

ANANDAM MANUFACTURING COMPANY: ANALYSIS OF FINANCIAL STATEMENTS

Vinay Goyal and Subrata Kumar Mitra wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Version: 2016-04-06

In July 2015, Anand Agarwal, owner of the Anandam Manufacturing Company (Anandam), approached the local bank for additional funding of ₹50 million¹ to meet the growing requirements of his garment manufacturing company. After a fourfold increase in revenue from 2 million to 8 million in three years and a phenomenal increase in profit after taxes (PAT) from ₹0.364 million to ₹0.84 million during the same period, Agarwal confidently discussed the financial needs of his company.

In a lengthy and healthy discussion with the bank manager, Agarwal explained the development of his company and the dynamics and growth opportunities of the garment and textile market in India. Agarwal proudly presented the performance of his company to the bank manager, which he believed was excellent in a highly competitive industry environment. The bank manager handed over the financial records of Anandam, including an income statement and balance sheet (see Exhibits 1 and 2), to his loan officer and ensured Agarwal that once the documents were processed and analyzed, he would get back to him in the coming week. He instructed the loan officer to process the loan application submitted by Agarwal as soon as possible and inform him about the decision taken by the bank.

INDIAN GARMENT MANUFACTURING SECTOR

India was the second-largest producer of garments in the world. The textile sector in India contributed 24 per cent of the world's spindle capacity and 8 per cent of the global rotor capacity. By 2021, this industry was expected to grow in size to US\$223 billion.² An ample availability of raw materials and a skilled workforce had helped the country become a lucrative centre for the world garment industry.³

The Indian textile sector contributed 4 per cent to the gross domestic product of the country; 14 per cent of India's industrial production came from this industry and 27 per cent of its foreign exchange inflows

¹ ₹ = INR = Indian rupee; US\$1 = ₹64.03 as of July 31, 2015.

² All dollar amounts are in U.S. dollars.

³ Corporate Catalyst (India) Pvt Ltd, *A Brief Report on Textile Industry in India*, 2, July 2015, accessed July 11, 2015, www.cci.in/pdfs/surveys-reports/textile-industry-in-india.pdf.

came from the Indian textile sector. More than 45 million people were directly or indirectly employed in the garment industry. Demand for garments in the domestic market, as well as in the international market, had strengthened the growth prospects of the textile sector. In 2014, cloth production in the Indian textile mill segment grew by 6 per cent, and the production of man-made fibre increased by 4 per cent. It was anticipated that the textile and garment manufacturing segment was set for strong, robust growth, which was also supported by data.⁴ The industry average of key ratios also illustrates that the financial performance of companies in the textile segment are reasonably constant and stable (see Exhibit 3).

In the past three years, the textile market in India had registered growth of approximately 14.58 per cent. In FY2013/14, the Indian garment industry attracted foreign direct investment worth \$11 billion, and a textile industry expert had anticipated that the exports of garments from India would reach \$60 billion in the next three years. This would be supported by increased labour costs in China, improvements in demand from the United States, and improvement in the quality of products manufactured in India. An approximate 12 per cent higher growth over 2012–13 was achieved in 2013–14 in the export of textile products in India, which touched the encouraging figure of \$35.4 billion.⁵ The United States had been the primary market for Indian garment exporters.⁶

CHALLENGES FACED BY THE INDIAN TEXTILE INDUSTRY

The Indian textile industry faced many challenges, including:

- a dearth of trained employees,
- a shortage of energy and simultaneously increasing costs of energy,
- high transportation costs,
- ambiguous and obsolete labour laws,
- outdated technology and reluctance by industries to implement new technologies, and
- a lack of economies of scale.⁷

ANANDAM MANUFACTURING COMPANY

Established in 2012, Anandam was in the business of garment manufacturing, specializing in formal party dresses for girls up to 12 years of age. Agarwal, a qualified textile engineer who had worked for almost 12 years in a local garment manufacturing company, had left his job to open this small manufacturing unit, together with some of the skilled labourers he had known for many years. He was aware that competition was stiff in the sector, as both small-scale units and large-scale manufacturing units were present.

