Test of Professional Competence in Management Accounting

Heather Barnwell
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Adrian Sims

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Important Note

A new edition of the *CIMA Official Terminology* is due to be published in September 2005. As this is past the publication date of this Study System the page reference numbers for 'Management Accounting Official Terminology' contained in this Study System are for the 2000 edition. You should ensure that you are familiar with the 2005 *CIMA Official Terminology* (ISBN 0 7506 6827 X) once published, available from www.cimapublishing.com

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May 2005 Exam

Guide to the Icons used within this Text

Key term or definition

Equation to learn

Exam tip to topic likely to appear in the exam

Exercise

Question

Solution

Comment or Note

2005.1

About the TOPCIMA Exam and the Assessment Matrix

LEARNING OUTCOMES

By the end of this introductory chapter you should:

- have an understanding about the aims of the new TOPCIMA exam;
- have a clear understanding of how you can access the pre-seen material and what you should do to prepare for the exam;
- have a clear understanding of the new TOPCIMA assessment matrix and how it will be applied to mark your answer.

1.1 Acknowledgements

The authors, Heather Barnwell and Adrian Sims, would like to thank all contributors to this first edition of the TOPCIMA Study System. Both authors have been heavily involved in CIMA FLCS examinations for several years and have a wealth of experience in writing and analysing past FLCS cases. Whilst every effort has been made to contact the holders of copyright material, if any have been inadvertently overlooked, the publishers will be pleased to make the necessary arrangements.

1.2 The International Federation of Accountants (IFAC)

The International Federation of Accountants (IFAC) states that their mission is 'the worldwide development and enhancement of an accounting profession with harmonised standards, able to provide services of consistently high quality in the public interest'.

CIMA is a member of IFAC and is a recognised leading accountancy body worldwide. CIMA has decided to change the final CIMA exam, previously called *Final Level Management Accounting – Case Study (FLCS)*, to bring it in line with the recommended IFAC criteria. The TOPCIMA exams that will be set in 2005 are the FIRST totally IFAC compliant exam worldwide, and confirms CIMA position as one of the leaders in the accountancy profession.

The TOPCIMA assessment matrix (detailed in Section 1.9) is based on the nine recommended IFAC criteria.

IFAC has published an International Education Statement (IES) called IES 6 on the 'Assessment of Professional Capabilities and Competence', which becomes effective from January 2005. It is the responsibility of IFAC member bodies (of which CIMA is one of the many member bodies) to have in place assessment procedures that ensure that candidates admitted to membership are appropriately qualified. In IES 6 IFAC have set out that candidates need to be able to demonstrate that they have the necessary skills under nine headings. These nine headings form the basis of the new TOPCIMA assessment matrix.

1.3 Aims of the TOPCIMA exam

The TOPCIMA exam can only be sat by candidates who have ***passed*** all three Strategic level exams and, unlike its predecessor FLCS, is taken as a stand-alone exam. The aim of the TOPCIMA exam is to test higher level skills of candidates as a final gateway to CIMA membership. CIMA has recommended that it be sat by those who have already had their practical experience assessed and approved.

The TOPCIMA exam aims to test the candidate's ability to:

- apply strategic management accounting techniques and technical knowledge to the organisation given in the case material and to prepare appropriate strategic recommendations.

The TOPCIMA syllabus aim is to test the capabilities and competence of candidates, to ensure that they:

- have a sound technical knowledge of the specific subjects within the curriculum;
- can apply technical knowledge in an analytical and practical manner;
- can extract, from various subjects, the knowledge required to solve many-sided or complex problems;
- can solve a particular problem by distinguishing the relevant information from the irrelevant, in a given body of date;
- can, in multi-problem situations, identify the problems and rank them in the order in which they need to be addressed;
- appreciate that there can be alternative solutions and understand the role of judgement in dealing with them;
- can integrate diverse areas of knowledge and skills;
- can communicate effectively with users, by formulating realistic recommendations, in a concise and logical fashion;
- can identify, advise on and/or resolve ethical dilemmas.

There is a much heavier emphasis on technical knowledge and techniques than under the old FLCS exam, and the techniques included in Chapter 4 of this Study System are now vital to ensuring that case material is analysed using this technical knowledge and techniques.

Using the above syllabus aims the TOPCIMA case material requires candidates to:

- analyse and identify the current position of the organisation (position audit);
- analyse and identify the relevant problems facing the organisation in the pre-seen material;
- Appraise possible feasible courses of action;
- evaluate and then choose specific proposals (using the unseen material on the exam day);
- identify and evaluate priorities related to the proposals;
- recommend a course of action, with reasoned arguments for each course of action;
- prepare and present information in a format suitable for presentation to senior management.

Preparing your answer in the exam hall is difficult, due to pressure of time and exam conditions, but the report should be presented in a logical fashion, covering all of the above requirements and should conclude with clear well-reasoned recommendations. The report should be able to be read by a senior manager who could act on each of the recommendations made. A jumbled confused, or repetitive report would not be well received by a senior manager – or by the TOPCIMA examiner!

1.4 About the TOPCIMA exam material

The TOPCIMA exam material is split into two parts:

- the pre-seen material, which is available on the CIMA website (www.cimaglobal.com) about six weeks before each TOPCIMA exam;
- the unseen material and the requirement, which is available on the exam day.

Like the previous FLCS *Case Study* exam the pre-seen material will be available on the CIMA website several weeks before the exam sitting. This is typically available in early March for the May exam sitting and early September for the November exam sitting each year.

CIMA offers students advice on its website (cimaglobal.com) and has also prepared two guides for students sitting the TOPCIMA exam. The CIMA guide S11 (freely available on the CIMA website) is an introduction to the aims of the TOPCIMA exam. The CIMA guide S12, again available from the CIMA website, explains the new TOPCIMA matrix (which is analysed in section 1.9).

CIMA also recommends that students read relevant articles from CIMA's magazine and that students concentrate on developing the skills described in the assessment matrix, and should aim for the 'clear pass' level. CIMA also recommends that students should complete at least three case studies under exam conditions and that you should review your answers carefully, using the assessment matrix.

CIMA also recommends that you should read the 'Post exam guidance' reports on its website, which the TOPCIMA examiner writes after each exam sitting. From reading these reports you will get an insight into what students do right and also the common errors made. Learn from others mistakes made in the past so that you DO NOT make the same mistakes.

The CIMA website offers much support to TOPCIMA students and you can freely access ALL past FLCS and TOPCIMA exam material (pre-seen, requirement and unseen material and case writer's answer) soon after each exam. All of this material is available free of charge. Many of these past cases have been included in this Study System.

Most of the past FLCS and TOPCIMA cases are included in this comprehensive Study System, with each case analysed and discussed in depth. This Study System also includes the case writers answer for each exam.

The best way to pass any exam is to practice, practice, and practice! TOPCIMA is no different – but there is a lot of material to read, understand and interpret. By the time you start work on preparing your third practice case, we are sure that you will find it easier than it was with the first case you looked at.

Only when you have practiced analysing and answering previous case studies should you start work on the pre-seen material for the TOPCIMA exam that you have entered.

1.5 Four TOPCIMA exams each year

CIMA intend to move towards providing four TOPCIMA exam sittings each year. This is a totally new venture for CIMA who have traditionally always had only two sittings each year (except for Foundation level computer based assessment (CBA) papers).

It is planned that for each pre-seen material there will be two separate sittings of the TOPCIMA exam, using *DIFFERENT* unseen materials, and a different 100 mark requirement.

The timing of the different sittings and the introduction of the four TOPCIMA exams is being piloted at present and will remain a pilot programme until CIMA are ready to have four sittings per year at all of its exam centres worldwide. This may be during 2006.

It is advised that you update yourself on exam dates and availability of pre-seen material using the CIMA website (www.cimaglobal.com).

1.6 The pre-seen material

The pre-seen material, typically around 16 pages long in total (including appendices) sets the scene for the industry and gives details on one or more companies operating in the industry. The pre-seen material usually gives organisational structures, with short biographies of key personnel, financial data (historical as well as future forecasts and plans) and also text discussing how the company (or companies) are operating, with details of past and current successes and problems and also discussion of future plans in outline form.

You then have several weeks to thoroughly read and understand this pre-seen material and to research the industry in which it is set. Research can be undertaken in several ways, perhaps using the Internet, reading the financial pages in quality newspapers to pick up current industry data and problems being experienced by real life companies in the industry. Additionally, there are also some articles (on CIMA website and CIMA Insider) and also some specifically written texts on the pre-seen material. Whichever method you choose, it is vital that you understand both the industry and also the issues facing the company (or companies) in the pre-seen material.

Also it is advised that you should use Chapter 4 of this Study System to guide you through the techniques that you should use to analyse the pre-seen material.

While the techniques in Chapter 4 are *all* very important, it is vital that you understand how to construct a position audit (Section 4.8), so that you can fully understand where the company (or companies) stand now, so that you can correctly assess future strategy. Additionally, the position audit should be updated for information included in the unseen material on the exam day.

Furthermore, the position audit will help you to earn marks in the prioritisation criteria of the assessment matrix (see Section 1.9).

With the introduction of the TOPCIMA exam in May 2005, when you have read the pre-seen material, you will realize that the pre-seen material is less specific than in some previous cases and that the requirement or possible unseen material is harder to guess. The TOPCIMA exam is aimed at CIMA students who have passed all other CIMA exams, who should have acquired the analytical skills needed for this exam.

In order to pass the TOPCIMA exam there is a far greater emphasis on the business skills that should be understood and used to analyse and interpret the company and the industry in which the case is set. This Study System will teach, or help you to revise, ALL OF THE NECESSARY SKILLS.

It should be noted that many other publishers only produce texts based on the actual case pre-seen material and do not teach the skills required to pass the exam. They simply do some of the research for you. One of the many reasons for a case study exam at TOPCIMA level is to help you to learn these skills that you will need in your career as a CIMA accountant – learn them properly now using this Study System!

1.7 The unseen material

On the day of the exam, you will also be given additional material relevant to the case, which is usually a further 6 pages long. This is given to you in the exam hall, together with a 'clean' copy of the pre-seen material, which you should already be very familiar with. It is very important that you thoroughly read the unseen material and incorporate all of the new factors into your answer.

From May 2005 TOPCIMA exam, an extra 20 min READING time will now be given for all TOPCIMA exam candidates. In addition to the usual three hour exam time CIMA is now allowing candidates to have an additional 20 min of reading time to read and absorb the material given in the unseen material and the requirement.

The wording on your TOPCIMA exam booklet from May 2005 will show the following:

> You are allowed 20 min reading time **before the examination begins** during which you should read the question paper and, if you wish, make annotations on the question paper. However, you will not be allowed, **under any circumstances**, to open the answer book and start writing, add any loose sheets/supplements to the answer book or use your calculator.

The unseen material usually gives details of changes in the company since the pre-seen material, and alternative strategic options. These should be carefully considered and incorporated into your answer.

Candidates who fail to incorporate data given in the unseen material into their answer, such as in a SWOT, or do not discuss all of the new strategic options, but simply write out a pre-prepared answer, will not be able to earn all of the marks available under each of the criterion in the assessment matrix. Therefore, do ensure that all new data given to you is analysed, discussed and that your recommendations incorporate all of the new relevant information.

It is planned that each of the TOPCIMA exams will have two exam sittings for each set of pre-seen material, with two different sets of unseen material and two different requirements available on the exam day for each sitting. For example, one set of unseen material could discuss expansion strategies and give alternative strategic plans, whereas the other later TOPCIMA sitting may give a totally different picture, such as the company choosing to divest some of its divisions to meet a change in the company's strategic direction. Each unseen material will have a different 100 mark requirement.

It is not yet known when the four sittings will be available for all TOPCIMA students worldwide, as it is currently being piloted. Candidates are advised to check availability from the CIMA website (www.cimaglobal.com).

1.8 The requirement

Unlike all of the other CIMA exams, the TOPCIMA exam includes a 100-mark requirement. This is usually broken down into several sections, and it is VERY IMPORTANT that your report answers the requirement of the question. The requirement given to you on the exam day may be different to what you had expected or prepared for. However, it is the requirement that has been set that must be answered – NOT the one that you wanted!

Additionally, your report should be prepared to include the new data that you will have been given in the unseen material on the exam day. Many students have not been successful in the former FLCS exam for the following reasons:

- they have not prepared a position audit or review and prioritisation of the issues facing the company;
- they have not related their answer to the new material and the requirement set but have simply written out their pre-prepared answer;
- they have not prepared clear and well-reasoned recommendations (it is inadequate to simply make a recommendation without clearly stating the justification for it);
- they have not demonstrated their technical knowledge or applied it to the company.

As you will see from the next paragraph it is important to understand how your report will be marked using the new TOPCIMA assessment matrix. However, the underlying rule must be that your report must be a stand alone report that reads well and covers all of the key issues and makes well-reasoned and justified recommendations and is supported by appropriate calculations. It should be the sort of report a non-financial manager (as many Boards of Directors include non-financial managers) could understand and act upon.

Your report should include a report heading, a brief introduction, a terms of reference (which should help the candidate to understand who is writing the report and to who the report is aimed). An executive summary is NOT required. The body of the report should then be divided up into a review of the issues facing the company, a discussion of the main alternative strategic alternatives, followed by clear recommendations, which should be justified. Reports should end with a short conclusions paragraph and all supporting calculations, financial ratios and SWOT analysis etc. should be included in appendices to your report.

1.9 The TOPCIMA assessment matrix

1.9.1 The new assessment matrix

The TOPCIMA assessment matrix will be used to assess, i.e. to mark, all scripts from May 2005. This new assessment matrix differs quite significantly from the previous matrix that has been in use with the FLCS exams since May 2001. CIMA students with no experience of the FLCS exam should not worry about the changes to the assessment matrix. The guidance below is provided primarily to assist re-sit candidates transferring from FLCS and also for tutors.

There are some new criteria in the new TOPCIMA matrix and some other assessment criteria have been given more emphasis, particularly knowledge, which carries far more of the available marks.

The new TOPCIMA assessment matrix is analysed as follows by each assessment criteria:

Criterion	*Suggested marks available*
Technical	10
Application	10
Diversity	10
Focus	10
Prioritisation	10
Judgement	10
Integration	10
Logic	20
Ethics	10
Total marks	100

The new TOPCIMA assessment matrix is shown at the end of this chapter.

For those students and tutors who are familiar with the former FLCS assessment matrix, it may be useful just to see how it compares to the new assessment matrix, before this section discusses each one of the nine new criteria.

The old matrix (using the marks have been allocated for the May 2004 Ofood4U case) was as follows:

OLD FLCS assessment criterion	*Marks available*	
Prioritisation	15	Prioritisation remains but only at 10 marks
Knowledge	10	Knowledge goes up to 30 marks in total – but includes numerical skills
Numerical skills	15	No separate category for numerical skills – but merges in with application (to apply knowledge and also diversity e.g. different calculations such as DCF and ratio analysis)
Structure (recommendations)	20	This is replaced by Logic at 20 marks
Business communication	5	This criteria disappears but is included in Logic (as effective communication)
Format	5	This criteria disappears
Business awareness	10	This criteria disappears – but marks could be awarded under integration or Diversity
Breadth	10	This criteria disappears
Depth	10	This criteria disappears
Total marks	100	

As in any exam, you need to achieve a minimum of 50 marks in order to pass the TOPCIMA exam. As with other exams, there are a number of ways to achieve 50 marks. It is NOT necessary to pass every criterion, so a poor mark in one criteria may be offset by a good mark on another criteria. However, you should always aim to achieve a 'clear pass' in each criteria.

1.9.2 Discussion on the definition of each of the new assessment criterion

Technical

This 10-mark area of the assessment matrix rewards the knowledge itself and will reward students who have a sound technical knowledge of the subjects in the CIMA curriculum.

This area of the matrix is similar to the 10-mark area of the previous assessment matrix, which rewarded students for knowledge, such as an understanding of relevant business knowledge and business and industry awareness, as well as, SWOT analysis, suitable financial ratios and financial techniques, such as DCF.

Much of the technical knowledge that will be rewarded under this criterion is detailed in Chapter 4 of this TOPCIMA *Study System*.

Application

This is a new area that has been added to the assessment matrix to emphasise how important it is for students to be able to apply the technical knowledge in an analytical and practical manner.

The application of technical knowledge under the old assessment matrix was included in Knowledge within the available 10 marks, whereas the new matrix has 10 marks available for demonstrating their technical knowledge and a further 10 marks available for applying that technical knowledge to the case material in your answer.

This much greater emphasis on knowledge further demonstrates the need for students to ensure that they have brushed up their technical skills and that they are able to apply the knowledge to the case itself. It is not enough to be able to simply quote names of theorists or ratios, but marks will now be awarded for your application of the technical knowledge for the particular case. Some of the marks are available for correctly applied numerical skills (which now does not have its own criteria). For example, if the data given in the case suggested that NPV calculations are relevant, marks will be awarded for correctly applying DCF techniques for the numbers given in the unseen material.

Diversity

This is similar to the 'breadth' criteria in the previous assessment matrix – but instead of rewarding students for marks on the breadth of the topics discussed, the new assessment matrix will reward students for their ability to use the business knowledge to solve complex problems. This will also be applied to reward students for preparing correct calculations and correct financial ratios, as there is now no specific criterion for calculations. This will also include marks for business awareness and knowledge of the industry.

Focus

This is another new criteria, which will reward students for their ability to solve a particular problem by distinguishing the relevant information from the irrelevant. It relates to a

student's ability to sift through all of the data given (in both the pre-seen and the unseen and appendices) and to select which data is relevant to the question asked in the requirement.

This new category is particularly important as there is a plethora of data given in the pre-seen and unseen material and it is important to be able to discuss the most important key information as a priority for senior management. For example, your line manager will not want a report on a departmental budget covering all of the many assumptions made, but would require a report which highlighted the most important, or most sensitive of the assumptions.

This new assessment criteria should also help candidates to concentrate their answer on the key issues that need to be addressed and not to discuss at length some of the minor problems that the company may be experiencing. Your answer should be able to demonstrate to the TOPCIMA examiner that you have correctly identified the key issues and made appropriate recommendations, and have sorted and dealt with the relevant data, out of the wealth of information presented to you.

Prioritisation

This is the same criteria as under the previous assessment matrix. This criteria rewards students for their ability to identify the issues facing the company and to place those issues in priority. Therefore, in multi-problem situations (and all case studies give students a very wide range of small and large problems) marks will be awarded based on a student's ability to rank the problems in the order in which they need to be addressed.

A relevant example of this criterion came in the Sparkle case (May 2003 – reproduced in Chapter 5 of this *Study System*) in which the company faced a take-over bid and also had a number of other short- and long-term problems. The key priority here was how the company could convince its shareholders not to accept the proposed take-over bid. Unless it was able to do this, it simply did not have a long term – and therefore addressing long-term problems were not a key priority, as unless the take-over could be defeated, it simply would not exist.

Another example is in the May 2004 case on Ofood4U (reproduced in the appendices to this *Study System*), where candidates had to prioritise the issues facing the company, which had some expansion opportunities, as well as cash-flow problems and also some changes at Board level. Many candidates, however, omitted to discuss the very competitive environment in which the company operated in or the IT and staff issues that it had.

Students should remember that where they have prioritised several issues in the prioritisation area at the beginning of their report, that they need to ensure that in later sections of their report that all these prioritised issues have been thoroughly discussed. Additionally that each of the issues has appropriate recommendations, which are justified.

