

*ADVIK Group*

*Return on Capital employed*

*Guidelines for Computation and related SOPs*

Prepared on	
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## 1. Project Objective

Advik Group ("Advik") is planning to restructure the Financial MIS in order to review the business performance in a holistic manner (i.e., including Balance sheet & Return matrices) at a Business Unit & Plant level

## 2. Business plan & ROCE

- ❖ The Board of Directors of Advik wish to evolve from an EBITDA based performance monitoring system into a more holistic, ROCE based review mechanism. This is in line with Advik's strategy over the next few years.
- ❖ ROCE benchmarking
  - **For established Plants and Warehouses** : could be benchmarked basis the historical trends and duly adjusted for future capex and any operational changes
  - **For New Plants/ Acquisitions** : comparison of the performance to budgeted ROCE basis feasibility study/ commercial due diligence

### 3. What is ROCE?

#### CONCEPT :-

ROCE stands for **Return on Capital Employed**. It is a financial ratio used for assessing a company's profitability and capital efficiency.

ROCE gives the amount of profit a company is generating for each Re. 1 of capital employed.

As **companies mature** in their lifecycle, they typically rely on holistic ratios like ROCE to measure business performance.

$$\text{ROCE} = \frac{\text{EBITDA}}{\text{Capital employed (C.E)}}$$

EBITDA = Earnings Before Interest, Tax, Depreciation & Amortization

**Capital employed =**

Fixed assets (Gross Block + Capital Work In Progress)  
+ Net working capital (Receivables + other current assets  
+ Inventory - Trade & other Payables - Interplant balances)

Alternatively, it can also be calculated as Equity Capital  
+ Reserves and Surplus + Debt (long term and short term) - Cash and Bank balance - Interplant balances

#### ❖ IMPLICATIONS :-

- Capital markets rely on this ratio to compare performance across different companies / sectors.
- ROCE also indicates the margin of safety relative to the borrowing costs of the Company.

#### ❖ LEVERS OF ROCE :-

- Net Fixed Assets : Any reduction or optimization in capex for an expansion project / plant will positively impact ROCE.
- Net Working capital : In most capex light businesses, working capital is a key lever to improve ROCE.
  - Higher Inventory holding – negatively impact ROCE.
  - Higher Receivable cycle (e.g.: exports) reduces ROCE.
  - Higher Payable cycles may improve ROCE but might have adverse impact on Company reputation due delayed payments over & above the credit period.

**As per industry practice, ROCE = EBIT/C.E but as per internal discussion with Advik leadership, the formula has been customized to achieve Advik's objectives.**

**\* EBIT = Earnings before Interest & Taxation ; C.E = Net Fixed Assets + Net Current Assets excl. cash**



4. Components of ROCE : definitions, inclusions, exclusions from Advik perspective

+ EBITDA:

**MANUFACTURING PLANTS**

Income

Sales	Plant	BU	Apex	Group/ MD	
Manufacturing Sales	✓	✓	✓	✓	
Scrap & Other Sale	✓	✓	✓	✓	
Interplant Sale and Intercompany sale	✓	✗	✗	✗	BU level - adjust in RMC
Pass through Sale	✗	✓	✓	✓	shown in other income
Child Part Sale to Vendors	✗	✗	✗	✗	shown in other income
Wind Power Sales	✗	✗	✗	✗	shown in other income

Other Income	Plant	BU	Apex	Group/ MD	
Foreign Exchange Fluctuation Gain/Loss (AP/AR)	✗	✗	✓	✓	
Foreign Exchange Fluctuation Gain/loss (borrowings)	✗	✗	✓	✓	
Income from Investment	✗	✗	✗	✓	Not to be allocated to BU / Plants
Non Manufacturing Sales (tool, Rm, asset sale)	✗	✗	✗	✗	
Other Income (govt incentives, Cash Discount)	✓	✓	✓	✓	
Pass through sale	✓	✗	✗	✗	
Child part sale to vendors	✓	✓	✓	✓	
Wind Power Sales	✗	✗	✗	✓	Not to be allocated to BU / Plants
Volume discount	✓	✓	✓	✓	* See Below Note

Raw Material Cost

RMC - Direct Material & Sub Contracting (B)	Plant	BU	Apex	Group/ MD	
Raw Material	✓	✓	✓	✓	
Interplant Sale BOM Cost	✓	✗	✗	✗	shown in other raw material costs
Child Part Sale to Vendor BOM Cost	✗	✗	✗	✗	shown in other raw material costs
Pass through RMC	✗	✓	✓	✓	shown in other raw material costs

Other raw material costs	Plant	BU	Apex	Group/ MD	
Interplant Sale BOM Cost	✗	✓	✓	✓	
Child Part Sale to Vendor BOM Cost	✓	✓	✓	✓	
Pass through RMC	✓	✗	✗	✗	
Volume discount	✓	✓	✓	✗	* See Below Note

\* Volume Discount Note:-

Volume discount will work out and reduce from sale & shown in other income. Same values should be considered as volume discount expenses provision under other Raw material costs. In short volume discount effect will be nullified at plant level, BU level and Apex level. Whereas group level actual position will be considered.