Agarwal felt that there was a dearth of good-quality dresses in the market. He was confident that if he provided innovative and modern garments to customers at reasonable prices, a sizeable share of the market still not penetrated by large companies could be captured. He was also aware that opportunities were growing in this segment.⁸

⁴ Ibid.

⁵ India Brand Equity Foundation, *Textiles and Apparel*, 15, August 2015, accessed April 1, 2016, www.ibef.org/download/Textiles-and-Apparel-August-2015.pdf.

⁶ Alessandra Mezzandri and Ravi Srivastava, *Labour Regimes in the Indian Garment Sector* (London, UK: Centre for Development Policy and Research, SOAS, University of London, October 2015), 16, accessed March 31, 2016, www.soas.ac.uk/cdpr/publications/reports/file106927.pdf.

⁷ Corporate Catalyst (India) Pvt Ltd, op. cit., 10.

⁸ Ibid.

Agarwal was familiar with the complete process of garment manufacturing, so he had no great difficulty starting the enterprise. With limited capital of ₹1.2 million, he opened for business in April 2012 at his residential premises, half of which he had converted into a small factory. The installation of machines and the procurement of raw materials were not challenging tasks for him, and he was able to arrange for all the resources required for manufacturing without encountering any obstacles. The only problem he faced was getting a stylish designer who could help him in designing new, modern dress styles for children. He felt that his exposure to design was inadequate; therefore, he recruited Ragini Iyer, a young fashion designer who had taken a course in fashion designing.

With the commitment of Ragini, a team of dedicated, skilled labourers, and the experience and expertise of Agarwal, the manufacturing unit suddenly started getting orders in numbers beyond its expectations. The fresh and new creative designs, good-quality fabrics, and fine finishing details spurred demand for the dresses, and the business started to grow.

FINANCIAL SITUATION OF ANANDAM

Financial liquidity and funding problems started increasing with the growth of the business. Agarwal began to face funding problems due to:

- the working capital required for regular purchases of raw materials,
- excessive credit periods granted to customers,
- a shortage of funds for purchasing new machines required for manufacturing, and
- insufficient factory space.

In 2012, when he started the business, Agarwal incorporated the company as a private limited company where he and his wife were the only shareholders; they had shares of ₹1.2 million. He borrowed funds during that year in the form of a mortgage loan and used the borrowed funds for both the short-term and long-term requirements of the business. The total amount borrowed by the company during 2012 was ₹0.736 million (taken against the mortgage of his assets, which had a value of ₹1.9 million). As the business expanded in subsequent years and the asset requirements increased, he continued to borrow money from the bank. In the second year, the loan from the mortgage was ₹1.236 million; in the third year, it was ₹2.5 million. Agarwal had little difficulty in procuring the mortgage loan, as the mortgaged value of his assets was quite high, and he also provided collateral security (his residential house) to the bank. With positive cash flows from operations, interest serving on the loans was also not much of a problem. Agarwal was not particularly cognizant of the financial nuances of long-term or short-term loans, so he simply continued to withdraw money and to use the funds wherever the need was felt.

A part-time accountant maintained the financial records of Anandam. The accountant kept daily accounting records, including vouching, cash maintenance, receipts, and payments for the company, and prepared monthly, quarterly, and annual financial statements as per statutory requirements. His financial statements were audited by a professional accountant. The business was generating profits after all the expenses and interest payments, so Agarwal was happy and always felt like a successful entrepreneur.

FUTURE PROSPECTS

Analysts believed that the domestic and export demand would lead the Indian textile and garment sector to the \$220 billion mark by 2020. An increase in consumerism and disposable income was causing the

retail sector to undergo rapid growth. Many national and international players were entering the Indian textile market. A compound annual growth rate of more than 13 per cent was expected in the apparel segment over the next 10-year period.⁹

The various drivers that enabled the growth of the textile sector in the Indian market were the following:

- Increases in per capita income and demographic distribution.
- A shift among the youth towards branded products and changes in the lifestyle of the general population.
- Superior-quality products.
- Favourable trade policies.
- Increased opportunities for exports.
- Increases in cloth production due to demand in the local market.
- Growth in the retail sector due to increases in the consumerism and disposable income of the population.
- The government of India being determined to provide training for approximately 2.7 million people in their integrated skill development scheme. This scheme, as per the 2012–17 five-year plan,¹⁰ would cover subsectors of the textile industry, including apparel, handlooms, jute, sericulture, and handicrafts.¹¹

PROPOSAL TO THE BANK: CURRENT SCENARIO

Agarwal urgently needed the loan to meet the cash and investment requirements of the business. He submitted a detailed proposal and project report to the bank, along with the financial statements of previous years.