Judgement

This is another totally new assessment criteria. This rewards students for recognising alternative strategies available and for selecting and recommending what the student feels is the optimum solution. There is some overlap here with knowledge, application and diversity.

Additionally as CIMA are asking students to apply their judgement, the unseen material may be less prescriptive than it has been in the past. Candidates will need to choose which strategy they feel the company should select, rather than a choice of two or three given to them as a stark choice in the unseen.

Another example is in the Homejay case (November 2003 – reproduced in Chapter 7), which asked candidates to select which divisions should be divested, and whether the company should acquire Makeitco. Candidates had to justify all of their decisions based on the

range of data given to them, including their own financial calculations, and make a judgement. There is no clear cut answer to any case (although CIMA do publish the case writer's suggested answer) and marks will always be awarded for well-reasoned arguments and for applying their technical skills to the issues raised.

The TOPCIMA paper is a strategic paper – not a calculation paper – and will always have several alternative answers, and marks are awarded based on the candidates skills to convey their recommendations, based on the judgement that the candidate has made upon all of the key issues.

Candidates are able to pass the TOPCIMA exam even if their answer differs from the case writers recommendations, as long as the candidate has used his or her own judgement to decide courses of action and has justified each of the recommendations made.

It is expected that the TOPCIMA exam will give students much more scope that previous FLCS case studies did for applying their own judgement. Therefore you need to be able to demonstrate to the TOPCIMA examiner that you can choose between alternative courses of action and that your decisions have been made after consideration of all of the appropriate factors.

Integration

Another totally new assessment criteria. This is again testing the students' ability to integrate his knowledge skills effectively. The CIMA guide quotes 'this criterion checks whether you are able to integrate the various skills and knowledge areas into a cohesive answer'. In effect this is a type of business communication and presentation criteria, and it also includes an element of business awareness and how the candidate has used his knowledge of the industry and applied it to the case.

The most important point about this assessment criteria, is whether the entire report reads well, is comprehensive, and has clear convincing, well reasoned and justified recommendations.

In simple terms, marks will be awarded under the integration criteria on the basis of whether your report can be read by the TOPCIMA examiner like a professionally prepared business report that understands all of the issues affecting the industry in which the company is operating.

Logic

Recommendations and communication skills – replaces 'structure' from the old matrix. This should be the most important area of your report and can often make the difference between a pass and a fail.

There will usually be around 20 marks for logic and it is very important that exam time is managed effectively so that clear well-justified recommendations are prepared. After all the main purpose of the report is to make recommendations, so ensure adequate time is allowed for *this key area of your report.* If your recommendations are not clear or are simply stated with no reasoning, they will earn low marks in this key area of the assessment matrix.

This criteria carries around 20 marks – the most out of all of the 9 assessment criterion and it is the most important. As candidates are usually time pressured writing their report in the exam hall, it is all too easy to allow insufficient time for detailed recommendations. However, what is the meaning of preparing a report (whether it be for the TOPCIMA exam or for your line manager or a Board report) if it does not have clear well-argued recommendations that have been justified in your discussion.

Therefore, a rushed recommendations paragraph at the end of your report that lists a range of recommendations (without the underlying reasons for the recommendations) will earn very low marks in the assessment matrix for logic.

It is necessary to clearly state all recommendations, with supporting justification and reasons (perhaps supported by your calculations) in order to earn high marks. Also the main recommendations that are key to the business should be presented first, with lesser or less urgent recommendation following (which should also be justified). You are referred to Section 3.13 for more advice about preparing and writing your recommendations.

Ethics

Yet another totally new assessment criteria. Each TOPCIMA case will have a number of conflicts and ethical issues in both the pre-seen and unseen materials, so that candidates can discuss the ethical issues involved and make recommendations. This criteria includes personal and professional ethics, business ethics, corporate governance and social responsibility.

While this is a new assessment criteria, there has been plenty of scope in past cases for candidates to comment on ethical issues. For example, in the Homejay case (November 2003) there was the issue of redundancies if the company decided to divest Electryco.

Additionally in the Ofood4U case (May 2004) there was the issue of staff working excessive hours and stress related illness. It is the employers' responsibility to look after its staff and to ensure that HR issues are properly and professionally handled.

The major accountancy bodies, including CIMA, formed the Consultative Committee of Accounting Bodies (CCAB) during the 1970s. The CCAB offers guidance to accountants in business on ethical matters, based around five fundamental principles. These are:

1. integrity – not merely honest, but fair and truthful,
2. objectivity – having regard to all considerations relevant to the task,
3. competence – undertaking professional work only with the required level of competence,
4. performance – carrying out work with due skill, care and diligence,
5. courtesy – showing courtesy and consideration to all.

If we extend the above fundamental principles to business in general, there are several ethical issues involved in each FLCS and TOPCIMA case.

In your report you should have a separate section that deals with the ethical issues. The ethical issues may be about safety issues, good (or bad) business practice or poor staff training. Your report should show how each of the five CCAB fundamental principles shown above have, or have not, been put in place by the company, and where changes and improvements need to be made. You should also recommend what changes and improvements should be made and in what timescale (immediately or within 6 months, for example).

1.10 Using the CIMA web site

It is recommended that all TOPCIMA students should regularly access the CIMA web site (www.cimaglobal.com) which has been referred to several times in this chapter. The CIMA web site has all of the past cases which can be accessed free of charge, and also contains relevant articles and advice for TOPCIMA students.

Another useful resource that is available on the CIMA web site is the examiners report on the previous exam sitting. This report, which is around 5 pages long, gives students advice on the common errors made by candidates in the previous exam and also the areas

that were well prepared. The report is broken down by each criterion from the assessment matrix, which should help you to more fully understand what the TOPCIMA examiner of looking for in your answer. Whether you are sitting TOPCIMA for the first time, or whether you have failed before, it is useful to read this valuable feedback on candidates performance.

Read the TOPCIMA examiners report on the CIMA website so that you understand the common errors or omissions made by candidates in the last exam – so that you don't make these same mistakes.

1.11 Using this TOPCIMA *Study System* to pass the TOPCIMA exam

The approach in this *Study System* recommends that you adopt the systematic approach to passing TOPCIMA as described in Figure 1.1.

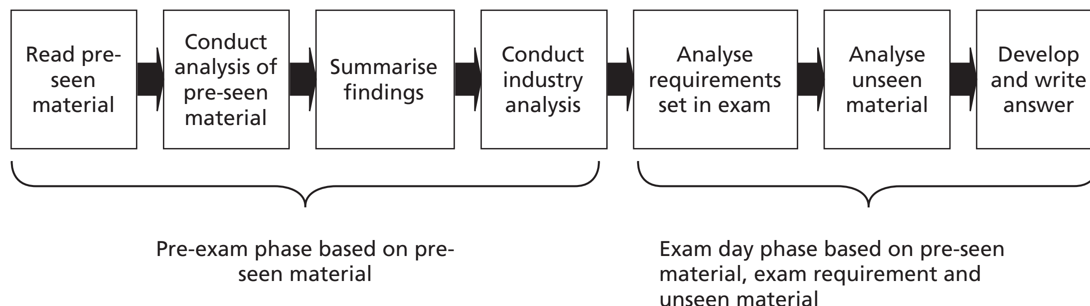


Figure 1.1 Diagram of process to pass TOPCIMA

The chapters of this *Study System* take you through this process using past FLCS material and the May 2005 TOPCIMA exam material to illustrate the skills and knowledge you will need.

The remainder of this study system is set out as follows:

Chapter 1	Description of the TOPCIMA exam detailing the purpose of the exam, the skills you will need and the assessment criteria you must satisfy. Chapter 1 also explains each of the TOPCIMA assessment matrix criterion and how each will be used to mark your answer.
Chapter 2	Review of the past FLCS and TOPCIMA cases since November 2001. This provides a quick way for you to appreciate the breadth of skills and knowledge you are likely to need to demonstrate in the TOPCIMA exam. The actual cases are reproduced and analysed in Chapters 5–7 and the in Appendices 1–4 to this study system
Chapter 3	Skills toolkit. This is a reference chapter that shows you some ideas on how to tackle the problems you will encounter as you work through TOPCIMA. Each skill is illustrated and applied in the later chapters. Chapter 3 takes you through the processes of how to read, understand and research the pre-seen material and how to plan your answer on exam day.
Chapter 4	Technical toolkit. This provides a reminder of how to perform many of the technical tasks you will need to perform in your analysis of the pre-seen and unseen material in TOPCIMA. For example, ratio analysis, risk assessment and application of strategic modeling. You should thoroughly read this important chapter and decide what range of

	techniques you may include on exam day. Practice writing answers using as many of these techniques as possible.
Chapter 5	Illustration of the technical skills of analysing and summarising the pre-seen material using two previous FLCS cases (Global Stores Inc. and Sparkle). Examples are given of how to answer the actual exam requirements.
Chapter 6	Illustration of how to research industry background and how to weave this into your analysis of the pre-seen material. A former FLCS case (Constro Pty. Ltd.) is used as the basis for this exercise. The tips in this chapter will help you to research the industry for the TOPCIMA exam that you are preparing for.
Chapter 7	Illustration of how to develop an answer for the TOPCIMA requirement. Based around the FLCS case Homejay Incorporated this presents an analysis of the pre-seen material but focuses particularly on how to analyse the requirement, undertake a revised analysis and develop a structure for satisfying the requirement. Use the advice given in this chapter to help you prepare practice answers to other previous CIMA FLCS and TOPCIMA case studies.
Appendices 1–4	Appendix 1 – Contains the complete case (including answers), for IRS Ltd. (November 2001) for you to practice your skills without guidance. Appendix 2 – Contains the complete case (including answers) for Ofood4U (May 2004). Appendix 3 – Contains the complete case (including answers) for Mayah Group of Hospitals (November 2004). Appendix 4 – Contains the complete case (including answers) for ReuseR and NOW, the first TOPCIMA exam in May 2005. You should use these past cases to practice researching and writing your answers.

1.11.1 Where to start

First we recommend that you read through Chapter 2 to gain a better understanding of the nature of a case study exam like TOPCIMA. Chapter 2 will help you to understand the industries that previous cases have been set in and the problems facing these companies in each case.

You should then thoroughly read and revise the Skills toolkit (Chapter 3) and the Technical toolkit (Chapter 4). Remember the new heavier emphasis of marks towards technical knowledge in the new assessment matrix – so make sure that you thoroughly understand and can apply the techniques in Chapter 4.

Next you should start at the beginning of Chapter 5 and work your way through to the end. Use the toolkits in Chapters 3 and 4 when you get stuck.

Proceed in this way until the end of Chapter 7. By this stage you will have been introduced to all the skills, and most of the technical knowledge, you will need.

Practice these skills on the four cases in the appendices and then review your answers against the case writers answer.

The key to passing this final CIMA exam is by improving your technical skills and by practicing writing case study answers – not just the case you will be sitting, but other past FLCS cases. After all you probably practiced past papers for your other CIMA exams – you should do the same here.

Good luck!

The new TOPCIMA Assessment Matrix

Criterion	*Marks**	*Clear Pass*	*Pass*	*Marginal Pass*	*Marginal Fail*	*Fail*	*Clear Fail*
Technical	**10**	Thorough display of relevant technical knowledge. **9–10**	Good display of relevant knowledge. **6–8**	Some display of relevant technical knowledge. **5**	Identification of some relevant knowledge, but lacking in depth. **3–4**	Little knowledge displayed, or some misconceptions. **1–2**	No evidence of knowledge displayed, or fundamental misconceptions. **0**
Application	**10**	Knowledge clearly applied in an analytical and practical manner. **9–10**	Knowledge applied to the context of the case. **6–8**	Identification of some relevant knowledge, but not well applied. **5**	Knowledge occasionally displayed without clear application. **3–4**	Little attempt to apply knowledge to the context. **1–2**	No application of knowledge displayed. **0**
Diversity	**10**	Most knowledge areas identified, covering a wide range of views. **9–10**	Some knowledge areas identified, covering a range of views. **6–8**	A few knowledge areas identified, expressing a fairly limited scope. **5**	Several important knowledge aspects omitted. **3–4**	Many important knowledge aspects omitted. **1–2**	Very few knowledge aspects considered. **0**
Focus	**10**	Clearly distinguishes between relevant and irrelevant information. **9–10**	Information used is mostly relevant. **6–8**	Some relevant information ignored, or some less relevant information used. **5**	Information used is sometimes irrelevant. **3–4**	Little ability to distinguish between relevant and irrelevant **1–2**	No ability to distinguish between relevant and irrelevant information. **0**
Prioriti-sation	**10**	Issues clearly prioritised in a logical order and based on a clear rationale. **9–10**	Issues prioritised with justification. **6–8**	Evidence of issues being listed in order of importance, but rationale unclear. **5**	Issues apparently in priority order, but without a logical justification or rationale. **3–4**	Little attempt at prioritisation or justification or rationale. **1–2**	No attempt at prioritization or justification. **0**
Judgement	**10**	Clearly recognises alternative solutions. Judgement exercised professionally. **9–10**	Alternative solutions or options considered. Some judgement exercised. **6–8**	A slightly limited range of solutions considered. Judgement occasionally weak. **5**	A limited range of solutions considered. Judgement sometimes weak. **3–4**	Few alternative solutions considered. Judgement often weak. **1–2**	No alternative solutions considered. Judgement weak or absent. **0**
Integration	**10**	Diverse areas of knowledge and skills integrated effectively. **9–10**	Diverse areas of knowledge and skills integrated. **6–8**	Knowledge areas and skills occasionally not integrated. **5**	Knowledge areas and skills sometimes not integrated. **3–4**	Knowledge areas and skills often not integrated. **1–2**	Knowledge areas and skills not integrated. **0**
Logic	**20**	Communication effective, recommendations realistic, concise and logical. **16–20**	Communication mainly clear and logical. Recommendations occasionally weak. **11–15**	Communication occasionally unclear, and/or recommendations occasionally illogical. **10**	Communication sometimes weak. Some recommendations slightly unrealistic. **5–9**	Communication weak. Some unclear or illogical recommendations, or few recommendations. **1–4**	very poor communication and/or no recommendations offered. **0**
Ethics	**10**	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. **9–10**	Good evaluation of ethical aspects. Some appropriate advice offered. **6–8**	Some evaluation of ethical aspects. Advice offered. **5**	Weak evaluation of ethical aspects. Little advice offered. **3–4**	Poor evaluation of ethical aspects. No advice offered. **1–2**	No evaluation of ethical aspects. Unethical, or no, advice offered. **0**
TOTAL	**100**	***Note** The number of available marks allocated to each criterion will normally be as shown.					© *CIMA – January 2005*

Review of Past Case Study Exams

2

2.1 Previous CIMA Case Studies

2.1.1 The 2001–2004 Final Level Management Accounting – Case Study Examination

- CIMA has employed a case study as a final qualifying exam since May 2001. Before the first TOPCIMA exam in May 2005 this was called the *Final Level Management Accounting – Case Study* examination (FLCS).
- The format for assessment for TOPCIMA is in some ways similar to that of FLCS although FLCS candidates were assessed against an Assessment Matrix comprising of just nine generic headings with significant differences from the TOPCIMA criteria you will face. The new TOPCIMA assessment matrix is explained in Chapter 1, section 1.9.
- In presenting the analysis of past FLCS cases below the authors of this *Study System* have decided to highlight specific skills and aspects of the cases that might be expected to recur under TOPCIMA. The cases were authored to allow assessment of the FLCS assessment criteria and it would be inappropriate in our view to try to bend them to fit the new TOPCIMA criteria.
- The purpose of the brief review below is to convey the scope of the knowledge and skills that you will need to display in order to pass TOPCIMA.

2.1.2 The May 2005 TOPCIMA Case Study Examination

At the time of publication of this edition of the TOPCIMA Study System, there has only been one TOPCIMA examination, in May 2005. This case is set in the recycling industry, with details given in the pre-seen material on two companies, ReuseR and NOW.

More details on this first TOPCIMA examination is given later on in this chapter in section 2.9

2.2 November 2001 – IRS Ltd[1]

2.2.1 The pre-seen material

The pre-seen material, the requirement and the unseen material given to candidates on exam day for the IRS case is shown in Appendix 1 of this Study System, together with the case writers answer for the IRS case.

IRS Ltd. was a Glasgow (UK) based manufacturer of control systems for refrigeration equipment of the sort used by food retailers. The firm had grown principally through the success of one product line, Innate, which had the competitive advantage that it could be retro-fitted to the legacy fridges already owned by retailers. However it seemed likely that IRS would soon suffer falling growth as it ran out of legacy systems to fit controls to and original equipment manufacturers (OEMs) increasingly supplied fridges with control systems already fitted.

The pre-seen material closed with the tantalizing statement that 'Charan [Dill, the CEO of IRS Ltd.] was excited about the prospects for IRS Ltd. and he was eager to tell David and Alex [co-founders and directors of IRS Ltd.] and other members of the management team about these at their next scheduled meeting'.

2.2.2 The issues in the pre-seen material

The strategic issue in this case was how IRS Ltd. was to grow in the future. In particular what it could make and how it was to finance this.

Within the case several managerial issues were also evident which candidates needed to analyse and come to a view on in order to be ready to respond to the Unseen material and requirement. These included:

- the financing of IRS which to date had been bank debt underwritten by an absentee non-executive FD, Mohammed Khan;
- poor stock and cash flow management which seemed to be putting strains on the financing of IRS and had precipitated periodic stock write-offs;
- a poor IT system which meant that sales and production data couldn't be integrated and also cast doubt on some of the management information that its management would have available;
- the management style of the CEO which was apparently alienating some of his fellow directors;
- the possibility that some of the founders might require an exit route to cash in their investments;
- the failure of a previous venture in overseas retail marketing.

2.2.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

[1] The authors have not included the first FLCS exam in this *Study System*. The case, Proton Quest Ltd., was a complex case involving genome research. The format of the pre-seen material and requirements are not a helpful representation of the likely format of your TOPCIMA exam.

Candidates also prepared some contingency plans for attracting new finance and also for changing the management structure in case of the exit of one or more directors.

Candidates also researched the industry background and discovered that

- the refrigeration control market is dominated by a small number of large suppliers;
- various legal directives on energy efficiency meant that such systems were in demand in food stores but also in office temperature management;
- increasing concern over the dangers implicit in the escape of some of the gases used in refrigeration systems and the need for control systems to include 'sniffers' to detect escaped gases.

Many candidates discovered a real world firm, Elms Holdings Ltd., which was very similar to IRS Ltd in many respects but which had been sold to a major equipment controls manufacturer a year before the pre-seen material was set. A great many candidates concluded that this was also to be the fate of IRS Ltd. and would face them in the Unseen material on exam day. Some even tracked down the CEO of the 'real world' company and discovered he had started a new business making custom hi-fi components. No doubt this led to feverish speculation about possible new business ventures for IRS Ltd.

2.2.4 The unseen and requirement

On the day of the exam the unseen material included a revised management structure for IRS Ltd. and, as anticipated, some business proposals from the CEO.

The requirement put candidates in the role of a management consultant to IRS Ltd. advising on the feasibility of a number of strategic options presented by the CEO to his colleagues and intended to increase the size of IRS Ltd. tenfold by 2009 (i.e. within 8 years). This plan included:

- extension of business into 'total building management control' (TBMC) via new product development;
- increased sales to existing clients by piggy-backing TBMC on existing Innate systems;
- international expansion of refrigeration controls business via a special contract with a major US food store and, to a much lesser extent, European expansion;
- the financing of the strategy by attracting venture capital;
- the need for better IT.