Notes:

1. All other expenses to be considered at actuals
2. Provisioning for gratuity, leave encashment, etc. to reduce Year end reconciliation with actuarial valuation.
3. Volume discount to be considered under other income (to be accrued on quarterly basis ) and to be expensed out at all levels (Plant, BU and Apex) except Group level
4. Provisioning for export incentives on monthly basis.
5. Quarter end / Year end Sale in transit and respective COGM should be reversed.
6. Customer and Vendor price amendments : Provisioning to be made on a quarterly basis – this has been confirmed by relevant leadership team
7. Sales from India to other legal entity abroad to be eliminated at group level.

**Pricing policy for Interplant transfers (Domestic)**

- Sales within the BU
  - Finished Goods : Sales from supplying plant at end customer price
  - Semi-Finished Goods : Sale from supplying plant at raw material cost (process cost not considered)
  - Raw material : Sale from supplying plant at raw material cost
- Sales between BU : at Arm's length price. Will be decided by the BU heads at the time of budget
- Sales between Legal entities : As per Income tax Transfer pricing guidelines, certified by CA

**Forex transactions**

Following points were considered w.r.t forex transactions & their accounting :

- In order to consider Forex gain/loss on operating activities at Plant level, we will have to create separate EEFC accounts under each Plant
- Forward covers will have to be taken separately in each Plant
- These EEFC accounts will be used for operating activities of the respective Plants
- A separate EEFC account to be opened under SSD for financing transactions such as ECB repayment and interest payments
- However, we will need to consider the following aspects as well :
- EEFC balance transfer can be done from one account to the other but will require additional finance charges and administrative manpower for monitoring purposes
- In any case, there will be a deviation between budgets and actuals if the Forex rate changes. There practically doesn't seem to be a solution to address this
- For unrealised gains/losses - All the debtor and creditor accounts open entries and respective booking rates will have to be checked and JVs be passed. Cash/ Forex in transit (i.e. customer has made payment, but not received on cut off date) will have to be monitored carefully as well.
- ✓ Considering the above, the joint recommendation is that Forex gain/loss from operating activities be ignored while computing ROCE in Phase 1. As the process evolves, we can consider incorporating it as laid out above.
- ✓ ***As per internal discussions regarding the joint recommendation, all Operational & Financial forex gains/losses will be treated as non-EBITDA expenses at Plant, BU, Apex and Group/MD level.***

## WAREHOUSES

- ❖ **Warehouses sourcing majority of their requirement from a single plant (Parent Child relationship)**
  - P&L and Balance sheet of such warehouse should be clubbed with supplying parent plant
  - Actual receivable for warehouse (sale from warehouse to customer) to be considered in the parent plant
- ❖ **Warehouse sourcing from multiple plants (warehouse does not have an Administrative head) :**
  - Accountability of such warehouse shall be responsibility of the plant responsible for its administration. E.g.: Plant 9 administratively responsible for Plant 26.
  - P&L and Balance sheet of such warehouse shall be clubbed with the plant responsible for its administration.
- ❖ **Warehouse sourcing from multiple plants (warehouse has an Administrative head) :**
  - Admin head of such plant will be responsible for the P&L and Balance sheet
  - Such plant will have independent ROCE calculations for target setting / monitoring



## Shared Service Division (SSD)

### ❖ Wasuli Location

We understand that Wasuli location is being used by the following :

**Plant 15(BU1), Plant 34(BU2), Plant 35 (SSD), Plant 36 (BU2), Plant 39(BU1), Corporate engineering department**

1. Plant and Machinery at Wasuli location : Split on the basis of actual usage of each plant.
2. Land & Building : Gross Block to be split across the above locations (irrespective of age of construction), in the proportion of 50:40:10 for BU1, BU2 and SSD respectively.
3. Utilities : To be allocated in the same proportion as Land and Building

