الجامعة الإسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
يونيبرسيتي إسلام انتارابغسا مليسيا

CASE STUDIES ON THREE SELECTED MALAYSIAN CORPORATIONS

- **MALAYSIAN AIRLINE SYSTEM BERHAD**
  (Turning around An Airline)
- **EKRAN BERHAD**
  (Financing A Mega Project)
- **DIVERSIFIED RESOURCES BERHAD**
  (Diversifying through Acquisitions)

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Prepared by : JOHAR YUSOF MBA 9510133
Supervisor : DR OBIYATHULLA ISMATH BACHA

International Islamic University Malaysia

Approval Page

CANDIDATE NAME: JOHAR YUSOF (G 9510133)

TITLE OF PROJECT PAPER: CASE STUDIES ON THREE SELECTED MALAYSIAN CORPORATIONS

The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfilment of the requirement for the Master of Business Administration (MBA).

Supervisor

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DR. OBIYATHULLA ISMATH BACHA

Date: 10/1/98

Dedicated to my wife, Tengku Noor Aliza Tengku Zainudin
for being very patient and helpful

and

to my children
Noor Syuhada Johar
Noor Mutmainnah Johar
Abu Dzar Johar &
Usamah Johar
for being very understanding

May Allah Bless All Of Us

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Malaysian Airline System

When Tajudin Ramli took over Malaysian Airline System Bhd. (MAS) and became the new executive chairman on 6 Aug 1994, many industry analysts believed that he was trying to become a corporate hero. In fact, based on MAS' erratic earnings record and mediocre long-run outlook, Tajudin was actually taking a big risk, trying to fly MAS in heavy weather.

Earlier, MAS' outgoing chairman, Tan Sri Zain Azrai, had announced in MAS' 1994 annual report, that MAS had survived its turbulent period and recorded a small profit of RM2 million (1994) compared to huge losses of RM184 million in 1993. This result was not good enough to relieve its investors. For a company who had been 50 years in the business and the sole monopoly in the Malaysian airline industry, the profit should have been more encouraging. In fact, its 1994 performance would have been worse if not for the selling off of its aircraft and spares amounting to RM11.8 million. One of the main contributing factors to MAS' low revenue was the completion of the North-South Expressway. It drastically reduced the number of MAS passengers especially for the lucrative Kuala Lumpur - Ipoh and Kuala Lumpur - Penang routes (domestic passenger traffic accounts for 60 per cent of its load factor).

As a result, many investors and analysts expressed a loss of confidence in MAS' financial outlook, at least for the ensuing few years. As one stock analyst commented on MAS' March 1994 annual report, "it is more worthwhile looking at a small capitalized company with large profit and in growth areas than to look at a large company with small profit operating in a lackluster industry." Others quoted, " As it is now (1994), our foreign clients do not look at the counter". Foreign fund managers also said that the MAS management had not been transparent enough for a thorough analysis to be made of the company's financial performance. Issues like unprofitable domestic services and intense competition were among a few concerns that had not been solved by the national carrier management.

In sharp contrast, Tajudin saw "clear skies" ahead, confirming his optimism in MAS' capabilities and future opportunities in the airline industry. He had no regrets at having bought MAS' shares at RM8, or at spending RM1.8 billion to gain the 32% stake in the airline through his company, Malaysian Helicopter Services. In fact, he was not alone in his optimism. The Malaysian government also had full confidence in him and his team.

MAS History

Malaysian Airlines was born in 1937 under the name Malayan Airways Limited (MAL). It was formed by the Ocean Steamship Company of Liverpool, the Straits Steamship Company of Singapore and Imperial Airways to operate an air service between Singapore and Penang. In 1947, MAL went international when its 21-seater DC3 fled to Batavia (Jakarta), Medan, Palembang and Saigon. It became public listed in 1958 under BOAC/QANTAS and the Governments of the Federation of Malaya, Singapore and Borneo Territories. The company name was later changed to Malaysian Airways Limited (MAL) immediately after the formation of Malaysia in 1963. In 1966, the Governments of Malaysia and Singapore jointly acquired majority control of the airline. Its fleet then consisted of five Comet IVs, six F27s, eight DCs and two Twin Pioneers. MAL was renamed Malaysia-Singapore Airlines Limited (MSA) in 1967. MSA expanded its international destination to the Philippines, Australia and Taiwan. Unfortunately, the MSA partnership did not last long and was dissolved in 1971. The same year, Malaysia Airlines Berhad was incorporated on April 3rd with authorized capital of RM100 million. It was later renamed Malaysian Airline System Berhad. On 6 November 1985, MAS became the first Government Company to become public listed after the issue of 70 million shares for public subscription. This helped to raise funds to increase the number of its fleet.