2.2.5 The skills needed to pass the exam

The requirement and Unseen information for the November 2001 FLCS required candidates to demonstrate the following knowledge and skills in order to gain marks:

- ability to construct a SWOT analysis for IRS and the ability to select from it the key issues of differences in shareholder motivation, the fact that IRS was now operating in a mature market and also its financial and operating limitations;
- ability to assess the feasibility of the options presented by the CEO emphasising the risks of overseas exposure, the likely problems associated with the financial forecasts given that the new products and markets were subject to high uncertainty, and questions over management ability to run the expanded and extended operation, particularly given the tensions between them and their comparative lack of experience to date;

- ability to conduct a financial appraisal of the options including constructing cash flow forecasts, sensitivity analysis and basic ratio analysis;
- ability to make recommendations to management over the strategic issues associated with the CEOs proposals (in particular resolving the position and differing objectives of the founders and whether to admit venture capital) and also shorter term issues concerned with the new management structure, stock control, and the future IT strategy;
- ability to communicate the above in an objective and business-like way ensuring that priority is given to strategic over operational decisions.

2.3 May 2002 – Global Incorporated

2.3.1 The pre-seen material

Global Inc. was a massive food and household goods retailer based in a fictitious country called Westland which had the $ as currency. Although obviously inspired by the USA this communicated that Global was a fictitious firm and the themes in the case were synthetic although perhaps inspired by the situation and history of real-world firms.

Global's best days were behind it. It had grown during the supermarket boom of the 1960s and 1970s but, in the wake of increased car ownership, had since been overtaken by out-of town operator Market Stores. Local community stores and others operators were chipping away at its margins. It did however have a reasonably successful on-line shopping business. As a consequence its share price was falling and one major institutional investor was considering selling its holding in Global. Its top management seemed wedded to the past and autocratic with weak non-executives seemingly selected from friends of Global to 'make up the numbers' rather than for any independent expertise they might bring. There were references to potential accounting irregularities over the deprecation of fixtures and fittings and also pension liabilities. The 2001 financial statements were in the Pre-seen material with the note that they were 'subject to audit'.

Information was given on the performance of five smaller stores in a country called Eastland which has the Euro as its currency.

A feature of this case was the substantial number of persons in the case and the detailed biographical information on each. These revealed an autocratic CEO seemingly suppressing the contributions of an able cadre of relatively recently appointed senior managers one step below board level. On the board a newly arrived non-executive, General Thomas Frank, seemed set to make waves in the still waters of the board.

2.3.2 The issues in the pre-seen material

The strategic issue in this case was how Global was to reverse its fortunes and so recover its share price and stop a run on its shares by the institutional investor (Universal Insurance).

Within the case several issues were evident which candidates needed to analyse and come to a view on in order to be ready to respond to the unseen material and requirement. These included:

- the quality of corporate governance at Global and whether there was a need for a shake-out at top level, notably of the CEO;
- the appropriateness of some of the younger senior managers to take on new responsibilities;

- the future of its foreign operations and whether it should consider acquiring any of the stores in Eastland;
- how to take its on-line shopping business forward;
- the appropriateness of suggestions within the case to reduce supply chain costs by abandoning the preferred status of traditional suppliers, to enhance employee benefits and improve workforce diversity, to close the poor performing stores accounting for 20% of its outlets and the advisability of further acquisitions of stores with large property portfolios.

Features of this case were references to activity based cost information on the costs of having wider stock ranges and the suggestion that the IT systems were 20 years old and hence not able to run modern customer relationship management (CRM) and supply chain management (SCM) applications.

2.3.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

Candidates also prepared some contingency plans for changing the management structure in case of the exit of one or more directors and calculations on the impact of profits of cost reductions mentioned in the pre-seen material.

Candidates were also encouraged to revise the strategic and operational issues involved in cross-boarder acquisitions, the principles of good corporate governance and the essentials of supply-chain management in retailing.

Candidates also researched the industry background and discovered that:

- The case had close parallels with K-Mart stores in the USA which had been overtaken by Wal-Mart in a similar fashion. During the weeks before the pre-seen was issued K-Mart had filed for Chapter 11 protection from its creditors (a US protection offered to insolvent firms). Inevitably this led many to conclude that a similar fate for Global would be revealed on exam day.
- The range of goods offered by Global was substantially less than the range offered by firms like Wal-Mart. This led candidates to prepare a list of suggestions for additional products that Global could stock to improve margins (clothes, furniture, electrical durables, pharmacy products).
- Accounting for pensions liabilities had become a major issue in most countries (in the UK FRS 17 was in the press at the time) and final salary pension schemes of the sort being considered by the HR Director and CEO of Global were being closed to new employees to avoid increasing exposure to the, then, falling stock market. The recent collapse of Enron and the discovery of accounting irregularities at Worldcom and Rank Xerox had also heightened investor sensitivity to any whiff of accounting problems.
- Some stores were shifting format to local and convenience stores near workplaces and to cope for the 7/24 and urban lifestyles of consumers.

2.3.4 The unseen and requirement

On the day of the exam the unseen material included a number of exhibits, each being memos from characters in the pre-seen and a firm of Eastland merchant bankers, proposing strategic options for Global. The most significant was one from the CEO buried at the end of the unseen material and containing the revelation, that Global had unexpectedly

undershot profit expectations for 2001, the previous year, and that it was about to announce this to the investment community.

The requirement put candidates in the role of a management consultant to the Chairman of Global tasked with giving independent and confidential advice on how to take Global forward, taking into consideration the options being suggested. These were:

- a retrenchment strategy involving closure of home shopping and stopping information systems development combined with setting tougher targets to reduce costs;
- a modest programme of acquisitions of additional stores in Westland backed up by earnings forecasts;
- a proposal to restructure home shopping and IT systems to improve its efficiency;
- liquidation of existing foreign stores combined with a significant purchase of one of two of the Eastland stores for which earnings forecasts, purchase price projections and financing proposals were given.

2.3.5 The skills needed to pass the exam

The requirement and unseen information for the May 2002 FLCS required candidates to demonstrate the following knowledge and skills in order to gain marks:

- ability to construct a SWOT analysis for Global in the light of the potential abyss of a collapsing share price following the announcement of poor profits and likely disposals of holdings by Universal Insurance;
- ability to prioritise all aspects of the report to deal with the need for the board of Global to have a convincing strategy to give to investors at the same time as the poor profit figures for 2001; this would be the only way to avoid a melt-down in the share price;
- ability to conduct an earnings forecast based on the acquisition of the new stores in Westland and, together with strategic considerations, give advice on acquisitions;
- ability to assess the impact on future EPS of purchasing one or other of the Eastland stores and make recommendations based on this and other strategic factors;
- recognition of the need for greater efficiency as essential in its own right and as a component of any of the above strategies;
- realisation that announcements of closures and IT development may not be appropriate when also announcing sharply reduced profits;
- recognition that the position of the CEO had become untenable and that he would need to be sacrificed to placate investors. The succession issues raised should have been discussed;
- recognition that stronger financial controls and forecasting would be essential to restore investor confidence;
- ability to communicate the above in an objective and business-like way ensuring that priority is given to strategic over operational decisions.

2.4 November 2002 – Constro (Pty) Ltd.

2.4.1 The pre-seen material

Constro (Pty) Ltd. was a civil construction firm based in the (fictitious) North African country of Afri. It was contemplating diversification into building and operating a mobile telephone network by bidding in a licensing auction to be held by the Afri government at the beginning of 2003 for a network license.

The pre-seen material revealed that Constro was a private company whose founding shareholders were now retired and principally concerned with enjoying a steady dividend income from the firm. Construction contracts in Afri were drying up but there could be opportunities for further similar work for other governments elsewhere on the African continent. However the material also made clear the very great potential for mobile phone operators in African countries and the international pressure being put on governments to avoid allowing their countries to fall on the wrong side of the 'digital divide'.

2.4.2 The issues in the pre-seen material

The strategic issue in this case was whether mobile telephone operation was the right future strategy for Constro or whether it should stick to its traditional construction business. It seemed obvious that the attitude of the private shareholders would be crucial to this decision.

Within the case several issues were also evident which candidates needed to analyse and come to a view on in order to be ready to respond to the unseen material and requirement. These included:

- The danger of technical obsolescence of second generation mobile phones as third generation (3G) phones became available. The licenses were to be granted for second generation technology.
- The method of developing into mobile phones could be by Constro on its own or by a joint venture with a global telecoms company. The pre-seen material provided accounts of meetings with four global mobile phone operators and it was obvious that at some point candidates might wish to recommend, with reasons, which partner would be better one.
- Impact of the decision on the cost of capital. Information was given on Constro's beta and other variables that led to a cost of equity of 14.5% (it was entirely equity financed at present but would be taking on debt financing if it ventured into mobile telephony).
- The reliability of its present 5 years plan which showed gently increasing profits from its present construction business and rapid growth in electrical retailing.

2.4.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

Candidates anticipated that they would need to present a financial evaluation of applying for a license and perhaps even suggest a bid price. Data was given on likely subscription levels but missing was any mention of the number of licenses or of likely conditions of operating.

Candidates also produced cash flow forecasts on the basis of the 5-year plan (this became a tradition after November 2002 as we shall see).

Candidates also researched the industry background and discovered that

- mobile phone development in Africa had been very successful for many large firms already, particularly in Nigeria which seemed to have a similar population and demographic characteristics to Afri although a different pattern of exports;
- that telephone penetration in Africa was at a rate of about 1 phone per 300 people due to the problems of low incomes and the prohibitive costs of stretching telephone lines over large expanses of unpopulated land to reach isolated villages;

- that the technologies available to serve mobile phone market were changing and that once the license was won there would be hard decisions to take such as whether to use low earth orbiting satellites or radio masts to support the network;
- that in most countries local developers work in partnership with large multinational telecoms firms like Vodaphone and France Telecom (in real time during the time between the release of the pre-seen material and exam the latter company announced such poor profits that its CEO was forced to resign).

2.4.4 The unseen and requirement

On the day of the exam the unseen material included considerably more detail on the subscriptions and value of licenses together with information on a choice of only two joint venture partners.

The requirement put candidates in the role of a management consultant reporting to the CEO of Constro. They were to advise whether to go ahead with bidding for a license and, if so, whether the bid should go ahead alone or with a joint venture partner. They were also required to evaluate whether bidding for new construction contracts outside Afri and/or selling mobile phone handsets were additional extension strategies.

- The unseen data contained four strategies with quantitative information on the likely growth of mobile telecoms in Afri. This would be needed for any calculations to evaluate a license application and also mobile phone retailing.
- Some financing and cash flow information was provided.
- A new cost of capital was provided for the purposes of evaluating the strategies.

2.4.5 The skills needed to pass the exam

This need for financial evaluation was a striking, though not unexpected, feature of this case. The core of any evaluation of mobile phone provision and handset retailing required:

- an NPV calculation using probabilities of likely subscribers and utilising the discount rate provided in the case
- a cash flow forecast to assess Constro's financing needs

However, in addition, the candidate needed to show awareness of the following strategic issues:

- the impact of falling cash flows on the shareholders of Constro;
- the issues to be considered in entering a joint venture;
- the different sorts of risks involved in mobile phone network operation compared with managing construction projects outside Constro's home country.

2.5 May 2003 – Sparkle plc

2.5.1 The pre-seen material

Sparkle plc operated health and leisure clubs in Europe. Founded in 1988 by a former athlete, James Lellee it had floated in 1999 with ambitious growth plans to provide a premium quality chain of health and fitness clubs across Europe.

The core of the material contained an ambitious five year plan to increase its clubs from 64 in 2002 to 168 by the end of 2007 and shareholder concern given that its goals at flotation had been a high growth rate at the same time as making a 20% ROCE and so far it had failed to achieve either.

2.5.2 The issues in the pre-seen material

The strategic issue in this case was how to take Sparkle forward and whether it should build new clubs or instead achieve growth by acquiring existing clubs and turning them round. In the background at all times was the need for Sparkle to make good on its promises at flotation.

Other issues were:

- Some doubts over the business acumen of the CEO, James Lellee who appeared to as much focused on customer care for its own sake and on providing a place for budding athletes to train as he was in building shareholder value. His original playboy financier had already reduced involvement and so Lellee was facing harder minded investors than he was accustomed to.
- The fact that its most recent openings were failing to break even as quickly as planned.
- The need to update equipment at clubs which were starting to look tarnished and not befitting Sparkles premium positioning.
- The decision by management to pay a handsome price for a one-off purchase of a celebrity club which had yet to find its place in their firm's business portfolio.
- Comparative data on six other clubs (plus operating data on a seventh) which showed Sparkle to be second in the market but with some results out of line.
- Some concern over the quality of the firm's accounting and IT systems that fell short of maintaining adequate accounting information and also adequate membership data.
- The possibility that some managers might be pressing the board to consider diversification into restaurants.

2.5.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

Candidates generally assumed that they would be quizzed on the relative merits of organic versus acquisition-led growth (and possibly franchising) for Sparkle. They prepared notes on this.

In addition many candidates prepared cash flow forecasts for the 2003–2007 plan incorporating assumptions about the payback time of new clubs and different mixes of acquisition and organic growth.

Research into the industry revealed that, in the UK at least, there were four main operators: David Lloyd Leisure, Living Well, Esporta, and Fitness First plus smaller operators such as Holmes Place and Dragons. It was noted that only the first two of these had not recently been purchased by venture capital firms following a poor showing on the stock market. These first two were (and are) part of larger businesses: Whitbread plc and Hilton Hotels Group plc.

2.5.4 The unseen and requirement

On the day of the exam candidates found themselves facing a very different situation from the one in the pre-seen. Two significant managers were no longer at the helm and instead new interim managers were in place and facing a cash flow shortage, a falling share price, shareholder concern and with a takeover bid for Sparkle on the horizon.

The requirement put candidates in the role of a consultant to the Finance Director of Sparkle. They were required to evaluate and advise on the takeover bid and also assess the ability to Sparkle to deliver the growth and profits required by its shareholders in order to defeat the hostile takeover bid. The report had to recommend ways in which Sparkle's EPS, share price, and the confidence of investors in the company, could be improved in the short as well as in the long term.

A significant feature if this unseen was the very limited amount to financial information and instead considerably more information on managers and other stakeholders.

2.5.5 The skills needed to pass the exam

Given the takeover bid and the need to restore profitability and growth to assuage shareholders the ability to value Sparkle as a takeover, and also in terms of the present value of its forecast free cash flows, lay at the heart of any analysis and advice presented to management.

This involved use of the cash flow forecasts prepared in advance but also modified to take account of some new information on the reasons for the poor profits from the most recent clubs.

In addition successful candidates would have shown:

- an awareness of the motives, interest and power of different stakeholders;
- an ability to manipulate ratios of expenses to sales and asset turnover to demonstrate the potential for better management to increase earnings and so restore the share price;
- the ability to make a clear recommendation on whether the firm should be sold, and if so at what price, or retained.

Students who did not discuss the hostile takeover bid but who instead only discussed longer-term strategic alternatives earned low marks. There would have been no 'long-term' for Sparkle if the bid had not been defeated.

2.6 November 2003 – Homejay Inc.

2.6.1 The pre-seen material

Homejay Inc. was a USA-based retailing and manufacturing conglomerate with furniture manufacturing and shops in the USA and Do-It-Yourself (DIY) stores in Europe. It also had smaller business units involved in electrical durable manufacture, cosmetics retailing and greeting card retailing. Its growth in the 1970s and 1980s was impressive but in the decade since, co-incidental with the tenure of Ralph Black as CEO, the group has persistently failed to meet profit forecasts and, consequently, seen its share price fall.

2.6.2 The issues in the pre-seen material

The strategic issue in this case revolved around the value being added to the business portfolio from being part of a larger group and whether diversified business portfolios were in the interests of shareholders.

Other issues were:

- the management style of the corporate parent which seemed to alternate between merely financial control of divisions and attempts to introduce balanced scorecards;
- inventory and supply chain management issues;
- issues of quality management;
- a lack of integration following acquisition of divisions; it was mentioned that the furniture division had six factories of which three were large and the rest small and unchanged since acquisition;
- divisional performance evaluation and remuneration; the firm used ROCE as a basis for bonuses and substantial bonuses were being awarded despite very poor shareholder returns;
- corporate branding;
- investor relations;
- high HQ costs.

2.6.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

Candidates assumed that they would be called upon to evaluate the case for creating a corporate brand and also for store refurbishment.

Candidates also assumed that they would asked to develop financial and non-financial measures to replace corporate centre's reliance on ROCE alone for divisional control and evaluation.

Candidates also revised their understanding if business portfolio analysis using the BCG or the GE business portfolio models. Similarly the work of Goold and Campbell on strategic styles and the role of the corporate parent were revised.

Research revealed that Homejay had much in common with the UK retailer Kingfisher plc which built a wide portfolio of businesses in the 1990s from its base in volume retailer Woolworth's to include DIY retailer B&Q, electrical retailers Comet and Darty, cosmetics retailer Superdrug and direct sales DIY supplier Screwfix. By 2003 it had disposed of all but B&Q and Screwfix in its quest to return to a core business.

Similarly research revealed UK furniture manufacturer and retailer MFI used complex supply chain management technologies to improve its performance in a furniture market increasingly dominated by cost leader IKEA.

2.6.4 The unseen and requirement

The requirement put candidates in the role of a consultant to the new Chairman of Homejay and required them to analyse the situation of the firm and to evaluate four options presented in the unseen material. These were:

- a plan to increase profits of divisions
- the sale of one of two divisions
- acquisition of a rival DIY retailer

All against the backdrop of severe capital funding constraints to appease investors.

These effectively explored the issues about the value of diversified business by confronting candidates with an opportunity to focus resources on a core DIY business as Kingfisher had done in the UK.

2.6.5 The skills needed to pass the exam

The principle numerical skills required were to value the divisions of the firm (using divisional specific costs of capital) and also to forecast profits following implementation of a number of efficiency strategies.

Candidates needed to be aware of a valuation technique for conglomerates termed 'sum of the parts' which can show that a conglomerate can be less valuable than the sum of its component parts.

Broader strategic issues that would need to be discussed included:

- how to separate businesses which have some trading reliance on each other or which use common systems or assets;
- the risks of conducting acquisitions;
- the value of strategy based on core competences;
- whether to retain Electryco which was suffering quality assurance problems.

Candidates should have demonstrated the ability to prioritise. Given the problems revealed in the SWOT, the desire of the new Chairman to focus on a core business and the lack of capital the disposal of at least two divisions was clearly to be recommended and then the effect of the efficiency gains on earnings evaluated. Acquisition of another DIY group could only be recommended if it could be shown that it would improve the earnings forecast without demanding an excessive price to buy it. Earnings per share was critical in this case.

Furthermore the acquisition of the other DIY group could only be made if Electryco was divested due to the capital rationing constraint.

2.7 May 2004 – Ofood4U

The pre-seen material, the requirement and unseen material for Ofood4U is shown in Appendix 2 at the very back of this Study System, together with the case writers answers.

2.7.1 The pre-seen material

Ofood4U is a privately owned organic food manufacturer and distributor. Its shares were principally owned by three members of the same family who had built a successful direct sales business to the public using telesales and internet. The company had been innovative with its own brand products and had started to establish a brand which commanded a premium price and was in high demand. The firm faced a choice of developing each of its three routes to market: direct sales, own shops and supplying supermarkets. A 5-year plan showed an ambitious store opening plan together with a relocation of premises to put all logistics and customer service in one place.