### ❖ Other SSD (Baner location)

1. Entire P&L result (excl. R&D and New Product Development (NPD) costs) to be allocated to each plant (in excel MIS only) in the ratio of :-
  - a. 50% towards proportion of Plant Gross Block to the consolidated Group Gross Block and
  - b. 50% based on absolute value of Plant contribution margin to Group contribution margin
2. (Contribution = Sales (-) COGM) (defined as per the table on Page 5)
3. Allocation to be made on Quarterly basis.
4. Windmill related P&L result, Financial Income (interest, dividend etc.) and MD office expenses should not be allocated to the plants & BU. To be incorporated only in MD & CFO MIS.
5. R&D and New Product Development or "NPD" costs not to be considered/ allocated for ROCE calculation at Plant and BU level for the first 1-2 years. The R&D cost will be allocated to Plants as per the no. of products developed by each Plant/ BU from Year 2 or 3 onwards. Decision to be taken in the future on the basis of no. of products developed for each plant. Alternatively, R&D budget can be given to each plant at the beginning of the year.
6. Fixed assets of Baner location (excl. assets of MD office) will be considered in capital employed at Apex and Group level and not at the Plant and BU level. MD office vehicles and any other assets of MD will only be considered at Group level



**✚ Capital Employed**

- Capital employed will be calculated at each plant based on :

**Gross block of fixed assets + Net Working Capital (excluding Interplant balances approach)**

<p><b>Net Fixed Assets:</b></p> <p><b>Inclusions :</b></p> <ul style="list-style-type: none"> <li>• Tangible fixed assets (Gross Block)</li> <li>• Intangible fixed assets (Before impairment)</li> <li>• Capital work in progress (Tangible/ Intangible)</li> </ul>	<p><b>Exclusions :</b></p> <ul style="list-style-type: none"> <li>• Intercorporate deposits</li> <li>• Investment in shares etc.</li> </ul>
<p><b>Net working capital :</b></p> <p><b>Current Assets</b></p> <p>Following components considered as part of Current Assets for net working capital figure:</p> <p><b>Inclusions :</b></p> <ul style="list-style-type: none"> <li>• Inventories</li> <li>• Debtors/ Trade Receivables</li> <li>• Loans and advances</li> <li>• Other current assets</li> </ul> <p><b>Exclusions :</b></p> <ul style="list-style-type: none"> <li>• Cash and cash equivalents</li> <li>• Interplant receivable balances/ zero balance clearing account.</li> </ul>	<p><b>Current liabilities:</b></p> <p>Following components considered as part of Current Liabilities for net working capital figure:</p> <p><b>Inclusions :</b></p> <ul style="list-style-type: none"> <li>• Trade payables</li> <li>• Outstanding expenses</li> <li>• Other payables</li> </ul> <p><b>Exclusions :</b></p> <ul style="list-style-type: none"> <li>• Interplant payable balances/ zero balance</li> <li>• Clearing account</li> <li>• Short term borrowings</li> <li>• Current Maturities of long term borrowings</li> </ul>

**Assumptions & Notes :**

- Sales from a plant in one legal entity to a plant in another legal entity gets classified as AR/AP and not as interplant transaction. Same will be eliminated at group level during consolidation.

## 5. Calculation of ROCE

1. Calculation and monitoring of ROCE to be done on quarterly basis, based on MIS, and reinstated for Q4 as per Audited figures.
2. ROCE calculations to be performed at Plant, BU, Apex and Group / MD levels including foreign entity PT Advik Indonesia (PTAI) and Advik Vietnam (AVCL).
3. For target setting of ROCE, AR to be adjusted for normative credit terms (PO terms + Transit days+ other agreed time period) and customer sales mix of each plant and same will not be considered at actuals
4. Other components (Inventory, Trade payable) of working capital to be taken on actual basis (except for inventory at certain warehouses as mentioned on Page 7) and represented in the Capital employed calculation accordingly.
5. Other Net working capital (i.e., excl. AR, AP, Inventory) to be factored in as per the ratio at a group level. (e.g.: It was 3 days in FY20).
6. Since we have used customised approach for ROCE calculations that excludes the interplant balances from capital employed, separate working capital KPIs need to be given for monitoring working capital targets/ performance at Plant, BU and Apex level.

On behalf of Advik Group



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Glossary :

Abbreviations	
EBITDA	Earnings before Interest, Tax , Depreciation and Amortisation
EBIT	Earnings before Interest and Tax
ROCE	Return on Capital Employed
AR	Accounts receivable
AP	Accounts payable
RMC	Raw Material Consumption
COGM	Cost Of Goods Manufactured
WDV	Written Down Value (After depreciation / net of impairment)
GVA	Gross Value Added (Sales – COGM)
SSD	Shared Service Division
WH	Warehouse
KPI	Key Performance Indicator
TBD	To be decided
Forex	Foreign Exchange

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