THINK INDIA JOURNAL

ISSN:0971-1260
Vol-22- Issue-14-December-2019

Analysis Of Performance And Profitability Of Sunbird Malawi

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ABSTRACT

This research paper is focused to analysis of performance and profitability of Sunbird Malawi. The objective of this study is to analysis the return on capital employed ratio, average rate of return and return on revenue to determine the financial structure of the company (Sunbird Malawi). This is a very important case because it helps to know how the company is doing on the market and if the finances invested (capital) is being put to its best use. Sunbird Malawi is one of the leading among most resorts located in Malawi. According to the information and data gathered, the paper will recommend the best and more efficient ways on how capital can be put to its best use.

Key words: Analysis of performance and profitability, capital employed, return on capital and EPS

1.1 Introduction to the Study

Return on Capital employed, average rate of return and return on revenue determine the profitability of a company, with complex calculations concerning the earnings. Before making an investment decision, there is need to look at the return on capital employed, average rate of return and return on revenue. Financial statements aim at providing financial information about a business enterprise to meet the information needs of the decision-makers. Financial statements prepared by a business enterprise in the corporate sector are published and are available to the decision-makers. These statements provide financial data which require analysis, comparison and interpretation for taking decision by the external as well as internal users of accounting information. Analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial

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information and points out the areas which require investigation. Analysis is a technique which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a lot of information which helps the analyst to know the areas of the business which need more attention, to know about the potential areas which can be improved with the effort in the desired direction, to provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business.

Every business regardless of its size or function needs to measure its performance and once measured, benchmark itself against its peers in the market. This, however, can be difficult as it's hard to find a tool that not only allows for both inter-company and intra-company comparisons that can also be used year-in, year-out as a consistent basis for performance measurement. Return on Capital Employed (ROCE), Average Rate of Return (ARR) and Return on Revenue (ROR) are tools that can be used for such comparisons as it is a consistent measure of performance and profitability from year to year.

The Balance Sheet is just a snapshot of the assets and liabilities of a business at a point in time. However, its interaction with profit and loss, through Earnings Before Interest and Tax (EBIT) and Earnings After Interest and Tax provide the platform for developing a totally dynamic analytical structure.

1.2 Introduction about the Company

Sunbird Malawi is one of the most known destinations or hospitality locations in Africa, with its location in the warm heart of Africa (Malawi). It helps to bring foreign exchange in Malawi and also helps to improve the tourism industry. Sunbird is strategically positioned to lead change in the hospitality space in Malawi. The Board's attention remains improved service delivery and guest experience, product improvements (refurbishment) and intensified sales and marketing activities to key accounts. There are a number of key product improvement plans that are currently underway. Sunbird complies with MALAWI CODE 11 (Code of Best Practice for Corporate Governance in Malawi 2010) and endorses the principles of the King Report on Corporate Governance for South Africa, 2009 (King III). Although the Malawi Code II follows a "comply or explain" principle, and specifies that a company can adhere to the Code or explain where it has not adhered, Sunbird follows all the recommendations.

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Sunbird Tourism still enjoys market leadership in the hospitality industry. To consolidate this market position, management's attention remains focused on improved service delivery and guest experience, product improvement (refurbishments) and intensified sales and marketing activities to key accounts.

1.3 Background to the study

Sunbird Malawi is the largest hospitality enterprise in Malawi and it creates an overriding backdrop of the Malawi hospitality and tourism sector. Sunbird Malawi exists to provide excellent accommodation, catering and related hospitality services with the intention of increasing shareholder value.

1.4 Problem statement

Malawian businesses or companies face huge problems on how to manage their capital and in turn investors and all other people involved are affected. The research will do an analysis on performance and profitability of Sunbird Malawi and suggest better ways on how it could be improved to protect the investors and the other individuals involved.

1.5 Research Objectives

1.5.1 Primary Objective:

The objective of this project is to do an analysis of performance and profitability of Sunbird Malawi.