2.7.2 The issues in the pre-seen material

The strategic issue in this case revolved around a firm seeking to make the transition from being a small family-controlled business to one able to compete in a market against much larger retailers and food producers.

The main problem facing Ofood4U was the increasing competition in the retailing of organic foods by High Street supermarkets.

Other issues were:

- The problem of retaining differentiation in a fragmenting market. The case indicated that fresh food sales was suffering falling margins and that higher margins necessitated that the firm make packaged and processed foods under its own name.
- The problem of the buying power of supermarkets which the case presented as being able to set much lower margins to suppliers like Ofood4U than they were willing to take.
- The difficulties faced by family-run firms where the board is often not as commercial as it will need to be to take the firm forward (in this case some directors were keen to establish a work-life balance and had ethical commitments to organic food).
- Financing developing businesses. The firm had effectively exhausted its ability to raise debt except on physical assets whereas its high reliance on IT/IS and possibility of investment in brands would not qualify as collateral.

2.7.3 The pre-exam preparation

Successful candidates would have conducted analysis of the case and arrived at an understanding of the issues above. They would have prepared a SWOT analysis on the basis of these.

Candidates assessed the 5-year plan and constructed cash flow forecasts based on it.

Research revealed that 80% of organic food sales take place from supermarkets and that several of the large fast-moving consumer goods firms (FMCGs) such as Heinz, Unilever, Masterfoods and Kraft had recently entered the organic food market. The success of organic foods in the babyfood market was cited by many as an encouraging sign.

2.7.4 The unseen and requirement

The requirement put candidates in the role of a consultant, appointed by Derek Smythe (the FD) to prepare a report for the next Board meeting in June 2004.

The report should discuss and make recommendations on the company's expansion strategies (including two new opportunities given in the unseen material) and also a recommendation on the most appropriate financing strategy.

The alternative expansion opportunities are:

- the current 5-year plan (with profitability now reduced by 10%);
- whether the Ofood4U shops should expand as planned given the current loss making situation;
- opening of 10 shops at FFT garden centers;
- proposed strategic alliance with TZ (a major international food; manufacturer with established global supply chain) to jointly manufacture a range of organic baby foods;
- Ofood4U to launch its own range of baby foods (as included in the original 5-year plan).

Furthermore, the cash shortage for the company was continuing and the shortfall by 2006 could be calculated to be almost £15 million – clearly action needs to be taken, as the company had not got enough cash to fund its current plans. Financing needed to be put in place.

Also the unseen introduced yet more problems for the troubled Ofood4U company with the resignation of its Chairman, Sarah Hall (co-founder and wife of Richard Hall, the Chief Executive). Also, the hard working Operations Director, Jonathan Winters, had been removed from the company as he had been off sick with a potentially long-term stress related illness. With a small company, the absence of these two crucial people can be disastrous. The company needed to address these two vacant posts as a matter of urgency. The company's good reputation had been achieved by a good record of prompt delivery in its Internet business. With Jonathan Winters' absence, the warehouse operations needed to be well managed, so that business was unaffected. Business reputations take a long time to win – but a short time to lose – particularly in this competitive business.

The organic market continued to enjoy strong growth but a major factor in this case was the very severe competition that small companies such as Ofood4U are experiencing from the major supermarkets. The supermarkets have very strong buying power and now that they are giving prominence to organic produce, they are making life difficult for smaller companies to enjoy the level of profitability that they once did.

It was not a feasible option for Ofood4U to simply continue what it had been doing, it needed to change and adapt to the competitive forces operating in its market place.

The unseen material gave several alternatives, which were mutually exclusive. Therefore, the company could not enter into a strategic alliance with TZ to produce baby food and also produce its own range of baby food. Therefore each of these opportunities had to be discussed and recommendations made. Furthermore, the unseen material stated that the company would be unable to procure enough organic produce to undertake the TZ proposal as well as open shops in FFT garden centres.

To summarise, the alternatives were:

- TZ strategic alliance and continue with its Internet and mail order business and its shop retailing business (or any combination);

or

- FFT shops and continue with its Internet and mail order business and its shop retailing business (or any combination) AND also launch its own range of baby food;

or

- say no to both FFT and TZ and continue with its existing business (however, the company need to adapt and change to survive – so is this really a choice?).

The unseen material gave some fairly basic cash flow data to prepare NPV's with, which produced fairly similar answers – FFT shops was an expected NPV of £9.8 million, and the Ofood4U share of the TZ strategic alliance was £9.4 million. What was required here was much more than 'lets choose the project with the highest NPV' – it required discussion of risks (possible future threat of TZ acquiring Ofood4U or acquiring organic recipes and dumping Ofood4U after 3 years) and the strategic nature of these wildly different opportunities.

2.7.5 The skills needed to pass the exam

The principle numerical skills required were to prepare NPVs for Ofood4U shops at FFT centres (and perhaps evaluate the high- and low-growth alternatives) and NPV calculations of selling baby foods with TZ (with Ofood4U taking a 30% share of the NPV) and going alone with selling baby foods.

The other calculation required was to update the cash flow forecast to identify the cash shortfall in 2006 (which was around £15 million). This involved reducing the forecast cash-flows for the overstatement of 10% (given in the unseen material) and including capital expenditure, loan repayments, interest and dividends (although some candidates chose to omit dividends and to recommend that these should not yet be paid – which was an acceptable recommendation).

The report also required a review and prioritisation of the issues facing Ofood4U, which is an area of the report that is often neglected (or even omitted!) by some candidates. If you do not identify the issues facing the company how can clear recommendations be made? Candidates should prepare a SWOT (and include it in an appendix to their report) and this should be updated to reflect all of the new data included in the unseen material, particularly the weaknesses in the Ofood4U Board with Sarah Hall and Jonathan Winters absent. The SWOT should also be referred to and discussed in tour prioritisation of the issues facing the company.

The prioritisation of issues should help you (and the report reader) to identify what the key problems and issues are. In the case of Ofood4U, these issues were:

- competition (any candidate that did not recognise the competitive environment demonstrated a poor understanding of the industry);
- staffing and weaknesses in the Board;
- IT systems;
- expansion opportunities (which should then be discussed in depth in the main body of your report, together with recommendations and justification for your chosen expansion route for the company);
- future financing strategy – how can the chosen expansion be financed;
- Ofood4U premises and lack of space to expand and the problems and lack of cash to finance the proposed move to new premises in 2006.

In the main body of the report the answer should have taken each of the proposed expansion opportunities and discussed in some depth the advantages and disadvantages of each of them. This case was not about simply stating that the NPV from the FFT centres was a little higher than the TZ alternative – it is a STRATEGY paper and decisions such as these are made on the basis of what would be the best strategic opportunity at this point in time for Ofood4U.

There is a range of acceptable answers, and any well-argued and well-justified answer would receive good marks, but the case writer's answer considers that the TZ opportunity and the access to overseas markets is the best one and is recommended over the FFT option. After all the FFT option is simply another 10 shops and Ofood4U's limited track record of successfully running retail outlets is not good.

By joining a strategic alliance with TZ, it can learn much about marketing and will gain 30% of a much higher NPV on baby foods than if it marketed and sold baby foods on its own.

The discussion and recommendation required on the most appropriate financing strategy should deal with how the company could prepare for a floatation on the AIM market in the future and how it could raise some (although limited) funds from a sales of shares to staff. Alternative financing strategies could be the franchising out of shops, the leasing of the new £18 million premises and the introduction of longer term debt financing.

The question did not ask for a calculations of alternative valuations for the company or detailed discussion on the costs and time taken to bring a company to become listed. Again, the TOPCIMA paper is a strategy paper – not a detailed paper. It is looking for recommendations based on what is best for the company long term, not a discussion of the short-term operational problems that would need to be overcome to deliver the agreed strategy.

Your report should conclude with clear well argued recommendations that follow through from earlier sections of your report.

2.8 November 2004 – Mayah hospitals

The pre-seen material, the requirement and unseen material for Mayah hospitals is shown in Appendix 3 at the very back of this Study System, together with the case writers answers.

2.8.1 The pre-seen material

The Mayah Group of Hospitals (MGH) case was the first FLCS case set in the public sector. All previous cases have concerned commercial profit-making companies of various sizes. The MGH case involved the use of private finance to provide financing for new buildings, similar to the Private Finance Initiative (PFI) used by the UK Government. The case is set in the fictitious country of Zamorna in Western Europe, and the case material stresses that Zamorna's health system is NOT the UK's National Health Service (NHS), although there are similarities.

The MGH pre-seen material gives details on three proposals for change, and in Appendix B to the pre-seen material, gives information on performance measures and the expected outcome under each of the three proposals.

In brief the three proposals for change are as follows:

- Proposal 1 is to build a completely new hospital on a new site that would provide the full range of services currently available within the MGH group (including a district hospital, a mental hospital and a maternity and child welfare clinic).
- Proposal 2 is to build a completely new hospital, but all other services (mental health and maternity and child welfare) would be merged with run by a private organisation or merged with another child welfare clinic.
- Proposal 3 is a 'minimum' change proposal, with refurbishment of existing premises.

Details are also given in the pre-seen material on two alternative contractors, ArkFin consortium (led by Arwright plc) and the LinMel group. The appendices to the pre-seen material gave historical financial data for MGH, Arkwright plc and LinMel Inc, as well as demographic statistics, performance measures and a glossary of terms for this case.

2.8.2 The issues in the pre-seen material

To some extent, the pre-seen material gave considerably more information about the case and the direction of the unseen material and the requirement was heading towards, than in many previous FLCS cases. This case was about which of the three proposals should be recommended and justified, both financially and supported by performance measures.

The pre-seen material had introduced the three alternative proposals for candidates to analyse, as well as the two contractors and candidates had plenty of data (both cost data and background information) to analyse and interpret.

A crucial issue in the public sector, in which MGH is based, is performance measures. Candidates should have identified this and interpreted and commented on the performance measures given, as this is important in the selection of which of the three proposals should be chosen.

Other issues to be considered in this case:

- review of the strategic issues facing MGH,
- review of each of the three proposals,
- review of the alternative contractors and the build costs for each contractor for each proposal.

2.8.3 The pre-exam preparation

Candidates had been given much data in the pre-seen material to use in their pre-exam preparation. It is recommended that candidates should have reviewed of each of the three proposals and prepared a position audit or a SWOT analysis for each proposal. They should also have analysed and reviewed the two contractors and the proposed build costs for each proposal.

A further area for pre-exam preparation was to understand and investigate the key performance measures and to interpret the expected outcomes of each of the three proposals for change upon the performance measures.

2.8.4 The unseen material and requirement

The requirement was quite clear and it put the candidate in the position of an outside professional advisor to MGH. The requirement asked for a report that covered three areas, which were:

- to evaluate and prioritise the strategic issues facing MGH,
- to evaluate the three proposals,
- to recommend actions to address the strategic issues.

The unseen material given to candidates on the exam day was brief and it included information that LinMel did not want to tender to provide finance. This caused some candidates problems as they had considered (or had been taught) that the requirement would be about the choice of contractor, but this had now been removed. The requirement was about which of the three proposals should be chosen and why and how the chosen proposal for change would address the strategic issues.

The unseen material included a table showing the weighting and ranking system to be used to appraise each of the three alternative proposals. The unseen material also included updated costs data from ArkFin for each of the three proposals.

2.8.5 The skills needed to pass the exam

The skills needed to pass this case were:

- The preparation and evaluation of a prioritised list of issues facing MGH. (Much of this could have been prepared using the pre-seen material, which then should have been updated to include the new data given in the unseen material.)
- Preparation of a position audit and a SWOT analysis. Ideally the answer should have included a brief SWOT analysis for each of the three proposals being considered.
- The unseen material gave build cost details and savings, and a DCF analysis should have been prepared for each of the three proposals.
- To prepare clear recommendations of action that addressed the strategic issues that should have been identified at the start of the report. The recommendations should link into the analysis prepared and should be justified.
- The industry of a public sector hospital was an easy background for research effectively and candidates should have acquired background information on other successful and unsuccessful PFI projects in the United Kingdom, which should have been compared and contrasted to this case.
- The calculations to evaluate the three proposals should be clear and well set out, and any assumptions made should be fully explained.
- The case writers answer recommended that Proposal 2 be selected with well justified recommendations, but other alternative answer would have been acceptable, if supported by suitable calculations and justified recommendations.

The November 2004 FLCS case on MGH produced a lower pass rate than for previous case studies. However, this was not because the case was considered more difficult by some students or because it was set in the public sector, but was simply because there was an exceptionally higher number of students that sat this last FLCS exam before the syllabus change to TOPCIMA, and there was a significant number of ill-prepared candidates.

The four key problems that candidates experienced with the MGH case were:

- Not providing a review of all of the major issues affecting MGH and not providing a position audit or SWOT analysis
- Many candidates did not recognise the significant and growing financial deficit for MGH and its poor current performance
- Many candidates spent too much time on contractor issues, and this was not required.
- Calculations were generally weak and sometimes not relevant or technically correct.

2.9 May 2005 – ReuseR and NOW

The pre-seen material, the requirement and unseen material for ReuseR and NOW is shown in Appendix 4 at the very back of this Study System, together with the case writers answers.

2.9.1 The pre-seen material

The pre-seen material gives details on two companies, ReuseR and NOW, that operate in the recycling industry. Both companies are growing fast and ReuseR, a listed company, has just secured additional loan finance to pursue its acquisition strategy.

2.9.2 The issues in the pre-seen material

This case is different to previous FLCS cases as it gives details on two companies and also the information given on these companies is less specific than in some previous cases. Additionally there is less financial data given on each of the companies in the pre-seen material.

Using the pre-seen material, candidates should research the recycling industry and the main European companies that are operating in this industry. Candidates should also research the supply chain for recycled waste, both industry waste and government initiatives on domestic waste. In addition, candidates should research the demand and the end customers who purchase recycled waste and the social and financial benefits of using recycled materials as part of the manufacturing process.

The pre-seen material gives data on proposed acquisitions by ReuseR and candidates should revise the alternative techniques for valuing listed and unlisted companies, which are shown in Chapter 4 of this Study System in section 4.15.

2.9.3 The pre-exam preparation

The new TOPCIMA assessment matrix (shown in Chapter 1 section 1.9) has a far greater emphasis on technical knowledge. The assessment matrix has more marks available for the display and application of technical knowledge. Technical knowledge is now assessed in 5 of the 9 assessment matrix criterion, as shown in Chapter 4 section 4.2.

Successful candidates need to have a sound knowledge of relevant analytical techniques and also to be able to demonstrate how they can be applied to the material in the case, including the unseen material that will be given to you on the exam day. The Technical Toolkit in Chapter 4 is a very useful reminder to candidates of the many relevant techniques that you will have learned in earlier CIMA exams

Additionally, the Skills Toolkit in Chapter 3, gives advice on how to analyse the pre-seen material. It is often useful for candidates to prepare a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats) on the pre-seen material. For the May 2005 case, this will necessitate candidates to prepare a SWOT analysis on each of the two companies, ReuseR and NOW, given in the pre-seen material.

2.9.4 The unseen material and requirement

The most important factor to success in the new TOPCIMA exam is to answer the requirement. This may sound obvious, but surprisingly many candidates write their answer to the question they thought would come up, or their lecturer has taught them!

In many instances, whilst their answer was good, if the answer presented is not relevant to the actual requirement set, then the answer will not earn good marks under the assessment matrix.

Candidates MUST remember that on the exam day, it is very important that if a SWOT analysis is included in your answer, it is UPDATED to include data given in the unseen material and not just data that was pre-prepared prior to the exam.

It must be remembered that data given in your answer must be relevant and applied to all of the case material, including the unseen material given to you on the exam day.

At the time of writing this update to the TOPCIMA Study System, the unseen material and the case writers answer are not available, and therefore cannot be commented on. They have, however, been included as Appendix 4 of this Study System.

2.9.5 The skills needed to pass the exam

As stated above, the unseen material and the requirement are not known at the time of writing this update but candidates should be fully familiar with the new TOPCIMA assessment matrix. You should ensure that your answer:

- displays appropriate technical knowledge including a position audit and a SWOT analysis which MUST be updated for data given in the unseen material;
- discusses the ethical issues raised in the case – both those in the pre-seen material and also any new ethical dilemmas posed in the unseen material;
- answers fully the requirement of the question set.

2.10 Summary

2.10.1 The knowledge required in previous FLCS and TOPCIMA exams

The knowledge that has been required in the past few FLCS examinations included the following:

- cash flow analysis,
- business valuations,
- sources of capital for developing firms,
- mergers, acquisitions and divestments,
- SWOT analysis,
- investment and project appraisal,
- divisional performance measures,
- business portfolio analysis,
- risk in overseas operations,
- stakeholder analysis,
- strategic alliances,
- management skills to manage change,
- IT strategy,
- Board level skills and identification of Board weaknesses.

Skills Toolkit

3

3.1 Introduction

(1) The approach adopted in this *Study System* follows the 7-step model shown in Figure 3.1.

(2) TOPCIMA poses different challenges because it requires you to display different competences. Unlike the previous nine papers in the CIMA syllabus (or 16 for candidates who have studied under the pre-2005 syllabus) TOPCIMA does not seek primarily to assess your knowledge of the technical content of a syllabus. TOPCIMA seeks to assess your skills as an advisor to management. Therefore, in order for you to pass, TOPCIMA requires that you practice these skills and hone them down.

(3) This chapter introduces you to the process needed in order to pass TOPCIMA and suggests some approaches and techniques that will help you. These skills are illustrated using real CIMA cases in Chapters 5–7.

You should practice these as you approach the case study exercises in Chapters 5–7 and in the four cases contained in the appendices to this *Study System*.

3.2 Initial reading of the pre-seen material

(1) The TOPCIMA pre-seen material and the assessment matrix will be available as a download in PDF (portable document format) from the CIMA website www.cimaglobal.com about six weeks prior to the exam date. Ensure that you have an up-to-date version of the Adobe Acrobat reader ready for when you want to take the TOPCIMA exam.

(2) In the past the pre-seen material has been between 11 and 18 pages long. You are expected to be thoroughly familiar with it and to use information from it in your final report.

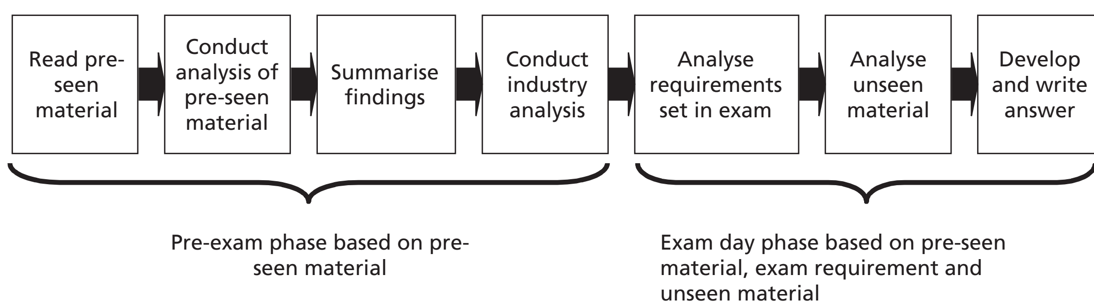


Figure 3.1 Diagram of process to pass TOPCIMA

Speed read the pre-seen material: The technique of SQ3R will help you to get into the pre-seen material quicker. It is also a skill you will need for dealing with the unseen material on exam day where time is very precious

You will need to have some paper and pens for this.