Four years later, Malaysian Airlines took delivery of its first two 747-400 aircraft, ordered eight A330 aircraft and equipment at a cost of RM2.4 billion to satisfy the airline's increasing frequencies, destinations and passengers. Today, Malaysian Airlines is striving to reach new levels of service and global expansion to elevate its standard to an international airline.

Financial Performance

Malaysian Airlines claimed that it finally regained control of its financial performance in 1994 when its company pre-tax profit surged back up to RM2.0 million from a dip of an RM184 million loss the year before. Whilst the management believed that the worst was over, many experts thought that this was no more than a reprieve. Even though MAS' revenue had been smoothly growing at an average of 15 percent annually (1990 to 1994) and its profit after tax consistently performing above RM100 million, it was insufficient to satisfy its own stakeholders. Technically, MAS profit was mainly generated from the sale of its old airplanes rather than from its flight operations.

Malaysian Airline System	*1994*	*1993*	*1992*	*1991*	*1990*
Operating Profit (RM million)	*4.5*	*(179.6)*	*41.8*	*(168.3)*	*146.4*
Profit On Sale Of Aircraft and Spares (RM million)	*11.8*	*337.1*	*77.5*	*370.3*	*47.7*

Table 1

Up until 1994, MAS had been selling its aircraft to other airlines and the income had contributed significantly to MAS' annual turnover. Table 1 shows that from 1990 to 1994 itself, MAS had sold more than RM800 million worth of planes and spares, and clearly digressed from its original core business activity in airline services.

In addition, MAS might well have slipped into the red in 1994 had it not been for the revision of the residual value of its aircraft depreciation from 10 per cent to 20 per cent. The revision resulted in an 69.1 per cent reduction in the airline's depreciation charges. Tan Sri Zain Azrai explained that "we thought it would represent accurately the residual value of all the aircraft at the end of their expected life. It is a calculation we made that 20 per cent was a more accurate representation of what we can reasonably expect from an aircraft after its planned life compared with the 10 per cent we used previously".

Malaysian Airline System	Life-Years	Residual Value As A Percentage of Cost	
		1994	1993
Boeing 747	15	20	10
Airbus A300B4	15	20	10
DC10-30	7-15	20	10
Boeing 737	10	20	10
Fokker F50	10	20	10
Twin Otter	7	20	10

Source: MAS Annual Report 1994

Table 2

The change had resulted in the depreciation charge for the year 1994 being reduced by RM69 million. Also, see Exhibit 1 & 2 for MAS Balance Sheet and Profit & Loss Statement.

Moreover, MAS debt-to-equity ratio had reached 1.8 in 1994. MAS had taken delivery of 27 aircraft during the year comprising of 16 B737-4006, B747-400, 4 B737-500 and 1 B737-300 freighter and leased 1 F50. MAS was also hit by external factors. "To be fair to Malaysian Airlines, the past few years since the Gulf War was a very bad time for the airline industry globally, due to the slump in fare prices and over capacity", one analyst commented.

The Acquisition

In Dec 1993, Bank Negara, the major stakeholder of MAS (on behalf of the Malaysian government) entered into a three-phase agreement with Malaysian Helicopter Service (MHS) to sell its stake, partly due to the government effort to privatize the National carrier. MHS was controlled by Tajudin Ramli, a corporate high flyer who was also the major stakeholder of Technology Resources Industries

Bhd. Malaysia's leading telecommunication company. Bank Negara Malaysia, MHS and RZ Equities(which was 99.99 per cent owned by Tajudin and family) had entered into several agreements to finalize the acquisition.