1.5.2 The specific objectives

- To analyze the return on capital employed, average rate of return and return on revenue.
- To know the valuation of capital employment.
- To understand the effect of changes in capital employed, average rate of return and return on revenue.

1.6 Significance of the study

The study is significant as it will enable the business and company world to know how Sunbird as a company can best use its capital. The problems faced in profit and performance and to know if the company is a going concern.

1.8 Limitations of the study

This research is based on the data available in the balance sheet of the company. Moreover the article contains the analysis related the facts mentioned in the research. The

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main challenge faced in this study was omission of relevant information in the financial statements of Sunbird Malawi. For example, after tax costs were omitted, this affected further analysis in consideration of cost of capital. The other limitation was that not that many studies have been done on the company to help in referencing.

2.1 LITERATURE REVIEW

Return on Capital Employed (ROCE), Average Rate of Return and Return on Revenue are a measure of business effectiveness, profitability and performance. Every business should earn sufficient profits to survive and grow over a long period of time. It is the index to the economic progress, improved national income. Firms often make the mistake of focusing just on revenues, operating under the assumption that greater revenue means greater profitability when, in fact, their profitability is the key metric. According to Edge International Consultants, revenue is simply easier for firms to calculate. And with so much emphasis placed on recorded billable hours, firms fail to look at the bigger picture.

Thus, it leads to the conclusion that profitability means ability to make profit from all the business activities of an organization, company, firm, or an enterprise. It shows how efficiently the management can make profit by using all the resources available in the market. According to Harward and Upton (2001) profitability is the 'the ability of a given investment to earn a return from its use.

Performance is the execution or accomplishment of work feats etc. or a particular, action, deep or proceeding is referring as performance. However, the manner in which or the efficiency with which something reacts or fulfils its intended purpose is defined as performance. Performance may thus, mean different things to different businesses. Success or failure in the economic sense is judged in relation to expectations, return on invested capital and objective of business concern. Performance can be evaluated from various angles and by different users from their own point of views. A financial analyst will judge the performance from profitability and growth point of view. Profitability has been used as measure of performance. One of the financial indicators that give the utmost satisfaction to the investors is return that is generated by their investment but at the same time they are worried about the risk that is associated with their investment.

2.2 Return on Capital Employed

ROCE is a function of profitability, how much profit a business generates before interest on debt and tax (EBIT) and activity, how much a business has invested in operating

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assets to generate that level of profitability. Return on Capital Employed (ROCE) is a measuring tool that measures the efficiency and profitability of capital investments undertaken by a corporation. Return on Capital Employed ratio also indicates whether the company is earning sufficient revenues and profits in order to make the best use of its capital assets. High ROCE is a validation of a company's competitive advantage. It indicates that the company has something special to offer products or services that command a high return. It usually follows that margins are above average. The trend of both capital employed, and margins is, therefore, of considerable importance. Comparison of the ROCE of a company with others in its sector is a far more pertinent measure than comparison with the market as a whole. Companies with low returns are always suspecting because they are in danger of becoming loss-making if trading conditions deteriorate. Companies with exceptionally high returns may invite competition for their products or services, unless they are fully protected by patents or in some other way.

According to Abarbanell and Bushee (1998), ROCE allows comparison between business units of different size over time, shows where to invest further and where to cut back, shows whether it is worth borrowing further to invest, shows if expectations of shareholders are being met, indicates the maximum sustainable growth of a business and it's used to track whether or not a project is performing according to plan.

Ratner et-al (2009) ROCE can be used to test operational efficiency, balance sheet management efficiency and the adequacy of return on total capital employed to make an assessment of a business's performance. ROCE can be used to help management improve both the profitability (EBIT) and balance sheet management. Improvements in these areas will lead to improvements in the Return on Capital employed.