S *Scan* the material. Pay attention to main headings, dates and subjects to get a feel for what you have been given and how it fits together. Do not read the fine detail yet. You are just getting an initial impression

Q *Question*. Using a scrap of paper try to jot down some initial questions and answers to them. These could include things such as

- What is the sequence of events here?
- What are the main issues in the situation?
- Who is who and who reports to who?
- What is the financial situation of the firm?

R *Read* the case closely. Try to underline key points (or better still write them on a separate sheet of paper) and conduct any ratio or other calculations. Its a good idea to write this on the face of the material. The spider diagram technique described below is useful here

R *Recap* what you know. Look at your initial questions and the notes you have made since.

- Note any questions that are still unanswered
- Draw organisations charts
- Write quick character sketches of any characters in the case
- Summarise the key financial information

R *Review* the case material by reading it through again. This may expose additional insights you have not noticed so far or contradict your initial assumptions. If so jot these points down too

3.3 Making effective notes on the pre-seen material

3.3.1 Introduction

Psychologists tell us that using conventional linear notes on their own use only a small part of our mental capacity. They are hard to remember and prevent us from drawing connections between topics. This is because they seek to classify things under hierarchical headings.

Here are some techniques that candidates find useful. See which ones work for you as you practice on the past cases in this *Study System*.

The examples that follow use the November 2001 case study IRS Ltd (reproduced in the appendices to this *Study System*). You may like to read it first before looking at the techniques below.

3.3.2 Page summaries

Page summaries are a précis of what each page tells us about the firm and an attempt to understand the significance of what we have been told.

The following headings can be used (here illustrated using IRS Ltd from November 2001):

	Main information	*Significance*
Page 2	• IRS founded in 1992 as Intelligent Systems (burglar alarms) changing to Intelligent Refrigeration Systems in 1993 • Grew by exploiting problems of CE Ltd in making temperature controls for OEMs • Found it hard to crack the OEM market by offering partnership due to competition • Grew by retrofitting 'Innate' controls to existing equipment in relationship with supermarkets • Main rival CML	• Strategy emergent or opportunistic not planned • OEMs have buyer power • Supermarkets also have buyer power • Must be a limit to number of legacy systems so growth will stop eventually

3.3.3 Spider diagrams

Spider diagrams (or clustering diagrams) are a quick graphic way of summarising connections between subjects.

The pre-seen for IRS Ltd. told us that the company made something called an OEM controller, which provided 20% of its turnover, and something called Innate that provided the remaining 80%. This main product was sold to food stores, mainly in the United Kingdom, with OEM sales being to refrigerator manufacturers. It had been unsuccessful in selling domestic thermostats in Japan.

This information could be quickly summarised in a spider diagram as shown in Figure 3.2. You cannot put much detail into a spider diagram, just a few key words. However, it does help you to 'visualise' the information in the case study.

Notice also the attempt to connect across the different legs of the diagram, in this case between overseas and domestic thermostats. A few of these can be helpful although trying to draw in a lot of links will make the spider diagram very messy and hard to follow.

You must expect to update your spider diagram as you go along and to redraft it when it starts to get too messy. Its all part of the learning process.

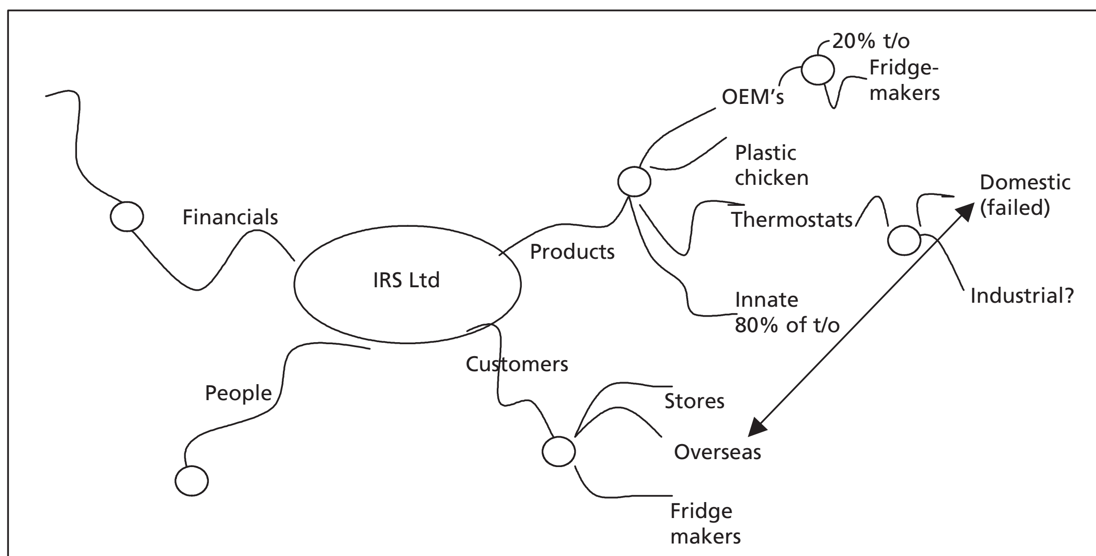


Figure 3.2 Spider diagram

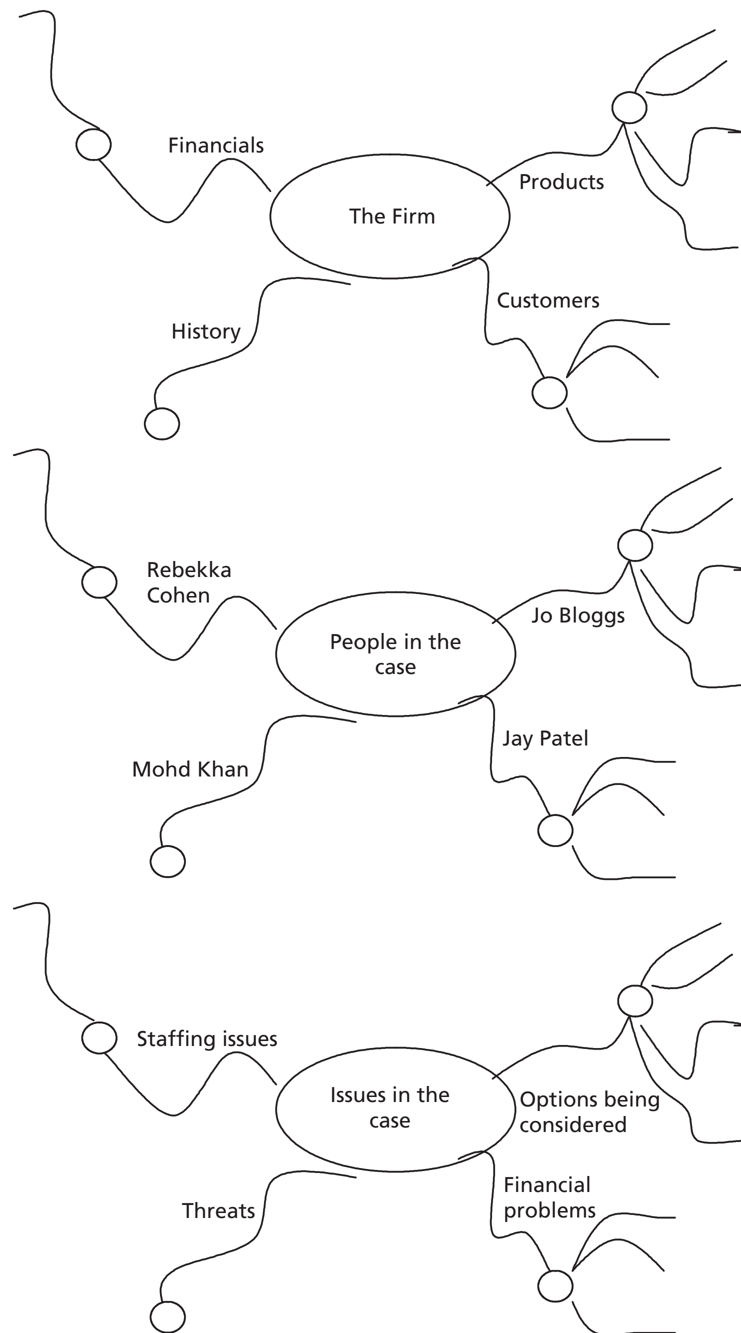


Figure 3.3 Typical spider diagrams for TOPCIMA cases

Candidates usually draw several of these diagrams exploring different aspects of the case. Each one can be drawn on a single piece of A4 paper *landscape format* (apparently we think laterally not vertically!).

The drawings shown in Figure 3.3 are commonly used as the basis for spider diagrams.

3.3.4 Timelines

Timelines are valuable to make sense of the sequence of events in the pre-seen and to understand where the firm presently stands.

TOPCIMA takes place in real time so you need to be clear how long is likely to elapse between the data in the pre-seen and the actual exam. This is the time period during which the author can spring surprise changes in the circumstances of the firm on you. The time-line does not need to be to an exact scale (such as an inch equalling a month) but you do need to get things in the right sequence. The pre-seen material will be given to you with real dates on the accounts and other exhibits such as memos and reports. You know the date on which you will be taking the exam. Therefore in drawing up your timeline you should:

- start at the right-hand side of your sheet with the date of the exam;
- work back from right to left slotting in a summary of the information you have at each crucial date;
- try to use the vertical axis to record the sales turnover or market capitalisation of the business. It will help you to notice whether the firm is growing, stagnant or contracting. You may have a separate line for profit too.

Using the November 2001 case as an example, an illustration of timelines is depicted in Figure 3.4.

3.3.5 Organisation maps

Here is an organisation map (Figure 3.5) for the November 2001 Case Study on IRS Ltd. Note how it reveals an essential feature of the case, that there is ambiguity in roles in both marketing and in project management.

3.3.6 Biodata files

A biography of each character is also useful for several reasons:

- they may be an important source of strength or weakness to the business;
- you may be required to write your report to them and so will need to understand their perspectives;
- the unseen material may involve them, for example, perhaps they leave or you need to find someone suitable for a new venture, and you will need to recall quickly what you know about them.

Here are the biographies of the characters in the IRS Ltd. Case Study (Figure 3.6).

3.3.7 Post-It-Notes[1]

Post-It-Notes can be used to jot key points on. For example, one for each person named, business division or product. If questions occur to you as you read through put each of these on a Post-It-Note too. Stick the notes on your desk, a notice board or wall so that you can keep glancing at them to remember who's who in the case.

3.3.8 Colours

Colours help you remember things you may want to draw upon in the exam room. You could write down all your financial calculations and observations in green whilst having red

[1] Post-It-Notes are a registered trademark of the 3M corporation.

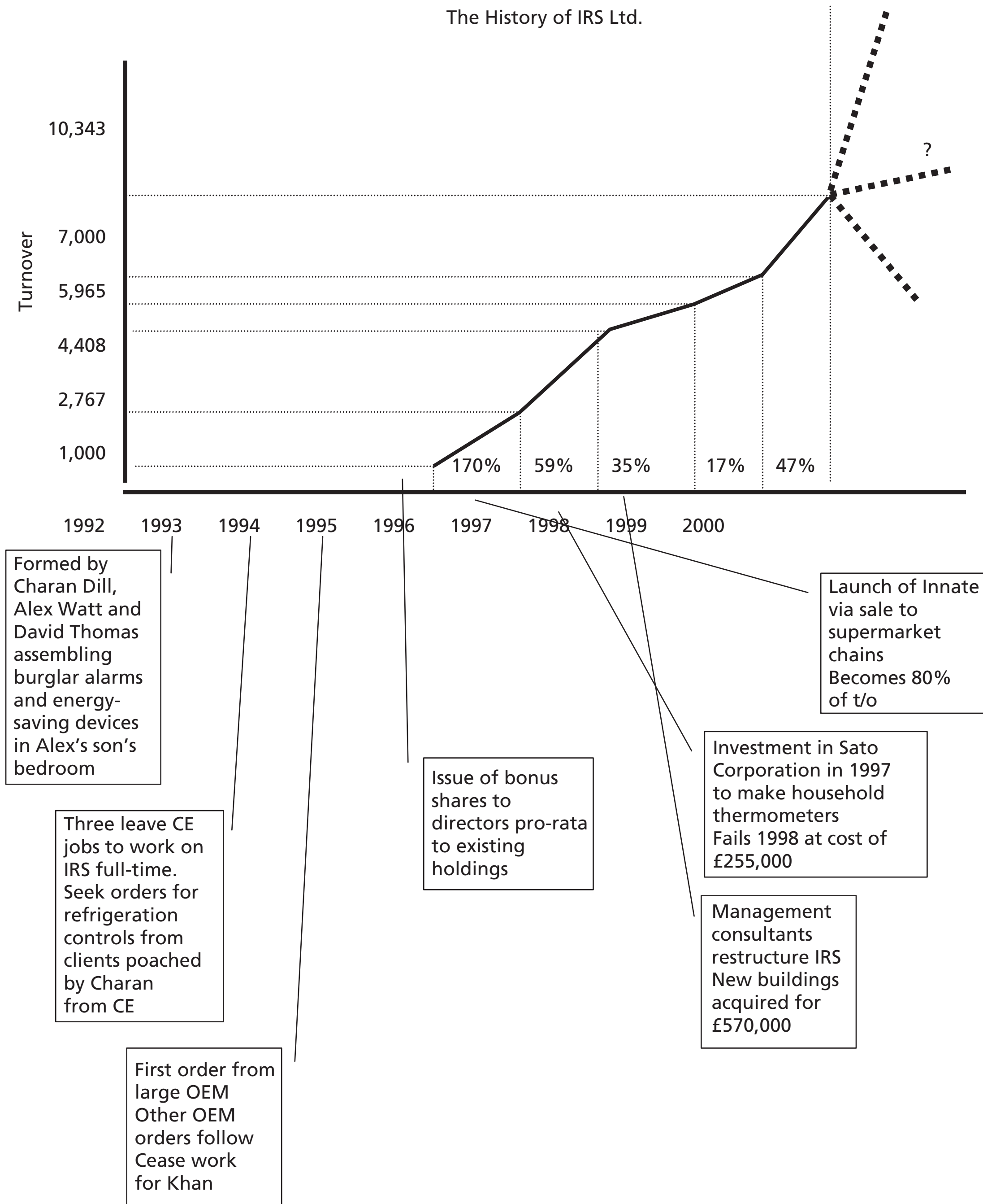


Figure 3.4 Illustration of a timeline applied to November 2001 case

for organisational and blue for strategic. Some candidates use different colour highlighter pens to emphasise different aspects of the pre-seen material perhaps using the same colour coding suggestion.

3.3.9 Cut and paste analysis

Some candidates glue each page of the pre-seen on the left-hand side of an A3 sheet to enable them to write comments and conduct analysis in the blank space on the right. Other

candidates choose to stick the page of the pre-seen in the centre of the A3 page and use call-outs and thought bubbles to make their notes in.

3.3.10 Pictures

Pictures can help you. Where a case study has a lot of people some candidates cut pictures of people from magazines to represent the people in the case and create a biography file

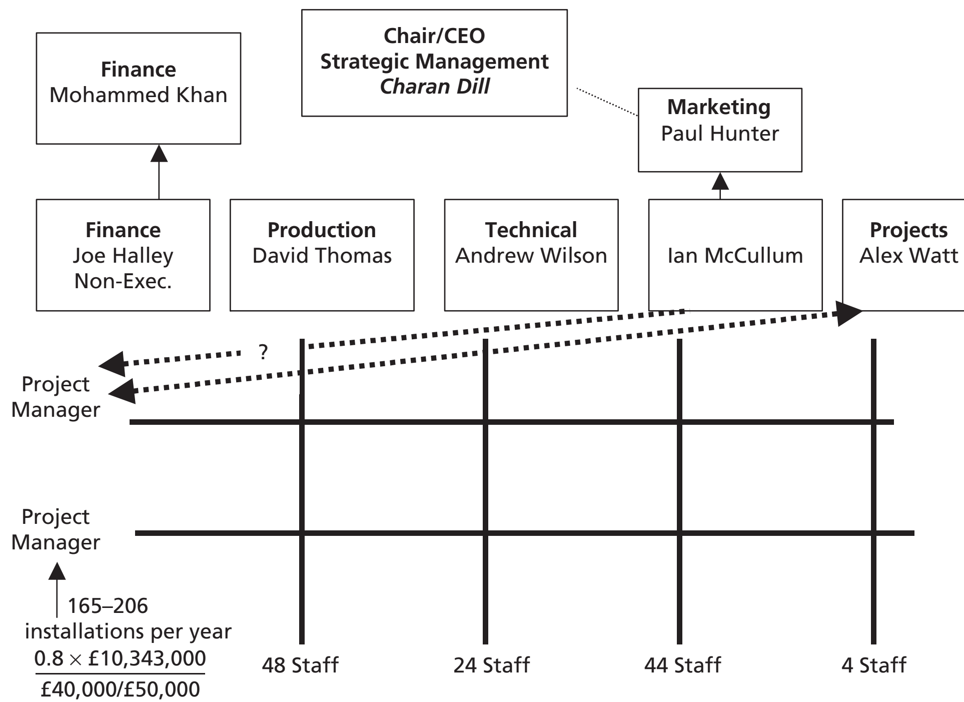


Figure 3.5 Illustration of an organisation map

Charan Dill
Chairman and CEO

Background
41 years old
Graduate in Electrical Engineering
Married, 2 children
Wife accepts workaholic ways needed to *establish* IRS
1st generation Malaysian from wealthy Indian family (property development)
Family are close friends of Mohammed Khan

Role
Shifted from closely involved in everything to 'strategist'
Key account liaison in UK
Develops business ideas in Far East: Japan? ('ideas' = customers?)
Main link to Khan (Khan in for reasons of family loyalty or for prospect of gain?)

Characteristics
Ambitious and driven
Thinks 2 years ahead not 2 weeks
Lives IRS
'Obsessed' with customer service and partnering customers
Autocratic/Dictatorial style from 1998 – sees co-directors as 'not keeping pace with him'
Anti-union views

Issues
Undervalued dynamo of business (same 23% of shares as lesser directors)
Seems to override formal roles (Hunter is Marketing Director)
Combines Chair and CEO (not acceptable if new listed co.)
Style may not be suitable for larger organisation
(Greiner: growth through creativity? crisis of leadership ? growth through control)
Will external investors want him in charge?
Will he (and his wife) support IRS once it is established and shares have a value?

