Capital Spending	5,383,968	7,558,041	2,705,203
Less Change In Stock	56,443	9,198,567	-3,995,418
Annual Cash Flow	18,465,081	899,458	15,447,924

Source for Appendix A4-A6 accumulated from documents found in Ministry of Trade and Industry

4. What are the short-term targets of the company and/or your division?

5. What reasons could you mention for the company and/or your division not meeting the required targets? (Tick all that is relevant from the following points)

- | | |
|---|---|
| <input type="checkbox"/> Disturbances of materials supply | <input type="checkbox"/> Absence of orders, contracts |
| <input type="checkbox"/> Lack of cash | <input type="checkbox"/> Lack of getting a loan |
| <input type="checkbox"/> Non-paying debtors | <input type="checkbox"/> High bank debt |
| <input type="checkbox"/> High trade liabilities | <input type="checkbox"/> Transportation problem |
| <input type="checkbox"/> Irregularity of production operation | <input type="checkbox"/> Poor work discipline |
| <input type="checkbox"/> Frequent breakdowns of machineries | <input type="checkbox"/> Managerial inefficiency |
| <input type="checkbox"/> Irregularity in electric energy supply | <input type="checkbox"/> Lack of workers skill |
| <input type="checkbox"/> Lack of incentive to workers | <input type="checkbox"/> Employment lay off |
| <input type="checkbox"/> Others (please specify) | |

6. Tick the performance measurement tools used in the organization.

- | | |
|--|---|
| <input type="checkbox"/> Profit before interest and tax | <input type="checkbox"/> Return on capital employed |
| <input type="checkbox"/> Net income after interest and tax | <input type="checkbox"/> Cash flow analysis |
| <input type="checkbox"/> Earning per Share | <input type="checkbox"/> Economic value Added (EVA) |
| <input type="checkbox"/> Return on Total Assets | <input type="checkbox"/> Share holder Value Added |
| <input type="checkbox"/> Return on Equity | <input type="checkbox"/> Others (Please specify) |

7. The company is trying to enhance its value using the following strategies (tick on the relevant column.)

Operations	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="checkbox"/> Increase local sales					
<input type="checkbox"/> Increase exports					
<input type="checkbox"/> Drop product price					
<input type="checkbox"/> Increase product price					
<input type="checkbox"/> Strengthen marketing					

<input type="checkbox"/> Establish local sales offices					
<input type="checkbox"/> Increase advertising					
<input type="checkbox"/> Increase number of employee					
<input type="checkbox"/> Cut wages					
<input type="checkbox"/> Increase wages					
<input type="checkbox"/> Being more selective to suppliers					
<input type="checkbox"/> More effective use of resources					
<input type="checkbox"/> Increase product quality					
<input type="checkbox"/> Change of product mix					
<input type="checkbox"/> Improve production efficiency					
Investments					
<input type="checkbox"/> New investment in equipment					
<input type="checkbox"/> Upgrade technology					
<input type="checkbox"/> Dispose of unprofitable assets					
<input type="checkbox"/> Control of capital expenditures					
<input type="checkbox"/> Reduce collection period of receivables					
<input type="checkbox"/> Increase payment period of payables					
<input type="checkbox"/> Implement cash control					
<input type="checkbox"/> Change in inventory policy					
Financing					
<input type="checkbox"/> Undertake long-term loan					
<input type="checkbox"/> Increase short-term loan					
<input type="checkbox"/> Decrease short term loan					

8. The company uses long-term loan as a financing instrument.

- Yes
- No

9. If your answer to question number 8 is No, list the possible reasons for not using it?

10. What are the main determinants of value creation in the company? (Value drivers- the driving forces that enable the company to be successful; For example, (a) The organization has a continuous improvement focus, (b) The organization has effective cost management processes)

11. Does the company employ an incentive scheme?

- Yes
- No

12. If your answer to question number 11 is yes, what type of incentive scheme is employed?

13. On what basis is an employee promoted? (Choose one)

- Merit
- Seniority
- Others (please specify)

14. What communication channels are used to update the employees?

15. At every level of the organization there is a sufficient degree of understanding of how actions and decisions affect value of the company. (Choose one)

- Strongly agree
- Agree
- Neutral
- Disagree
- Strongly disagree

Completed by:

- General Manager*
- Financial Manager*
- Marketing Manager*
- Production Manager*
- Technical Manager*
- Other Division Manager*

Thank you for completing this questionnaire.