As the business expanded and the number of clients increased, his financial problems had also increased. Agarwal's credibility in the market was good, so he had no problem procuring the necessary raw materials, but he faced a problem when trying to collect money from his customers because he had no structured system for keeping track of extensions of credit periods. He had also begun to observe stock piling up in his factory, as the orders were either not dispatched or the customers delayed delivery. His machines were also getting old, and he felt that the time had come to replace them with new ones that were modern and more efficient. The factory space was not sufficient, and a larger location was essential. New skilled labourers and some additional staff members were also required to support his expansion plans.

All in all, Agarwal faced a severe need for additional financing of 50 million at a minimum to continue with smooth operations and to expand his business.

Eagerly awaiting the decision of the bank, which he was anticipating would be favourable, Agarwal sat in his office and envisaged taking Anandam to new heights.

⁹ Ibid.

¹⁰ The Planning Commission was set up by a resolution of the government of India in March 1950 in pursuance of the declared objectives of the government to promote a rapid rise in the standard of living of the people by efficiently exploiting the resources of the country, increasing production, and offering opportunities to all for employment in the service of the community. The Planning Commission was charged with the responsibility of making an assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilization of resources, and determining priorities. The new Modi government in India announced the formation of the NITI Aayog (National Institution for Transforming India) by dissolution of the Planning Commission. See "History," Planning Commission, November 5, 2014, accessed February 3, 2016, <http://planningcommission.nic.in/aboutus/history/index.php?about=aboutbdy.htm>.

¹¹ Ibid.

EXHIBIT 1: INCOME STATEMENT, APRIL 1 TO MARCH 31 (IN ₹ THOUSANDS)

	2012–13	2013–14	2014–15
<u>Sales</u>			
Cash	200	480	800
Credit	1,800	4,320	7,200
Total sales	2,000	4,800	8,000
Cost of goods sold	1,240	2,832	4,800
Gross profit	760	1,968	3,200
Operating expenses:			
General, administration, and selling expenses	80	450	1,000
Depreciation	100	400	660
Interest expenses (on borrowings)	60	158	340
Profit before tax (PBT)	520	960	1,200
Tax @ 30%	156	288	360
Profit after tax (PAT)	364	672	840

Source: Company's audited financial statement.

EXHIBIT 2: BALANCE SHEET (IN ₹ THOUSANDS)

	2012–13	2013–14	2014–15
<u>Assets</u>			
Fixed assets (net of depreciation)	1,900	2,500	4,700
Current assets			
Cash and cash equivalents	40	100	106
Accounts receivable	300	1,500	2,100
Inventories	320	1,500	2,250
Total	2,560	5,600	9,156
<u>Equity & Liabilities</u>			
Equity share capital (shares of ₹10 each)	1,200	1,600	2,000
Reserve & surplus	364	1,036	1,876
Long-term borrowings	736	1,236	2,500
Current liabilities	260	1,728	2,780
Total	2,560	5,600	9,156

Source: Company's audited financial statement.

EXHIBIT 3: INDUSTRY AVERAGE OF KEY RATIOS

Ratio	Sector Average
Current ratio	2.30:1
Acid test ratio (quick ratio)	1.20:1
Receivable turnover ratio	7 times
Receivable days	52 days
Inventory turnover ratio	4.85 times
Inventory days	75 days
Long-term debt to total debt	24%
Debt-to-equity ratio	35%
Gross profit ratio	40%
Net profit ratio	18%
Return on equity	22%
Return on total assets	10%
Total asset turnover ratio	1.1
Fixed asset turnover ratio	2
Current asset turnover ratio	3
Interest coverage ratio (times interest earned)	10
Working capital turnover ratio	8
Return on fixed assets	24%

Source: Computed by the authors using the Prowess database from CMIE, accessed March 22, 2016, <https://prowess.cmie.com>.