Figure 3.6 Illustration of biodata files for November 2001 case study

Mohammed Khan
Non-Exec. Director – Finance

Background
Accountant by training
Successful Malaysian businessman selling and designing energy-saving devices for hotels and burglar alarm systems
Family friend of Dill family (mainly C's father?)
Many business interests in Japan
Supported early bedroom operation of IRS with work
Invested in IRS in early 1990's and guarantees bank facilities (£1.8m: 2000)

Role
Main financial backer and largest shareholder (30%)
Main risk bearer/potential beneficiary of IRS
Possibly contributor to decision on Sato project
Mentor to Charan Dill
Quasi-FD role and organising influence

Issues
Not a good FD – balance sheet seems out of control
Will want to realise investment soon and restructure finances
Not convincing to external investors (not really non-Exec due to close relationship with Charan Dill)
Would support Charan Dill in any crisis over management or strategy for IRS
30% holding is maximum allowed for listed co.
Potential acquirer of IRS

Alex Watt
Projects Director

Background
47 years old, married with kids
Bourgeois Scottish family (Father a Bank Manager)
Graduate in Electrical Engineering
15 year career in design with EP Group and CE Ltd. before jointly founding IRS in 1992 with Charan and David
4 years in South Africa
Trained Charan
Friend of David Thomas

Role
Initially technical design but shifted to project management with arrival of Andrew Wilson
Responsible for 'critical path management' of project
Manages 4 subordinates
Shareholder (23%)

Characteristics
Not ambitious at all
Homebody – marriage caused him to leave SA and join CE.
Wants money but doesn't put himself out to get it
Impressionable and led by Charan
Potentially awkward to deal with on matters of company policy/strategy
A deadweight

Issues
Sidelined in management and not a major stakeholder other than through shares
Will benefit more than he deserves in flotation/buyout
Minority holding
Not convincing to external investors
Potentially resents Charan
Expendable but may be awkward if able to form alliance with David Thomas

David Thomas
Production Director

Background
46 years old, graduate of Engineering and Economics
Seemingly not Scots (English/Welsh?)
Design background
2 years management experience in India (1987–1989)
Made redundant
Formed IRS with Charan Dill and Alex Watt in 1992

Role
Director and shareholder (23%)
'Key lieutenant' to Charan Dill since 1998 (formally)
'Production and administration' role until 1998
Production only since 1998
48 staff

Characteristics
None given

Issues
Has management experience for CEO role perhaps
India exposure may help working relationship with Charan Dill (and Mohammed Khan?)
Could run home operation if Charan Dill goes abroad
Significantly no personal info.

Andrew Wilson
Technical Director
(engineering and support)

Leads Engineering and support (24 staff)
Collaborates as functional head in matrix
Has got Alex Watt's former job
Board member but no shares

Paul Hunter
Marketing (Sales) and Customer Service Director

Leads Sales support (44 staff = highest number)
Some involvement in project teams
Role seems eclipsed by intervention of Charan Dill

Joe Halley

Ian McCallum
Customer Service Manager

Figure 3.6 (Continued)

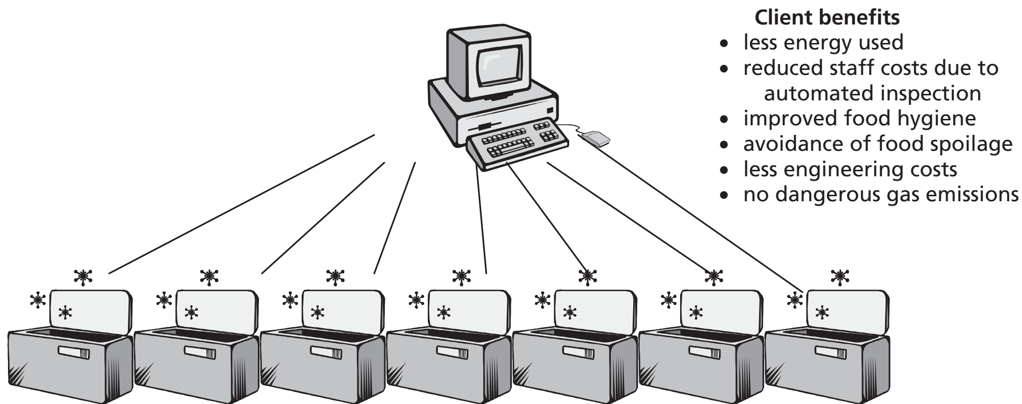


Figure 3.7 Diagram to support November 2001 case study

with each character and the main facts about them. These pictures help to make the case seem more real.

Here is an example of a picture created to help candidates remember the details of a product, the OEM Controller, made by the company in the November 2001 Case Study (Figure 3.7). The company, IRS Ltd., provided thermostats and computer monitoring of refrigeration installations for food stores.

3.4 Detailed analysis of the pre-seen

(1) You are seeking to show competence as a management accountant. This means that you must apply the knowledge from your CIMA studies to the TOPCIMA case.
(2) The approach we have adopted in the de-brief to all the cases in this *Study System* has been based on the following template. We recommend that you follow it as a step-by-step guide, perhaps photocopying the template to fill in.
(3) You will find the techniques above used in analysis of the cases in Chapter 5.

3.5 Analysing requirements in the TOPCIMA exam

(1) This is the first of the skills highlighted in Figure 3.8.

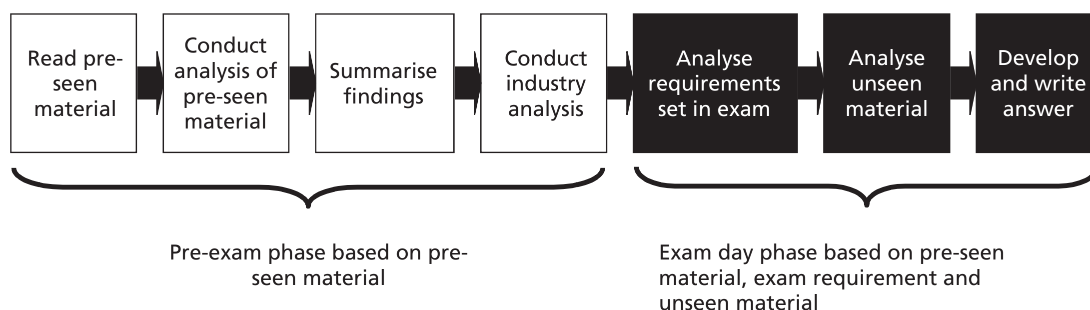


Figure 3.8 Diagram of process to pass TOPCIMA

STRATEGIC ANALYSIS TEMPLATE

Step	Analysis Tool	Key Conclusions
1	Asses the four elements of strategy (Competitive, Financial, Investment and Risk)	
2	Conduct financial analysis of company position (performance and fund sources)	
3	Assess business portfolio	
4	Conduct industry analysis on basis of information given	
5	Produce position audit of firm (see Chapter 4 section 4.8 for more information)	
6	Conduct managerial and organisational audit	
7	Identify critical success factors for industry and evaluate firm's performance against them	
8	Assess suitability of IT and of information systems strategy (see Chapter 4 section 4.11 for more information)	
9	Assess level of corporate risk and adequacy of policies for its control	
10	Estimate cost of capital and compare firm's returns to this	
11	Conduct business valuation (see Chapter 4 section 4.15 for more information)	
12	Draw up a corporate appraisal (SWOT) involving all the above (see Chapter 4 section 4.14 for more information of how to prepare a SWOT analysis)	

(2) In the TOPCIMA exam you will be given three documents:

- A booklet containing a fresh copy of the pre-seen material followed by the exam requirement and then several pages of new unseen material. This will also contain mathematical tables and formulae.
- A full-length answer booklet.
- A continuation answer booklet.

We recommend that you reserve the full length booklet for your main answer (e.g. a report) and that you use the smaller booklet for appendices and for rough working.

The second half of the continuation booklet should be for rough working.

The first double page spread following the centre staples will be needed for your skeleton plan (see below).

(3) Before you read the unseen material first read the requirement(s) and make an immediate note of the following elements in your rough working papers:
- *Your role or position*. For example, whether you work for the firm or an outside interest and your organisational position.
- *Format of response(s) required*. This is likely to be a report but could also involve a letter, presentation or memo.
- *Who it is addressed to*. This should influence the tone and content of what you write (e.g. your line manager, the board, a regulatory body).
- *What you are reporting upon*. There may be more than one thing required, for example a report that contains both a strategic analysis and an evaluation of a business plan.

Here is the requirement for Homejay Incorporated:

> *You are the independent management consultant appointed by the new Chairman, Ken Kato.*
> *Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.*

We can see several things in this requirement:

You are an independent management consultant	• This means we have to be objective and professional. It also means we must consider a broader range of issues than just management accounting ones
We are writing to the Chairman	• This means we do not need to worry about criticizing members of the Board of Homejay
The Chairman, Ken Kato, is a new name in the case	• This means we can criticise Ralph Black • It also means that we will need to explain things about Homejay in more detail because Kato may not know them all
We are writing a report	• Indicates required format of response
Review of the issues facing Homejay	• This mean an updated SWOT (see Chapter 4 section 4.14) which MUST analysis incorporate data given in the Unseen material • You should also include a position audit at the start of your report summarising the key issues for the company • Look for the changes between the Pre-seen and the Unseen
Evaluate each of the four strategic options	• We need to find out what these four options are
Conclude with recommendations	• We are supposed to advise Ken Kato on what to do with the firm he has just joined. The recommendations section of the report is very important (and carries 20 marks in the new assessment matrix). All recommendations made should be well argued and justified

3.6 Reading the unseen material in the exam

(1) To a large extent this will use the same skills your have developed reading the pre-seen material. However you will find it quicker because the scenario, and the issues and characters in it, are now familiar to you.
(2) The following steps should be taken:
- Update your analysis of the position of the firm(s) in the case in your rough workings.
- Conduct preliminary rough analysis on any proposals in the unseen material.
- Perform any necessary calculations in a presentable form, clearly identifying the figures used, as appendices to the report. Try to avoid performing calculations in rough workings, and then rewriting them. Remember that it will be necessary to refer to the results of these calculations and explain their significance in the main report.

(3) To help you make sense of the material you need to write some of it down. This could be in the form of the analysis template in Figure 3.9, or as a spider diagram as shown in Figure 3.10.

3.7 Update your SWOT analysis

In the Technical Toolkit in Chapter 4 of this Study System there are a wide range of techniques for you to revise and be familiar with. One of these techniques is how to conduct a corporate appraisal such as a SWOT analysis or Gap analysis (see Chapter 4 section 4.14 for more details).

In section 3.5, the strategic analysis template suggested the use of a number of analysis tools to help you understand the pre-seen material, of which one of them was to prepare a SWOT analysis. When you read the unseen material on the exam day, there will have been a number of changes to the company that have been introduced. Because things will have changed since the pre-seen, you will need to redraft your SWOT analysis and update it for the new factors.

Page	Main Information	Significance
19		

Figure 3.9 Analysis template for unseen material

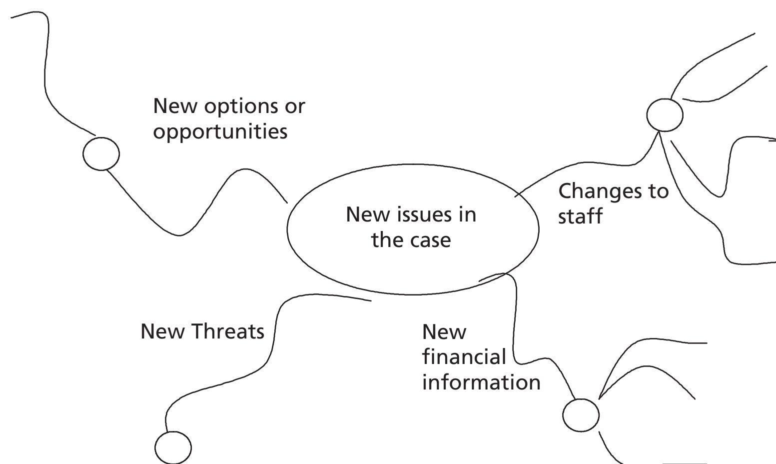


Figure 3.10 Spider diagram for unseen material

We recommend that you draw a new Cruciform Chart as your first appendix, that is, as the first page of the continuation booklet. You should refer to your SWOT and discuss it in your main report to justify your recommendations.

If you include a SWOT analysis in your answer, you must ensure that it has been updated to include material that has been given to you in the unseen material on exam day.

3.8 Conduct calculations

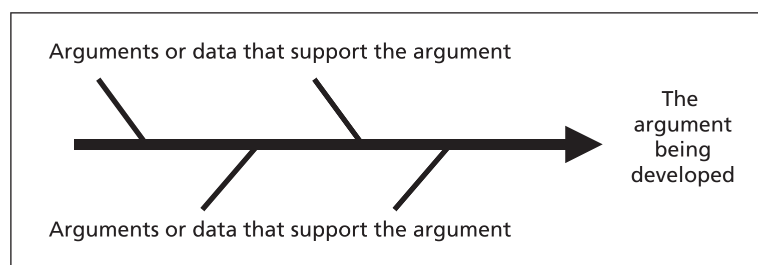
(1) It is certain that there will be calculations to present and that these will be the justification for the central core of your recommendations. It will be very hard for you to provide a discursive recommended for action if later you discover that financially it doesn't stack up.
(2) In past FLCS cases the calculations have included:
- NPV of projects,
- valuation of shares or a company,
- cash flow and profit forecasts,
- EPS forecasts.

(3) Because of pressure of exam time, whilst it is unlikely that you will produce these in a presentable form at first, you may wish to do some rough workings and calculations. However, remember that TOPCIMA is a strategy paper not a numbers paper – so spend your time carefully and ensure that calculation time is kept within sensible bounds (probably no more than 20 minutes).
(4) All calculations should be clearly set out and well spaced, with any assumptions made clearly stated. For example, if you are preparing NPV calculations, these should be prepared for the time period set out in the unseen material, such as 10 years. Therefore a 10-year NPV calculation should be prepared – not 5 years or into perpetuity. Therefore, the rule is follow the instructions given.
(5) Additionally if you are given a cost of capital, then use it. You may be given additional marks for including comments in your report as to why you consider a higher, or lower, cost of capital should be used, but the calculations should be prepared using the data given to you.

3.9 Decide structure of your argument

(1) The requirements set in the TOPCIMA exam must be met before you start branching off to discuss other issues you think relevant.
(2) Candidates report that having a clear idea of what they want to say is the hardest part of passing an exam like this.

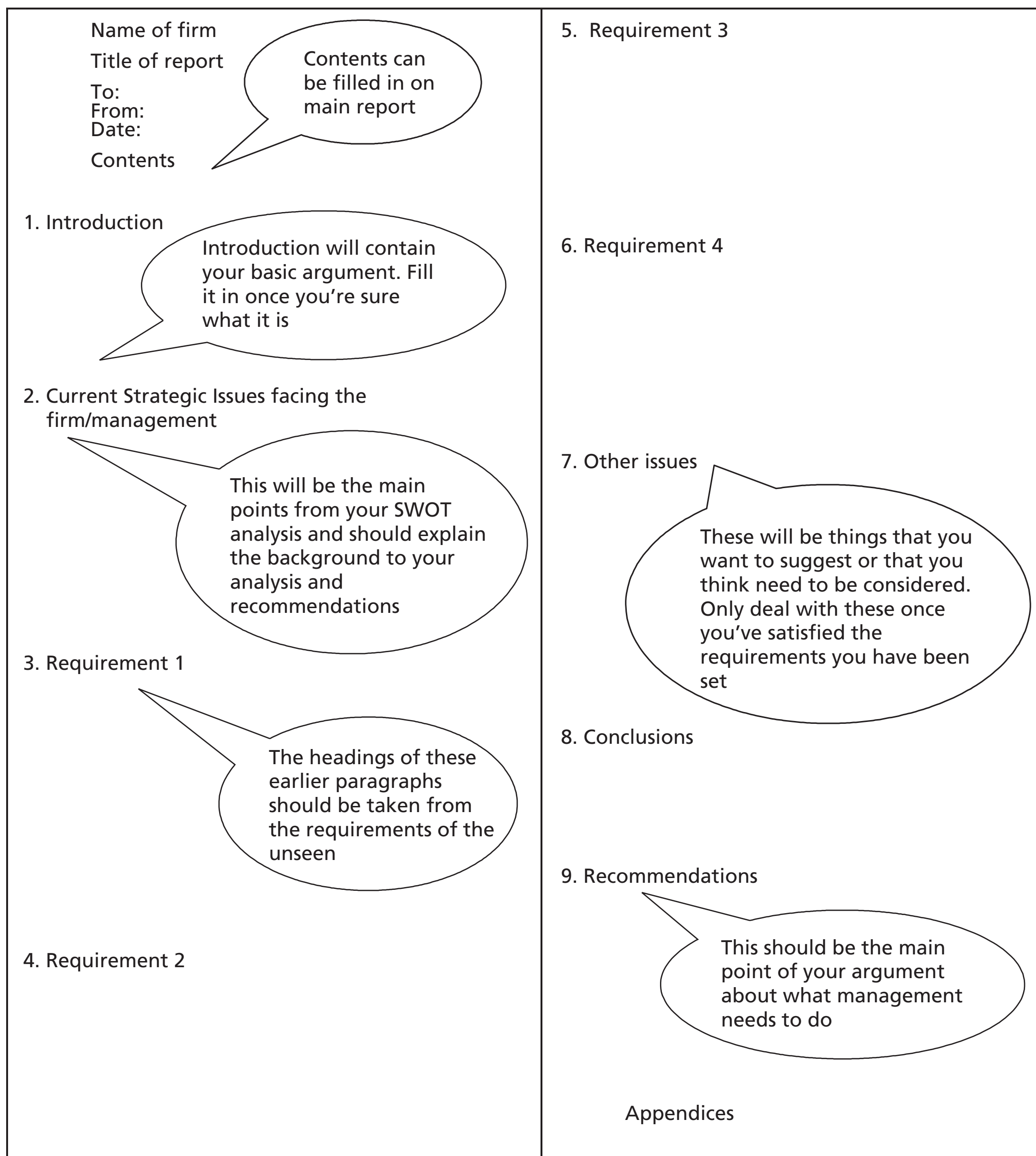
Some candidates have found *fishbone diagrams* a good way to plan their development sections.



(3) You should draw the fishbone(s) in the rough workings section of your answer books. Using pencil helps you to shift ideas about, although sometimes its just as quick to redraw them if a better sequence of ideas comes to mind:
- write the argument at the point of the fishbone;
- put each separate piece of data analysis or evaluation that lead to the conclusion of the argument as spines;
- ensure that each spine is essential to supporting the argument;
- ensure the spines are in the best sequence for leading the reader through your argument.

3.10 Developing a skeleton plan

(1) You should attempt to map your answer out on a double-page spread in your answer book.
(2) The following template is useful:



3.11 Adding depth to your answer

3.11.1 Appreciation of the many issues in a case

TOPCIMA candidates are required to show a broad appreciation of the many issues in a case. This means making connections between material in the pre-seen and unseen material and between these and the underpinning technical knowledge of a management accountant. You should also consider the 'bigger picture' in commercial terms and the competitive environment in which it operates.

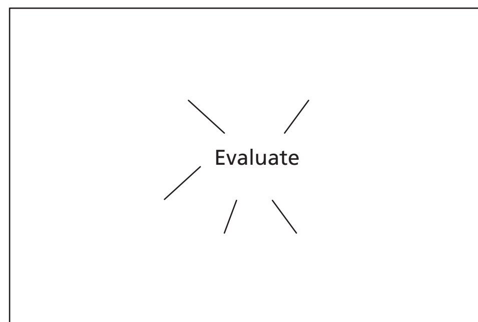
Your answer and recommendations should concentrate on the main strategic issues, but should also include recommendations on organisational structure and any changes required as well as Board positions and responsibilities and IT issues and solutions.

3.11.2 Radial thinking

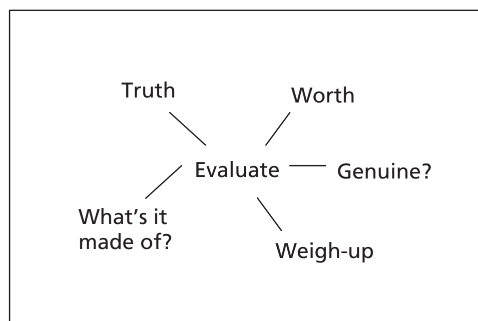
This technique is a kind of structured brainstorming or word association.