The first agreement between Bank Negara and MHS for the Sale and Purchase Agreement was finalized on 28 December 1993. Then a second Sale and Purchase Agreement between Bank Negara and RZ Equities was agreed, whereby RZ Equities, was to acquire Bank Negara's 32 per cent stake in MAS for RM1.79 billion. Thirdly, a put and call agreement between Tajudin and MHS was drawn up granting MHS the option to purchase the entire paid-up capital of RZ Equities from Tajudin. After exercising this option, MHS would effectively become the major stakeholder of Malaysian Airline System Berhad.

Many industry analysts were amazed with the acquisition. Why MHS? Questions were raised regarding MHS' financial capability, in view of the fact that its fixed assets were equivalent to the cost of two Boeing 737s. Was MHS capable of controlling a giant organization owning more than 65 aircraft, 40 of which were 737s? What would happen to the existing structure of the organization, and would the new management retrench some of their 20,000-strong staff?

New Strategy

One industry observer warned "running an airline is not as glamorous as it looks. What appears obvious from the outside, may not, in reality, be the truth." MAS had just survived some bad years for the airline industry, in the years following the Gulf War. The competition had been intense especially on the international routes, while operating costs had also been escalating. See Table 3 on MAS revenue versus operating costs. In addition, the timing of their need to expand and update the fleet had been inopportune, but the DC-10's and Boeing 737's were aging and had to be replaced. Worse still, their service had been declining due to shortage of pilots and cabin crews.

Malaysia Airline System	1994 (RM Million)	1993 (RM Million)	1992 (RM Million)	1991 (RM Million)	1990 (RM Million)	Average Growth
Operating Revenue	4081.2	3735.9	3570.1	2907.9	2306.2	15.4%
Operating Cost	4076.7	3915.5	3528.3	3076.2	2159.8	17.8%

Table 3

Tajudin's mission was crystal clear, namely: increased revenue and cut costs. To achieve this objective, Tajudin and his top management team had came up with a set of strategies to be implemented before the change of the millennium.

1. Optimize and increase efficiency of its divisions through creating new strategic business units. This approach required breaking up MAS existing divisions and converting it into profit centers. In addition, inherent bureaucratic processes had to be minimized. This strategy would also comprise restructuring

manpower, changing the organization policy and creating attractive employee benefits to enhance employee loyalty and improve services.

2. Creating new international routes through strategic alliances. Strategic alliances or Code-Sharing Systems agreements with other international airlines would provide MAS with better opportunities to increase its landing rights. By adopting this strategy, MAS would be able to fly to new international destinations thereby increasing its operating revenue. Moreover, increase in air fares was almost inevitable to ensure its competitiveness. MAS should also take the opportunity to explore the "open skies policy" with other countries such as the United States and European countries.

3. Part of MAS' modernization and rationalization programs were to purchase long range and wide-bodied aircraft. MAS planned to buy new aircraft to replace the older planes like DC-10 and Boeing 737. Earlier feasibility studies showed that MAS would need 25 more fleet to achieve this five-year transformation plan. The new aircraft such as Boeing 747 and the 'state of the art technology' Boeing 777 would transform MAS into a world class service provider in the airline industry. Anyway, the new planes would require an enormous outlay of money, and looking at the 1994 MAS gearing ratio of 1.8, it would be a formidable task for Tajudin Ramli.

Malaysian Airline's mission to become a global player and leader in the aviation industry would depend on the success of two factors: (1) its short term plan to improve its financial strength, (cost-cutting programs and organization restructuring), and (2) more importantly, its long term strategy, i.e. to form strategic alliances and transform its service standards.

Organizational Restructuring

As part of improving its efficiency, MAS completed its restructuring exercise in 1996 with the objective of becoming more competitive and profit-oriented. New work methodology and computerization programs were part of the exercise to replace the inefficient processes. Various changes in work processes were implemented across the board, even though during the earlier stage the company observed many obstacles and 'resistance to change' from the employees.

Since continuous and rapid improvements were considered imperative, the company shifted to a highly decentralized management structure, which transferred substantial responsibility to the business units' managers. MAS management converted its support units within the company into business units and then into separate companies, "thereby thrusting upon them the privilege of autonomy and the responsibility of profitability". As a result, five companies or core groups were set up to focus on passengers, ground handling, catering, cargo and engineering, while the other sectors of the organization became support units to the core groups. Each of the subsidiaries was primarily responsible and accountable for its own growth and profitability, while maintaining interdependency between themselves through continuous communication and feedback.