ROCE is a useful measurement for comparing the relative profitability of companies. But ROCE is also an efficiency measure of sorts; ROCE doesn't just gauge profitability as profit margin ratios do, it measures profitability after factoring in the amount of capital used. For example, say Company A makes a profit of MK 100 on sales of MK 1,000, and Company B makes MK 150 on MK 1,000 of sales. In terms of pure profitability, B, having a 15% profit margin, is far ahead of A, which has a 10% margin. However, let's say A employs MK 500 of capital and B MK 1,000. A has ROCE of 20% [100/500] while B has an ROCE of only 15% [150/1,000]. The ROCE measurements show us that Company A makes better use of its capital. In other words, it is able to squeeze more earnings out of every Kwacha of capital it employs. A high ROCE indicates that a larger chunk of profits can be invested back into the

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company for the benefit of shareholders. The reinvested capital is employed again at a higher rate of return, which helps to produce higher Earnings Per Share growth. A high ROCE is, therefore, a sign of a successful growth company.

Most companies need to invest capital in their revenue generating process to generate revenue. Capital refers to the plant and equipment used in the production function of a business, as well as its stock of financial assets. Capital is therefore the term used to refer to the amount invested in plant, property, equipment, inventory and other physical assets. Capital expenditure represents the funds used to acquire or upgrade fixed assets other than those associated with acquisitions. It includes but is not restricted to additions to property, plant and equipment, as well as investments in machinery and equipment. It typically represents the necessary expenditure associated with maintaining or increasing the scope of operations.

2.2.1 Calculating ROCE

The strength of this is its ability to measure a firm's efficiency in the deployment of its assets. However, as firms typically go through capital cycles or periods of increased capital expenditure followed by periods of lower capital expenditure. This tends to be unstable over time according to Coles (1997). Therefore, as capital expenditure varies from year to year, the static capital intensity measure tends to fluctuate.

According to Banerjee (2006) Return on Capital Employed = (EBIT)/ (Capital Employed) Where, EBIT refers to Earning or Operating Profit before Interest and Taxes. Capital employed is arrived at by subtracting Current Liabilities from Total Assets. EBIT is calculated by taking sales revenues less operating expenses and adding back any non-operating income generated by the business. Operating expenses usually include the cost of goods sold, cost to sell goods, and general or administrative expenses used to generate revenues for the business. Capital employed is the sum of ordinary and preference share capital plus reserves, debentures, loan stocks, all borrowings including obligations under finance leases, bank overdraft, minority interests and provisions. Deductions include investments in associated companies.

The basic idea is to arrive at a final figure that will tell you how much money (whatever the source) is being employed in the operation of a business. The resultant figure is then compared with the operating profits before tax, exceptional items, interest, dividends payable and share of profits or losses of associated companies. The percentage this figure bears to adjusted capital employed gives investors a measure of the return the business can produce on

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the capital employed within it. The return on capital employed denominator represents the total assets owned by a company minus current liabilities. Total assets include both the current and long-term assets listed on the company's balance sheet. Current assets typically include cash, marketable securities, inventories and accounts receivable. Long-term assets usually include any property, plant and equipment owned by the company to produce consumer goods or services. Current liabilities represent any money owed by the company, payable in less than 12 months.

According to Enyi (2005) and Khan and Jain (2000) Return on capital employed (ROCE) helps the company and the investors in the following ways:

ROCE is used to show how much a company is losing for its liabilities or gaining for its assets. It is used to show how much a company is losing for its liabilities or gaining for its assets.

It is also used to compare the performance of two businesses and for assessing whether a business generates enough returns to pay for its cost of its capital. Thus, ROCE should always be higher than the rate at which the company is borrowing; otherwise any incremental borrowing will reduce shareholders' earnings. In other words, ROCE denotes the return that a business should generate for it to function.

ROCE is used to prove the value the business gains from its assets and liabilities, a business which owns lots of land but has little profit will have a smaller ROCE to a business which owns little land but makes the same profit. It is basically used to show how much a business is gaining for its assets, or how much it is losing for its liabilities. Some investors consider ROCE the primary measure of profitability since it compares the inputs (total capital invested into the company) with the outputs (profits generated by the company). Industry and investors will possibly look at the relative size of the Return on Capital Employed ratio. This is because a high ROCE percentage that a company is profitable

According to Skinner (1990) businesses and analysts often make an underlying error in budgeting or forecasting business performance and hence a business valuation. When undertaking a valuation, the biggest error usually arises from utilizing overly optimistic forecasts. Discount rates are generally less susceptible to such errors.