Write a key word or phrase in the middle of a sheet in the rough workings section of your second answer booklet (tip: put the sheet on its side) and then draw 4 or 5 rays from it.

For example, 'evaluate the options'.

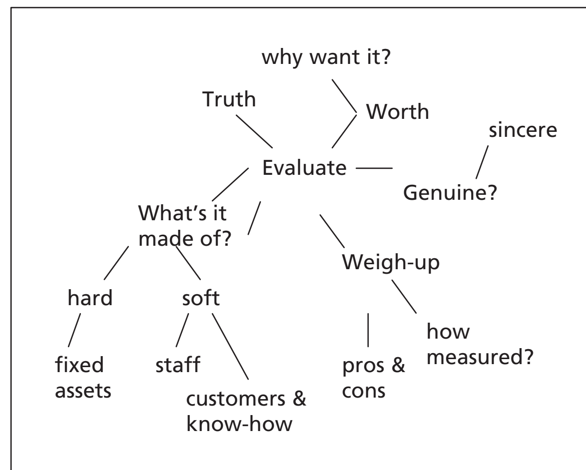


At the end of each ray write a word or phrase that comes to your mind as being connected with the central word. The important thing here is to suspend your critical filter. Rely on word association and do not worry if the words you write down seem silly or out of context. The fact you thought of them means that somewhere in your mind there is a connection between them.



A quick consideration of some of the words on this map may help us to realise that our report should discuss business valuation ('worth'), the future earnings, assets, management and technologies of the firm.

If you still have a problem getting ideas then repeat the exercise with the more promising words on the original rays, and so on, for example,



These further associations have reminded us to consider the validity of the accounting information ('how measured'); to itemise the benefits and risks clearly in our report ('pros and cons'); to check on the assets and protections available ('hard and soft') and also to consider the strategic logic to our assessment of value.

The skeleton plan can be further filled out.

3.12 Writing the introduction to your report

(1) Great thriller writers keep their readers in suspense until the last chapter or page to find out what happens. Sometimes there is a twist and the ending is the opposite of what the reader had been anticipating. However, this is NOT suitable for your TOPCIMA exam report!

(2) Your TOPCIMA report should be the complete **opposite** of a novel:
- the reader should be clear from the start what the conclusion of your report will be;
- the report should show the reader how you arrived at this conclusion in a way that builds the argument and shows how one point leads on to the next and makes your conclusion inevitable;
- it should end with a set of clear recommendations on what management should do next.

This opening paragraph has power and compels attention.

(3) A useful discipline is to ensure the first sentence of your Introduction begins with one of the following phrases:
- 'This report will argue that....'
- 'This report will present the case for.... (a given course of action or decision)'
- 'The central conclusion of this report is its recommendation that...'
- 'This report will demonstrate that... (the following situation is the case or certain actions are essential)'.

This only works if this sentence is the first thing you actually write in your skeleton plan and final report. Do not cheat by leaving a space and inserting the sentence once you have finished your report and finally decided what you think.

3.13 Dealing with conclusions and recommendations

(1) Conclusions should be drawn in two places during your TOPCIMA report.
   (a) At the end of each main section. This will help the reader understand what you have concluded from each evaluation or argument.
   (b) In the conclusions section. However there should be no new conclusions or surprise twists here, although your main recommendations paragraph could include a range of less important recommendations that have not been discussed elsewhere. These could be about strengthening the Board, recruitment of non-executive directors or IT issues.
(2) The conclusion need to be the one you promised in the introduction.
(3) The conclusions section should be the shortest one in the report because it does not add any extra information and so cannot gain any extra marks. However, do ensure you have reached a conclusion on all the issues you were asked to address in the requirement.
(4) Recommendations are plans of action and next steps. You should ensure these are clearly prioritised into the things that should be done immediately and the things to be done later.
(5) For example, one of the common errors in the Sparkle case was where candidates discussed the long-term future and the 5-year plans of Sparkle and almost ignored the fact that the unseen material changed the case into a hostile take-over situation. The priority for Sparkle was how to defeat the hostile take-over bid. If the company was taken over, then Sparkle would simply NOT have a long term! Prioritise your recommendations to take account of the new data in the unseen – which will probably be different to what you have prepared prior to the exam.

The recommendations should be the most important area of your report and can often make the difference between a pass and a fail. In the TOPCIMA exam there are 20 marks under the heading of 'logic' in the TOPCIMA assessment matrix.

There will usually be 20 marks for logic and it is very important that exam time is managed effectively so that clear well-justified recommendations are prepared. After all the main purpose of the report is to make recommendations, so ensure adequate time is allowed for *this key area of your report*. If your recommendations are not clear or are simply stated with no reasoning, they will earn low marks in this key area of the assessment matrix.

Technical Toolkit

4

Learning Outcomes

By the end of this chapter you should:

- have a sound knowledge of specific technical subjects within the CIMA curriculum;
- be able to apply technical knowledge in an analytical and practical manner;
- extract, from various subjects, the knowledge required to solve many-sided or complex problems;
- integrate diverse areas of knowledge and skills.

4.1 Introduction

The purpose of this chapter is to remind you of some key knowledge areas from your previous *CIMA* studies (Figure 4.1).

But despite the learning outcomes cited above, drawn from the TOPCIMA Learning Aims, this toolkit is merely an additional resource for you to dip into. We cannot cover the technical content of the whole *CIMA* curriculum in a single chapter. When you are using this chapter, if you come across subject knowledge that you do not fully understand we recommend that you consult the relevant *CIMA Study System* to ensure your technical knowledge is up to scratch.

The technical knowledge in this chapter should be applied to the pre-seen material. It is deliberately arranged in a logical sequence. You should consider each technique and assess whether it can be used to shed light on the pre-seen.

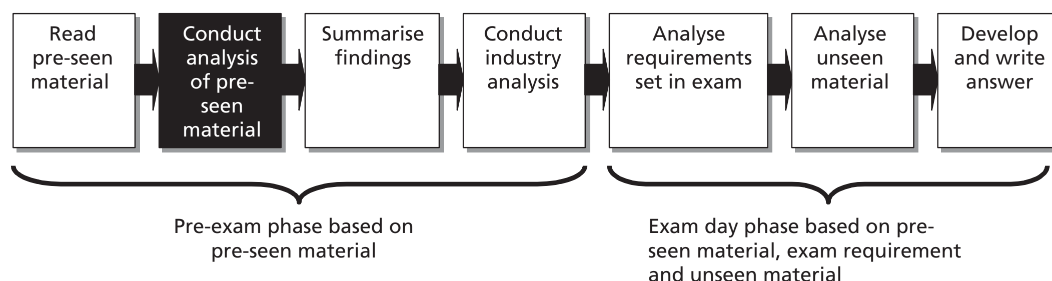


Figure 4.1 Diagram of TOPCIMA process

Refer immediately to Section 4.4 to refresh your memory on the breadth of technical knowledge you may be required to call upon.

4.2 Assessment of technical knowledge in TOPCIMA

Technical knowledge is assessed under 5 of the 9 assessment criteria, which are explained in Chapter 1 of this *Study System*:

Technical	A sound technical knowledge of the specific areas of the curriculum
Application	Apply technical knowledge in an analytical and practical manner
Diversity	Extract from various subjects the knowledge required to solve many-sided or complex problems
Focus	Solve a particular problem by distinguishing the relevant information from the irrelevant in a given body of knowledge
Integration	Integrate diverse areas of knowledge and skills

As you can see, demonstrating technical knowledge will gain your TOPCIMA script a lot of marks. But note the key words. As well as being 'sound' this knowledge must be 'analytical, practical, diverse and relevant'.

TOPCIMA is not a theory exam. Technical knowledge will only gain marks if it is relevant to helping management to understand the problems of the organisation or is used to justify the course of action you are recommending. You will not get marks for brandishing technical knowledge for its own sake.

4.3 Summary of the key areas of technical knowledge covered in this chapter

We have selected the following topics based on a consideration of past CIMA Case Study exams and also our experience of the difficulties facing learners and candidates:

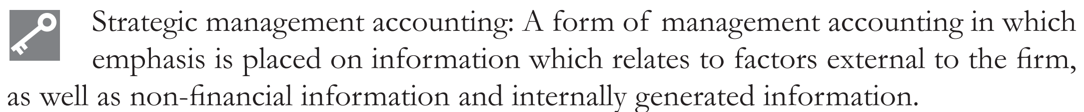
Technique	*Sections*
The four elements of strategy (competitive, financial, investment and risk)	4.4
Using ratios to conduct a financial analysis of a company's position	4.5
Assessing a business portfolio	4.6
Industry analysis	4.7
Position audit	4.8
Conducting a managerial and organisational audit	4.9
Critical success factors	4.10
Assessing information systems strategy	4.11
Assessing corporate risk	4.12
Assessing the cost of capital	4.13
Conducting a corporate appraisal (SWOT and Gap analysis)	4.14
Business valuations	4.15
Generating strategic options	4.16
Sources of business finance	4.17
Evaluating strategic options	4.18

4.4 The four elements of strategy

(1) According to the syllabus 'TOPCIMA (. . .) requires students primarily to apply strategic management accounting techniques to make and support decisions'.
Where the following definitions apply:

Strategy: A course of action, including the specification of resources required, to achieve a specific objective.

Strategic plan: A statement of the long-term goals along with a definition of the strategies and policies which will ensure achievement of these goals.


Strategic management accounting: A form of management accounting in which emphasis is placed on information which relates to factors external to the firm, as well as non-financial information and internally generated information.

CIMA: Management Accounting Official Terminology

(2) The following discussion provides an overview of the issues in strategy and how they interrelate (Figure 4.2). The reminder of this chapter is devoted to a detailed treatment of the main topics raised here.

4.4.1 Competitive strategy

This deals with how the firm competes for business and where its earnings come from.
Considerations in competitive strategy:

- which countries, markets and customers to target (affects volumes, revenues and risks);
- the positioning of firm in each market and the quality of its offerings (affects costs of production and cost of developing, supporting and defending brands);
- what products or services to provide (affects costs and the assets the firm must invest in);
- methods of gaining access to customers, markets and products (may lead to acquisitions, mergers, joint ventures, etc.);

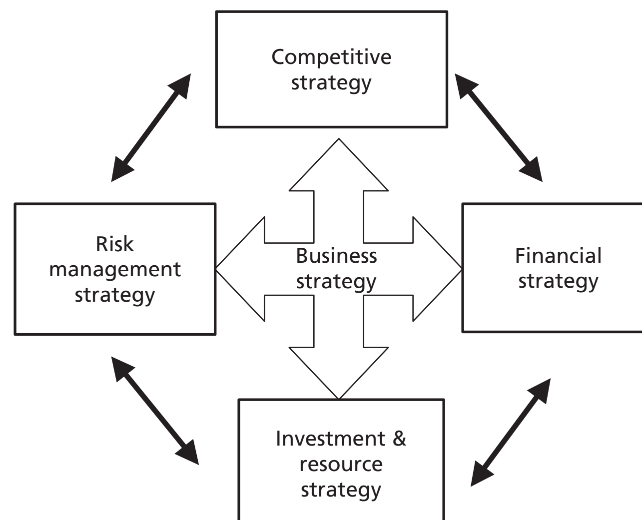


Figure 4.2 The four elements of strategy

- creating appropriate organisational structures and systems to support strategy;
- the role of the corporate parent in controlling strategy and maintaining control over divisions in the implementation of strategy.

Technical content:

- Porter's generic strategies (cost leadership, differentiation, focus);
- Ansoff product/market growth vector matrix (market penetration, market development, product development, diversification);
- theories of resource-based strategies (distinctive competences and strategic architectures);
- Goold and Campbell: strategic styles;
- strategy and structure: for example, Chandler's theory of stages, Greiner's model of organisational growth, virtual organisations, learning organisations, flexible organisations;
- strategic cultures (e.g. Miles and Snow);
- multidimensional performance measures (e.g. balanced scorecard).

Importance of competitive strategy:

- competitive strategy influences the operating margin of the business (profit/sales turnover ratio) and also the assets it needs to support its business (assets/turnover ratio);
- competitive strategy therefore determines the return on shareholders' investment (i.e. ROCE = operating margin × asset turnover) from the firm's core business;
- success of competitive strategy (e.g. sales growth, winning new orders, adequacy of margins, etc.) will influence investors' opinions of management and therefore the firm's share price or ability to borrow investment funds;

Application to passing TOPCIMA:

- evaluate the causes of the financial performance of the firm in terms of the adequacy of its competitive strategy in each if its markets/businesses;
- assess adequacy of management and organisation for carrying out the strategies being considered by the firm;
- justify any recommendations you make in terms of its strategic rationale and potential impact on ROCE and share price;
- ensure you consider all the implications of the strategy you recommend (e.g. implications for structures, control systems and performance measures).

4.4.2 Financial strategy

This deals with the firm's relations with its investors and other providers of credit. Management must meet the wishes of the shareholders of the business. They must also bear in mind the banks and suppliers who are also sources of capital.

Considerations in financial strategy:

- ensuring the return to shareholders exceeds the costs of equity in order to create shareholder wealth;
- maintaining appropriate relations with investors;
- ensuring that the business has sufficient funds available to meet its present and forecast cash needs;
- developing a capital structure appropriate to the financial needs of the business and the dynamics of the parts of its business.

Technical content:

- operation of stock markets (e.g. efficient markets hypothesis);
- methods of flotation and of raising equity finance (e.g. rights issues, warrants, venture capital);
- raising long-term debt finance (e.g. bonds, bank borrowing, project finance, sale and leaseback of assets);
- raising short-term finance (e.g. trade credit, factoring, hire purchase, leasing, bills of exchange);
- calculation of cost of capital;
- methods of share valuation (e.g. net assets, income flow, dividend, price/earnings, sustainable cash flow);
- theories of optimal capital structure (e.g. Modigliani and Miller);
- dividend policy.

Importance of financial strategy:

- activities of corporate treasury can improve or reduce earnings of shareholders;
- loss of support from shareholders will lead to changes in management and strategy;
- inadequate financial support can lead developing businesses to overtrade (i.e. to run out of cash) despite being profitable.

Application to passing TOPCIMA:

- evaluate the financial performance of the firm, and its share price, using ratios to assess whether management are acting in the interests of shareholders and able to maintain shareholder support;
- use cash flow forecasting to assess the adequacy of its financing its current strategy;
- value the company to assess the likelihood of being able to raise further capital, takeover another firm or resist a takeover itself;
- prepare financial analysis to advise management on how to restore investor support or raise additional finance.

4.4.3 Investment and resource strategy

This area of strategy concerns how management uses funds retained from profits or otherwise borrowed from investors. These provide the resources needed to carry out the firm's competitive strategy.

Considerations of investment and resource strategy:

- ensuring the business has the tangible and intangible assets it requires to carry out its strategy;
- ensuring all business investments are undertaken only if it can be shown that there is a reasonable prospect of a net return in excess of the costs of capital involved;
- evaluating whether existing assets, including entire business divisions, are yielding an adequate return or whether they should be divested or outsourced;
- appropriateness of potential asset investments (e.g. business acquisitions, tangible asset acquisition, programmes of marketing or human capital development);
- ensuring that performance measurement systems encourage management to utilise assets for the best long-term financial return.

Technical content:

- project appraisal (e.g. IRR, NPV);
- risk and project appraisal including sensitivity analysis;
- mergers and acquisitions;
- demergers;
- divisional performance evaluation (e.g. return on investment, residual income, shareholder value approaches);
- post-investment audit.

Importance of investment and resources strategy:

- the quality of management's investment decisions will determine the company's ability to make a healthy return on shareholder investment through time;
- present financial performance can be improved if assets returning less that the cost of capital are liquidated and the funds invested elsewhere or used to repay capital;
- strategic investments often contain loose forecasts of earnings, outlays and costs of capital that should be questioned before approval is given;
- post-audit of investments can reveal issues in the quality of management forecasting and also of its ability to manage projects to generate shareholder returns.

Application to passing TOPCIMA:

- assessment of investments undertaken to date will help you to draw conclusions about the quality of management, its strategy and the reliability of its forecasts;
- be prepared to advise on the suitability of investments being proposed by management in the pre-seen or unseen material;
- be ready to recommend investments or divestments to management, backed up by appropriate numerical analysis.

4.4.4 Risk management strategy

Considerations include:

- *Business or operational*: relating to the activities carried out within an organisation.
- *Financial*: relating to the financial operation of a business.
- *Environmental*: relating to changes in the political, economic, social and financial environment.
- *Reputation risk*: caused by failing to address some other risk.
- *International risk*: resulting from exposure to different currencies or political systems.

Technical content:

- *Risk management policy*: this defines the organisation's approach to risk management and its attitude to, and appetite for risk.
- *Resourcing risk management*: the resources required to implement, monitor and co-ordinate the risk management process including risk reporting.
- *Implementation of risk management*: formalizes the processes involved in identifying and defining risk, the assessment of risk in terms of likelihood and impact, and the key aspects of the business processes that are used to respond to risk. This includes *internal controls* such as planning, internal audit and the impacts of corporate governance on the top board.

- *Risk management review and reporting*: includes the form and regularity of reporting and the risk reporting structure.

Application to passing TOPCIMA

You should be prepared to

- assess the risks presently run by the organisation in the pre-seen material;
- consider the adequacy of the firm's current risk management and reporting procedures;
- forecast how those risks will change in the light of strategies it proposes or environmental factors in the pre-seen or which you subsequently research;
- identify the risks implicit in any strategies you propose;
- recommend techniques and procedures to manage risk in future.

4.5 Financial analysis of a company's position

(1) As a management accountant its your job to advise management on the financial position of the business. Other functional experts will advise them on the detail of the firm's marketing, human resource or operational position. You must therefore base your analysis of the pre-seen material in the firm's financial position.

(2) Financial analysis seeks to assess two factors:
- the quality of earnings management are returning in relation to the shareholders funds they control;
- the risks investors, and other stakeholders, are exposed to as a consequence of management's decisions.

Note that although we are analysing a company's figures we are really seeking to draw conclusions on the quality of its management, the strategy they have followed to date, and the control they exercise over the firm's operations.

When you qualify as a CIMA accountant you will use financial ratios to assess performance within your company or division or to review companies operating in your industry for benchmarking purposes or for possible acquisition. It is very important that you know how to calculate these key business statistics accurately.

In your TOPCIMA exam, the correct calculation and interpretation of these financial ratios demonstrates to the examiner that you are competent in calculating and understanding these key business indicators. It is surprising that in this last CIMA exam, there are still students who appear to be unable to correctly calculate even basis financial ratios such as earnings per share (EPS). I have seen EPS calculated on pre tax profits and even on retained profits after dividends. EPS should, of course, be calculated on profit for the period, that is, post tax and post finance charges, but before dividends, divided by the number of ordinary shares in issue.

4.5.1 A tree of ratios

Poor management performance means that they have failed to increase the value of the business. Good business management means the opposite.

Increasing the value of the business depends on being able to increase the returns to ordinary shareholders, measured as the earnings per share.

The diagram in Figure 4.3 shows the ratios driving EPS and therefore shareholder value.