In the first year of its operation, MAS Catering Sdn. Bhd. attained a 14.84 per cent increase in meal production, while Malaysia Airlines Cargo achieved a record growth for cargo and mail traffic of 44.6 per cent. Other business units, MAS Golden Holidays Sdn. Bhd., MAS Aerotechnologies Sdn. Bhd. and MAS Golden Boutiques Sdn. Bhd. gained management confidence with favorable results in the ensuing years.

Improved Service

Many international travelers complained that MAS' service had declined in recent years. It had even been reported that it was not unheard of for the airline to repeatedly delay flights due to the acute shortage of pilots. 'Staff pinching' by the country's growing list of rich and private jet owners had been the main reason for the shortage of pilots and cabin crew. Pilots of Malaysian Airlines had opted for career advancement by joining companies with jets. In 1995/96, it was estimated that the airline was 15% to 20% short of pilots to meet its expansion programs. Another report said that the national carrier faced a shortage of about 50 pilots for the 737s, and a slight shortage of pilots for the bigger 747 and 777 aircraft. In order to fly Boeing 747 and 777 aircraft pilots need more flying experience - at least 3,500 hours, equivalent to approximately 5 years experience.

To solve the manpower issue, MAS management and Malaysia Airline Pilot Association (MAPA) had signed an accord in 1996 on the Terms and Conditions of Employment for its 1,200 pilots . Under the agreement, over 1000 pilots would receive salary increases of between RM600 to RM2000 after a 27 per cent review of their basic pay. The three-year accord, which ended four years of negotiations, was retrospective to 1 September 1995. The revision in salaries cost the airline some RM43 million. Furthermore, MAS had also allowed air hostesses who were grounded during their pregnancy to return to work as 'flying mothers' in a move to ease the shortage of stewardesses. Tajudin had also offered 231 million shares under a proposed Employee Share Option Scheme designed mainly to reward the staff for their contribution to the success of the carrier.

Human Resource programs featured high on Tajudin's agenda. He always believed that his employees were the most important asset of the company. In 1996, RM65 million was dedicated for training programs, incorporating the newly opened Malaysian Airlines Academy in Selangor. The academy was targeted to become the center of excellence for MAS training activities in Human Resource Development Programs: services training, air freight as well as fares and ticketing. MAS had also invested RM250 million for seven flight simulators, one each for the Boeing 747-400, B737-200, Airbus A330, McDonnell Douglas DC-10-30 and Fokker 50, and two B737-400/500 models.

New Route and Strategic Alliances

In 1995, MAS added seven new points to its network, ending the year with a total of 111 destinations, including 36 domestic. In the same year, MAS signed three Code Sharing Contracts with Virgin Atlantic, Ansett Australia and Canadian Airlines International The year before, two successful strategic alliances had been formed between Ansett New Zealand and British Midland. Hoping to hasten its process of globalisation by forging more Code Sharing Agreements, increasing frequencies and adding new destinations, it operated new routes to Shanghai, Cairo, Zagreb and San Francisco in 1996/97, and planned to increase frequencies to Europe, Australia, North Asia and South East Asia. The next targets to be included in its plan would be Chicago and New York as entry points to the mid-west and east coast of the United States, while the former Republic of the Soviet Union, Africa and South America would further be possible sectors before the end of the century.

Among the Code Sharing Agreements signed by MAS, the MAS-Virgin Atlantic agreement was the biggest success for Malaysian Airlines. It was dubbed a "Partnership for Growth" by Tajudin Ramli and considered to be a major breakthrough, providing capacity to meet the continuous demand for seats on the Kuala Lumpur-London route - the frequency of which had jumped from 8 times weekly to twice daily. In conjunction with the London-based airline, MAS launched freighter operations with weekly services from London to Malaysia, Australia and Japan. "Teaming up with a dynamic and innovative partner such as Virgin Atlantic will not only strengthen our position in the Asia Pacific region, but also open a major window of opportunity for Malaysian Airlines' future growth in the European market", Tajudin noted.

Due to the increasing operational costs and volatile fuel prices, MAS had raised its international air fares by three percent. The hike was in line with the proposal made by IATA (International Air Transport Association) to reflect higher operating cost for airlines worldwide.