According to White et-al (1998) the underlying issue is that most budgets for mature businesses more than often assume expanding profitability, increasing activity, reducing levels of capital expenditure for every dollar of sales and therefore increasing ROCE. According to Jarvis and Skidmore (1978) more often than not a mature business is unlikely to

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see these improvements on an ongoing basis. While some improvement is always possible continuous expansion is unlikely to be experienced on an ongoing basis and the art of getting the forecasts correct is challenging such ongoing expansion assumptions.

According to Smith and Hickman (2006) ROCE is a measure of a company's profitability and its activity. Quite simply a good ROCE is a level that exceeds the weighted average cost of capital for the business. Where this is the case the business will be creating value for its shareholders.

Smith and Hickman (2006) the main features of ROCE as an investment measure are as follows:

High ROCE (in the region of 20% or more) is a validation of a company's competitive advantage. It indicates that the company has something special to offer, products or services that command a high return. It usually follows that margins are above average. The trend of both capital employed, and margins is, therefore, of considerable importance.

2.3The return on revenue (ROR)

According to White and Fried (1998) the return on revenue (ROR) is a measure of profitability that compares net income of a company to its revenue. This is a financial tool used to measure the profitability performance of a company. Also called net profit margin.

The return on revenue (ROR) is tool for measuring the profitability performance of a company from year to year. This ratio compares the net income and the revenue. The only difference between net income and revenue is the expenses. An increase in ROR is means that the company is generating higher net income with lesser expenses.

According to McLaughlin (2009) this ratio can help the management in controlling the expenses. It can give indications of rising expenses. If a decrease in return on revenue is observed, the management should know that the expenses are not being managed as efficiently as in the past. The management should find out why the expenses are rising and then take steps to reduce them. An increase in the ROR is an indication that the expenses of the company are being facilitated efficiently. These insights can help to see a clearer picture of the expenses and it can help to control expenses.

2.3.1 Calculation (formula)

The return on revenue (ROR) is calculated by dividing the net income by the revenue. This can be expressed in the following formula.

Return on Revenue (ROR) = Net Income / Revenue

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Both of these figures can be found in the income statement. Net income is also sometimes referred to as profit after tax.

This ratio should be used in conjunction with other financial ratio to see the full picture of a company financial performance and financial position. This ratio tells us only about the financial performance of a company and does not tell us anything about the financial position of a company because it does not consider the assets and liabilities of a company (According to Rutherford, 2002)

2.4 Average rate of return

According to Bishop (1969)average rate of return (also known as simple rate of return) is the ratio of estimated accounting profit of a project to the average investment made in the project. ARR is used in investment appraisal.

2.4.1 Calculation (Formula)

Average rate of return is calculated using the following formula:

ARR = Average Accounting Profit /Average Investment

Average accounting profit is the arithmetic mean of accounting income expected to be earned during each year of the project's life time. Average investment may be calculated as the sum of the beginning and ending book value of the project divided by 2. Another variation of ARR formula uses initial investment instead of average investment.

ARR = Annual average net earnings after taxes X 100

Average investment over the life of the project

ARR = Annual average net earnings after taxes X 100

Original Investment

The term average annual net earnings are the average of the earnings after depreciation ad taxes over the whole of the economic life of the project. In case of annuity, the average after tax earnings is equal to any year’s earnings.

According to Smith and Hickman (2006) like payback period, this method of investment appraisal is easy to calculate. It recognizes the profitability factor of investment. Disadvantages include that it ignores time value of money. Suppose, if we use ARR to compare two projects having equal initial investments. The project which has higher annual income in the latter years of its useful life may rank higher than the one having higher annual income in the beginning years, even if the present value of the income generated by the latter project is higher. It can be calculated in different ways. Thus, there is problem of consistency.