Another interesting move by MAS was the "open-skies" pact with the United States. The open-skies policy was defined as "a country that opens up its skies to any airline in the world to operate services to its country with any number of frequencies, with any aircraft type and on any routing without asking for reciprocity". It offered more expansion opportunities while landing rights requirements became obsolete. So the next challenge for MAS would be to find the right hardware and the right aircraft to fulfill its commitments.

Buying New Aircraft

Tajudin made an announcement on 9 January 1996 that MAS was to purchase 25 Boeing wide-bodied aircraft, including 15 Boeing 777s, for about US$4 billion. The purchased, to be spread over five years, were part of the national carriers modernization and rationalization program that required long range, wide-bodied aircraft. The other aircraft ordered were 10 Boeing 747-400s with an option for two Boeing 777s and three Boeing 747-400s. MAS planned to use the Boeing 777-300 for its regional routes, a move intended to optimize its fleet resources. It was a medium-range jetliner that could carry 20 per cent more passengers than other aircraft in its class. By year 2001, MAS would have a fleet of 120 aircraft, including the new purchases. Table 4 shows the fleet capacity and growth for MAS.

Malaysian Airline System	*1996*	*1995*	*1994*	*1993*	*1992*
Available Capacity (million Ton Km)	5,381	4,184	3,509	3,316	3,083
Available Passenger Capacity (million seat Km)	35,161	30,878	26,337	23,862	21,583
Available Fleet (own & lease)	90	91	94	67	70

Table 4

Tajudin had indicated that 70 per cent of the purchase cost was to be financed through internal cash flow and the balance from external funds. As the new orders would replace a number of existing aircraft, some finances would be generated by the sale of the replaced aircraft.

Financing the New Aircraft

Many experts questioned MAS' decision to purchase the new aircraft. Their delivery, which staggered over 5 years, would cost MAS US$4 billion or RM10 billion at an exchange rate of US$ 1 to RM 2.5. It was a risky decision for MAS to proceed with this purchase, since its gearing ratio had an average between 1.6 to 1.8. External factors such as currency exchange risk, unpredictable fuel prices and the competitive nature of the industry, demanded the MAS management do their homework very thoroughly before they make any decision.

Remarkably, Tajudin declared that the airline was only short of RM500 million to finance the purchase of the 25 new Boeings. The first breakthrough was on 13 May 1996, when it made a highly successful block share placement of US$230 million, the largest ever underwritten in the country. The 70 million new shares were placed at RM8 each and underwritten by Deutsche Morgan Grenfell. Interestingly, the shares were subscribed in Europe, US and Asia, thereby significantly expanding MAS shareholders' base. This proved that MAS had an enviably strong track record as well as international investor confidence in the new management team.

In March 1997, MAS' Vice President of Treasury and Risk Management Saril Salleh announced that MAS would need to generate RM1 billion annually from its operations to partly finance the progress payment of the new aircraft. He added, MAS has projected that within the next five-year period (from 1996), it would generate cash flow of between RM6 billion to RM7 billion and part of this would pay for the 777s and 747s. The turnaround strategy formulated by Tajudin which incorporating Strategic Alliances Programs, new routes, new business units and improved standards of service would be the catalyst to achieve this objective.

MAS also would sell five Boeing 747s, return the lease of four aircraft and sell between seven to ten 737s and DC-10s to finance the order. It anticipated making about US$500 million (RM1.25 billion) from these sales.

Later, on 1 April 1997, MAS issued RM1 5 billion in unsecured bonds with 770 million detachable warrants , to later be placed out via a restricted offer for sale to existing MAS shareholders on the basis of one warrant for each share held. Proceeds from the conversion of the warrants - at a price to be fixed later - were used to redeem the bonds. Experts considered the bonds was a prudent way to finance the national carrier's expansion plans since it would be drawn from a mixture of equity, bonds, annual earnings and sale of older aircraft. Of the RM2.27 billion proceeds, RM1 billion was allocated to the new Kuala Lumpur International Airport (KLIA) facilities. The balance was used to pay for new aircraft and the cost of the exercise.