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It uses accounting income rather than cash flow information. Thus, it is not suitable for projects which having high maintenance costs because their viability also

3.1 RESEARCH METHODOLOGY

The research was based on descriptive and analytical methods; the major purpose of descriptive research is description of the state of affairs as it exists at present. In this study the data are obtained through secondary source. The sources of data were the historical financial statements of Sunbird Malawi published from 2014 to 2017. The data collected from various publications of the government, various publications of foreign governments or of international bodies and their subsidiary organizations, technical and trade journals, books or magazines and newspapers and reports and publications of various associations connected with business and industry. The data is analyzed by using ratio analysis. Ratio analysis is applied to how the capital employed, average rate of return and return on revenue have been going about.

4.1 Discussion and Findings

The summary of findings is presented based on the detailed analysis and interpretation of the data prepared in the previous chapter. The inputs to the analysis were the financial results taken from the company's (Sunbird Malawi) published financial statements from 2014 to 2017. In this research paper return on capital employed, average rate of return and return on revenue have been considered as a value of measuring the performance and profitability of Sunbird Malawi. Sunbird Malawi shows an increasing return on capital employed, average rate of return for all the years and a decreasing return on revenue through the years 2014 to 2016.

The increase of return on capital employed and average rate of return reveals that there was improvement in resource allocation and improved efficiency in operations. Also based on the fact that the budget for the tourism industry was increased by the government, this hence improved many factors concerning the tourism industry, for example promotions and advertisements. While decrease of return on revenue from 2014 to 2016 is based on one factor that management had failed to control their business operating expenses, which eventually affected the company's bottom line or its net income in the case of return on revenue. The rise in 2017 was a sign that operating expenses were minimized to register a high return on revenue percent.

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4.2 Recommendations

From the findings, the study recommends that Sunbird Malawi should find ways on how to conduct their promotions and advertisements rather depend on the government budget in the tourism sector. Sunbird can also consider trading through the US dollar rather than the local currency which fluctuates; this would raise the return on capital employed, return on revenue and average return on revenue. There is need to improve on the operating expenses that affect the net income which in turn affect the return on revenue. Finance managers should undertake projects that yield higher returns as compared to the cost of raising it and funding should be done before drawing a project plan or starting to the project. For example, Sunbird Nkopola in Mangochi had to shut down its pool for more than three months and Sunbird in Mzuzu drew up plans to build a pool in 2016, upon which the project is yet to get underway.

A strong recommendation should be on the government to improve the budgets towards the tourism industry, this would improve the revenue and capital for Sunbird. Which may facilitate to manage the resources efficiently employed.

4.3 Recommendations for further research

There's need for further study on the subject to provide more light on how Sunbird Malawi operates and whether it will be a growing concern for years to come. Further study will also help the company world i.e. investors, shareholders and suppliers, to decide to get into business with Sunbird Malawi.

5.1 Conclusion

The data analysis of the financial statements of Sunbird Malawi (consolidated and separate) from 2014 to 2017 shows that Return on Capital Employed was increasing and a significant increase was seen in 2017. While Return on Revenue showed mixed results, with a decrease in 2015 and 2016, increase in 2017. The average Rate of Return behaved the same way as the Return on capital employed, with a significant increase in 2017. The idea behind selecting analysis of performance and profitability of Sunbird Malawi as a project topic was to analyze and to understand the usefulness of Return on Capital Employed (ROCE), Average Rate of Return (ARR) and Return on Revenue (ROR) as performance measurement tools and profitability measurement tools i.e. to understand the problems faced in capital use, to know if the company is a going concern, to know the valuation of capital employment and to understand the effect of changes in capital employed. Sunbird Malawi has managed to keep

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itself as a growing concern in the company world with an increasing return on capital employed and average rate of return whereas return on revenue had mixed results, with a decrease between the years of 2014 to 2016 and a rise in 2017.

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