One month after the bond issuance, on 26 May 1997, through its wholly owned financing company Malaysian Airline Capital (Labuan) Ltd.), MAS managed to raise 50 billion yen (RM1.09 billion) through a 40 billion yen (RM876.4 million) fixed rate Euroyen issue and 10 billion yen (RM219.1 million) floating rate note issue. The five-year fixed rate of 2.55 per-cent and five year floating rate issue which pays a coupon of the six month yen London Interbank (LIBOR) offered rate plus 25 basis points were said to be a big plus to MAS. The Labuan based subsidiary was rated A plus by Japanese rating agency Nippon Investors Service Inc. Due to over-subscription and an overwhelming reception by investors, the originally 30 billion yen issues were raised to 40 billion yen to meet the demand. Daiwa Securities (H.K) Ltd heads the management group for the fixed rate issue while Sanwa International Finance Ltd handles the floating rate issue.

MAS Financing Arrangement for New Fleet		*US$ (million)*	*RM (million) (at US$1 to RM2.5)*
1.	*Share Placement*	230	575
2	*Selling of Aircraft*	500	1250
3	*Unsecured Bonds*	508	1270
4	*Fixed Rate Euroyen*	351	876
5.	*Floating Rate Euroyen*	88	219
6	*Internal Funds (Cash Flow & Right Issues)*	approx. 2,400	approx. 6,000
	Total	**4,077**	**10,190**

Table 5

In September 97, MAS really proved its mettle when the ringgit was attacked and devalued against the US dollar. Surprisingly, the weakened ringgit did not undermine the purchasing arrangements for the new aircraft. Tajudin Ramli commented that Malaysian Airlines was well buffered against the effects of the volatility on the foreign exchange market. "As far as payment for the new aircraft is concerned, we have done hedging and we will come out a winner rather than badly affected (by the wild fluctuations)", Tajudin said.

Results

MAS took delivery of its first Boeing 777-200 IGW (Increased Gross Weight) in May 1997. This was to be the platform for the airline to set new customer service standards at par with the world leaders. It became the first operator of long range IGW in South East Asia region. MAS was also the first B777 operator to have an on-board business center completely equipped with fax facilities, phones, notebook personal computers, printers and even a mini multimedia library.

Financially, it had done better than expected. Many industry analysts believed that MAS would again make profits in 1997, three years consecutively after Tajudin took over the helm. In 1996, MAS had chalked up a 67.6 per cent increased in group pre-tax profits to RM251.2 million as compared to RM149.9 million in 1995. Experts anticipated that, unlike in 1996, MAS would not be able to display favorable results but would sustain the same level as before, i.e. predicted net profit would be between RM211 million to RM285 million. It was almost impossible for MAS to reap higher profits since many external factors that had already affected other airlines would have a similar impact on MAS. Higher fuels costs, increasingly stiff competition from the regional carriers along with the generally lower yields seen in the airline industry were among the major issues. In addition, an upward adjustment of 27 per cent in pilot wages and arrears backdated to September 95 could cost MAS some RM43 million. Fuel prices as reported by Singapore Airlines and British Airlines to have spiked by 20 per cent to per cent would also have hit

MAS' earnings. MAS international fares, which were increased by 3 per cent to offset the fuel price hike, would only marginally increase MAS' revenue.

Most of the predictions were not even close. MAS 1997 financial results reached a new record high. And this time around it was not due to selling off aircraft. As predicted by Tajudin, MAS strategies had started to bear fruit. In three consecutive years, MAS had broken its own record. Its 1997 pre-tax profit was at a hefty RM349.4 million, which reflected a 39.1 per cent increased over the previous year. For the first time, MAS' operating revenue had surpassed the RM6 billion level (13.5% from 1996) - the bulk coming from the increased in international flights. As for the 3 per cent increase in international fares, Tajudin noted that, "We (MAS) have always maintained that we will not discount our fares to keep up with our competitors, and the last year results (1997) proved that our strategy has worked. People are willing to pay for quality services."

The most significant impact was due to its strategic alliances with international airlines. The Code Sharing Agreement with Virgin Atlantic, allowing MAS to fly more frequently to London and Australia, made a big impact on 1997 performance. Overall, revenue from international routes had increased by 11.3 per cent which contributed 80 per cent of MAS' turnover.

Furthermore, the move to create profit centers and introduce new processes in the operation of the airline resulted in vast increases in the airline's subsidiaries profit over the last three years. In 1997 itself, the total subsidiaries pre-tax profit