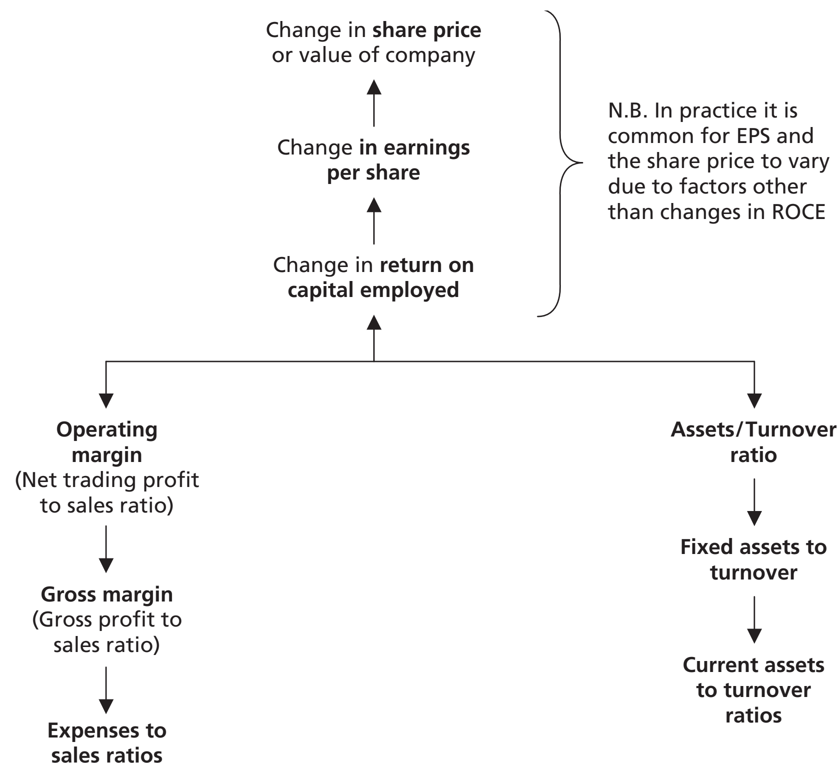


Figure 4.3 The tree of ratios driving earnings per share

To analyse the causes of the financial performance of the business adopt the following approach to work down the two branches that determine ROCE.

Calculate changes in the EPS and/or the ROCE. If they are falling through time management is failing. If they are rising management is working and the strategy is successful.

Check the margins and costs

- Calculate operating margin for each year to look for trends. If it is constant it is not the cause of the changes in ROCE and EPS. Alternatively if it is changing through time then look for causes by inspecting the gross margin.
- Changes in gross margin are due to changes in prices or changes in the costs of sales. If the gross margin is falling it suggests competitive pressure on prices, rising costs of sales or that the volume of the firm's business is not expanding as fast as its capacity.
- If gross margin is not obviously the cause of changing profitability then check some expenses to sales ratios. Things like administration costs or marketing costs may be changing.

Check asset/turnover ratios

These ratios check that whether management are utilising the firm's assets properly or not. If the TOPCIMA pre-seen material contains similar details for previous years or for similar companies then you should conduct a *comparative analysis*.

- Check fixed assets to turnover first. If this ratio is high (or increasing) it suggests that the growth of the business needs to be supported by high fixed investments. In other words, there will be negative free cash flows. This means that management will need to gain

further external finance (e.g. debt or additional equity) to help the firm grow. It also means that management will not be able to finance strong dividends from current cash flows.

- Check the ratios of the various current assets to turnover. For example, stock and debtors. These are uses of working capital and if the ratio is high or increasing it suggests that the strategy being adopted is tying up excess amounts of cash.

4.5.2 Using ratios to assess the potential of a business

The previous section shows how ratios can be used to indicate the origins of a firm's comparatively poor financial performance.

They can also be used to estimate the potential financial gains to made from getting things right.

This approach is often adopted as a first assessment by investment analysts, corporate raiders or venture capitalists who are assessing an under-performing company and considering changing its management.

Example 4.1 Turnaround plc

The following financial analysis has been conducted on Turnaround plc and a close rival Sitting Pretty plc.

	Turnaround plc $m	*Sitting Pretty plc $m*
Turnover	1014	2880
Operating profit	62	192
Capital employed	780	1600
Fixed assets	620	1382
Current assets	160	218
Costs of sales	628	1810
Admin and other costs	324	878

The following ratios can be derived

	Turnaround plc	*Sitting Pretty plc*
ROCE	7.9%	12%
Net margin	6.1%	6.7%
Asset turnover	1.3	1.8
Fixed asset turnover	1.6	2.08
Current asset turnover	6.3	13.2
Gross margin	38%	37%
Admin sales ratio	32%	30%

It can be seen that Turnaround plc is doing poorly compared to Sitting Pretty plc. By applying Sitting Pretty's ratios to Turnaround it becomes possible to assess the potential for improving Turnaround plc's results.

Management who prefer to cut costs would take the following approach to increasing ROCE (and therefore EPS)

		Improved financial performance $m
Savings from better administration on existing business	$324 − ($1014 × 0.30)	19.8
Reduction in fixed assets available	$620 − ($1014/2.08)	132.5
Reduction in current assets available	$160 − (1014/13.2)	83.2

Increase in operating profit = \$19.8m
Reduction in capital employed = \$215.7m
Potential ROCE
$\frac{(\$62 + \$19.8)}{(\$780 - 215.7)}$ = 14.5%[1]

A near doubling of ROCE. In shareholder wealth terms this amounts to the destruction of shareholder value to the tune of \$51.4m [\$780m × (0.145 − 0.0791)] per year by Turnaround plc's current management through poor margin management and excessive use of assets.

A more aggressive management team might see the potential to derive a greater turnover from the fixed assets of Turnaround plc as well as improve its profit margins. This would give rise to the following analysis:

		Improved financial performance \$m
Turnover available at improved fixed asset turnover	\$620 × 2.08	1289.6
Gross profit at current gross margin	\$1289.6 × 0.38	490
Admin costs at improved ratio	\$1289.6 × 0.3	386.9
Current assets at improved ratio	1289.6/13.2	97.7

Potential operating profit = \$490 − \$386.9
= \$103.1m

Potential capital employed = \$620 + \$97.7
= \$717.7m

Potential ROCE = \$103.1/\$717.7
= 14.4%[2]

2. Refer footnote 1

In your TOPCIMA assessment you should be prepared to conduct calculations like the ones above to demonstrate a number of things:

- the failures of management of the firm in financial terms;
- the potential impact of recommendations of changes in management or adoption of different competitive or investment and resource strategies;
- the true potential value of a company if it could be run correctly;
- the synergies available by combining firms (say Sitting Pretty and Turnaround from Example 4.1).

However, there are caveats to bear in mind in using ratios in this way:

- The ratios only suggest where things could be improved. They do not give clear guidance on how to change margins and asset usage. You will need to provide this in your exam.
- They assume that it's possible to make one company like the other. Where there are differences of location, production technology, operating conditions or products you will need to point out that this may not be possible.
- It assumes that accounting treatments in both firms are identical. If fixed or current assets are valued in different ways this will affect the reliability of your recommendations.

[1] The potential ROCE of Turnaround plc here is actually higher than the 12% achieved by Sitting Pretty plc. This is because Turnaround enjoys a 38% gross margin compared to 37% for Sitting Pretty. This improves its earnings by (\$1014 30.01) \$10m as year. If we deduct this form its profits the ROCE of Turnaround plc falls to (71.8/564.3) 12.7%. Allowing for rounding this is the same as Sitting Pretty plc's ROCE.

Table 4.5.3 A refresher on reading financial data

Aspect	Indicator	Calculation	Interpretation
Profitability	• Net profit of division or firm	Available from profit and loss	If profits are negative or falling through time the firm has difficulties: • will be disappointing investors leading to problem with share price or loan renewal • will not be able to invest in new or replacement assets • may be target of takeover if a listed company
	• Contribution	Sales revenue – variable costs	Used to check: • whether having particular product lines (or customers) is beneficial to the firm • assess scope for further price falls
	• Contribution margin or Contribution to sales ratio	Contribution/sales turnover × 100%	Commonly used by multi-product firms to rank alternative products and identify poorly performing ones.
	Contribution per unit of limiting factor	Annual contribution/units of limiting factor	Used where firm has a scare resource to maximise total profits by focusing on providing products with high contributions per limiting factor, for example, • retail stores consider product contribution per square metre of store space • factory considers contribution per hour of machine time
	• Gross margin or Gross profit percentage	(Sales − cost of sales)/sales revenue × 100%	Falling gross margin can indicate: • industry or market is maturing and competitive pressure increasing (compare with gross margin of rivals) • firm is not controlling its cost of sales (e.g. supplier power high or bad internal control)
	• Net margin or Profit to turnover ratio	Net profit/sales revenue × 100%	Summary of the overall profits made from activities of division or firm. Falling or low net margin can indicate: • highly competitive market (if gross margin also low) • poor control of costs and expenses by management (check ratio of particular expenses to sales to discover which costs are out of control) • need for firm to consider entering new business areas to sustain profits and perhaps ultimately dispose of under-performing business
	• Return on capital employed or Return on net assets or Return on investment	No single accepted way of calculation • Profit before interest and tax/year end capital employed	Summary measure that indicates the rate of return the business or division is making on the capital it has. Used to: • Consider whether the firm is maximising shareholder wealth. If ROCE of firm is less that a rival then it isn't because investors would be better-off if they had put their capital in the rival. This tends to lead to share price falls

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
		• Profit before interest and tax/average capital employed during year	• Assess whether investing extra capital is worthwhile. If firm's cost of capital is higher than its ROCE then borrowing further capital will destroy shareholder wealth • Compare divisions (and quality of divisional management) within the firm or with rivals to assess where improvements could be made • Justify disposing of lines of business with relatively low ROCE to invest liquidation proceeds in divisions with higher ROCE to increase overall ROCE of group
		• Profit before interest and tax/net assets	• Trend of falling ROCE may indicate increasing competition or history of poor investment decisions by management
	• EBITDA	Earnings before interest, tax, depreciation and amortisation	This is an investment analysts' approach. The rationale is that share prices are determined by the present value of free cash flows and so to assess this, a firm's profit figure should be restored to its cash value. EBITDA is one measure given by taking earnings before interest and tax and: • adding back depreciation for the year • adding back amortisation of goodwill during the year This measure is also used as the basis for recalculating ROCE and, after deduction of interest, tax and preference dividends, EPS
	• Residual income	Profit before interest and tax – (net assets × required rate of return)	Alternative divisional performance measure that calculates the actual amount the division has contributed to shareholder value in a year
	• Operating leverage or Operational gearing	Calculation depends on data given: • fixed costs/total costs × 100% • Annual change in pre-tax profit/ annual change in sales × revenue	Ratio denotes how volatile profits will be in relation to changes in activity or turnover Consequences of a high operational gearing ratio are: • sharp profit volatility in response to changes in the level of sales turnover • high financial risk, particularly if combined with high capital gearing, because a fall in activity may endanger ability to pay interest liabilities • high profit growth if firm increases sales • need for sales to reach forecast if firm is to ensure it breaks even
Liquidity & cash	Balance sheet figures	• Cash balance • Overdraft and borrowings	High short term borrowings and current liabilities are a danger signal: • the lenders can call in the loans or force the firm into liquidation if it does not pay up • lenders may refuse to extend credit further which will bring growth of business to an end

	• Current liabilities	• the firm's profits may be depressed due to paying large amounts of interest If these borrowings are increasing disproportionately to the growth in the firm's sales turnover it indicates overtrading: • firm may have budgeted for too little permanent capital to support its growth plans. This suggests bad financial management • the firm has problems in debtor control and working capital management; • the firm does not have a coherent financial strategy and is borrowing ad hoc. At some point it will run out of lenders • high 'burn rate'. The business overall, or the work of a division, is cash using. This means that despite being profitable the firm will not be able to reward lenders and shareholders in the short-run and will need continual cash injections (a Problem Child according to BCG matrix)
• Free cash flow	The profit figure is adjusted using some adjustments familiar to you from constructing cash flow statements: • add back depreciation • add back amortisation • deduct any increase in stocks during the year • deduct any increase in debtors during the year • add any increase in creditors during the year • deduct any increase in fixed assets during the year	• A strategic financial consideration is whether the growth of the business yields cash or whether it will demand cash to support it. • To assess this the profit figure is adjusted to take it back to a cash profit basis • If the firm has a negative free cash flow then it will have liquidity problems if it cannot raise additional finance • A negative flow may reflect poor working capital management or spendthrift investment decisions
• Quick assets ratio or Quick ratio or Acid test ratio	Current assets – stock at end of period/current liabilities at end of period	• Normally ratio should be at least 1 if firm is to be able to pay creditors in the short run even if they cannot sell stock • Retail stores often have quick ratios less that 1. This reflects their confidence that stock will sell in a shorter time period than their creditor days (check relative stock turn and creditor days to verify)

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
	• Current ratio	Current assets and end of period/ current liabilities at end of period	• Overall measure of firm's liquidity and should always be in excess of 1 • Ratio below 1 means that firm cannot pay creditors without selling fixed assets. This will be hard to do within the time available (danger of creditors applying to have firm wound-up) and would mean that firm is contracting • Ratio less than 1 in a growing firm suggests that trade credit is financing fixed assets. Some growing retailers buy on 90 days credit and sell for cash within 3 days, using the 87 days of credit to build new stores and expand sales. They rely on continually expanding revenue to repay suppliers. The capital is free but strategy will cause cash flow crisis if sales growth rate falters
	• Creditor days	Calculation depends on information given in case: • Average trade creditors/average daily purchases on credit terms • Trade creditors/purchases × 365 • Trade creditors/cost of sales × 365	Indicates the number of calendar days taken to pay creditors. A long (e.g. >30) or increasing number of days could suggest: • good working capital management because trade credit is finance for free • using supplier credit as a sales aid in a competitive market (e.g. firm sells product on to customer with similar generous credit terms) • cash flow problem. Management are deliberately delaying payments to suppliers because they are not receiving sufficient sales revenue • vulnerability of firm's finances to withdrawal of supplier goodwill • exploitation of suppliers and potential harm to their long-term survival
	• Debtor days	Calculation depends on information given in case: • Average trade debtors/average daily turnover on credit terms • Trade debtors/credit sales × 365 • Trade debtors/sales revenue × 365	Indicates the average time taken for credit customers to pay. Generally the firm should aim to have debtor days below or equal to creditor days to avoid working capital problems A long (e.g. >30 days) or increasing number of days could indicate: • poor working capital management. The firm may be extending its overdraft to support debtors and so eliminating its profits by higher interest charges • poor credit control. The firm is not controlling customer debts or has a lot of bad debts it has not written off. This may also mean its balance sheet is misleading • credit is being used as a sales aid in a competitive market

	Stock turnover	Stock value/average daily cost of sales	Can be used to indicate several things: • how long the firm can continue business without further deliveries of stock (e.g. in the case of a disruption in the supply chain) • how well in manages its working capital (i.e. low stock turn suggests too much money tied up in stock) • its vulnerability to obsolescence of stock due to changes in technology or fashion
	Interest cover	Profit *before* interest and tax/gross interest payable	• Assesses how many times over the firm's profits could pay its interest liabilities. • A low number (say < 3) indicates that a fall in business activity would promote a high risk of default and subsequent liquidation by creditors • Measure suffers from being based on profit and not cash. A profitable firm may still not have the cash it needs to pay its interest obligations
Efficiency and asset utilisation	• Fixed asset turnover ratio	Annual turnover/average net book value of fixed assets	Measures how well the firm is using its assets. Used to compare branches or similar companies • A higher number indicates the machines and premises and generating a lot of saleable output • Apply ratio of well-performing branch to the assets of a poor performing branch to assess potential for increased sales if managed properly • Low ratios indicate opportunity to dispose of fixed assets and gain cash providing remaining assets can be worked harder (e.g. branch rationalisation or reduction in number of lorries)
	• Sales per employee • Profit per employee • Customers served per employee	• Annual sales revenue/average number of employees • Annual gross profit/number of employees • Number of customers served/ numberof employees	Measures how well the firm uses its human resources • Usually a comparative measure between divisions/rivals or through time • Generally higher values are signs of efficient use of human resources and lower values indicate over-manning • Where personal service is important then low customer/staff ratios are better
	• Activity per limiting factor	Examples • Sales per m^2 of sales space • Output per machine hour • Annual bookings per hotel room	Shows how intensively used the resource is Low ratios indicate: • lost profit opportunities • poor capacity utilisation planning • disappointed customers

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
	• Capacity fill	Actual utilisation/maximum available capacity e.g. for a hotel number of room nights sold per year/number of rooms in hotel × 365	May be used to compare branches or to compare with competitors Low capacity fill suggests: • inefficient management of resource • excess capacity with possibility of redeployment or liquidation of capacity • unabsorbed overhead and consequent low profit • potential for growth in sales volume without need for increased investment in capacity or operating costs
Capital availability and risk	• Asset cover	Net tangible assets before deducting overdraft and other borrowings/total borrowings including overdraft	A high level of cover indicates low risk for investors and potential for further borrowing. Can be used in three ways: • to indicate the security of lenders money by showing that there are enough assets to liquidate to pay it back • to indicate the scope for further borrowing by the firm • to show equity holders the value of un-pledged assets available for distribution in the event of company liquidation However interpretation needs care: • ignores the value intangible assets which may also be valuable • book value of assets is not the same as market value in liquidation • ignores other liabilities of the firm that may rank higher in liquidation such as deferred tax and wages
	• Capital gearing or Capital leverage	Several methods of calculation • Total long-term debt/shareholders funds + long-term debt • Total debt financing/total shareholders funds • Total debt + overdraft/total debt + overdraft + shareholders funds	Shows the proportion of finance that comes from debt (or the ratio of debt to equity) A high capital gearing ratio has the following implications: • high financial risk to equity holders of dividend volatility and liquidation of firm if it cannot pay interest • limited potential for future borrowing (but compare with asset cover) • questions raised about why shareholders will not provide more finance to the business High capital gearing is less of a risk if: • the firm works in a market where earnings are not volatile • there are adequate tangible assets to give lenders security • the debt is owed to a related company such as a holding company

		from data in case	• the debt is short term due to seasonal factors or investment in particular projects • the debt holder is accustomed to high risk (e.g. venture capitalists)
Investor perspective	• Share price		Rise in the share price through time has following implications: • earnings of the investors are expected to rise. Usually this will be due to anticipated profit growth by the firm • shareholders support management • firm will find it relatively easy and cheap to raise extra capital • sudden rises in share price without similar improvements in profit suggest market anticipates a takeover bid for firm or a needed change of strategic direction or management
	• Earnings per share	Profit attributable to ordinary shareholders/number of shares *issued* The profit attributable to ordinary shareholders is usually the profit for the period (after tax and finance charges, but before dividends)	• Summary measure of how well the firm earns money for its equity holders • Usually compared from year to year for the firm • Meaningless to compare EPS of rival firms • Growing EPS will generally cause share price to rise • declining EPS suggests firm is in difficulties in its market and will pull down the share price or force firm to pay higher dividend to bolster share price
	• Price Earnings ratio	Market price per share/ earnings per share	A measure of investor confidence in management's strategy for the firm A high P/E ratio generally indicates: • earnings are expected to grow in the future • firm will be expensive to acquire in a takeover • investors are happy. However a sudden rise in P/E could mean: • rise in share price due to bid rumour • improved dividend payout expected from nervous management • a collapse in earnings that investors hope will be a one-off event A P/E ratio is usually industry specific – you should research what the P/E ratios are for other real life companies operating in the industry in which the case you are working on is set.
	• Dividend yield	• Dividend per share/market price per share × 100%	Essentially the income yield on the share. High dividend yield suggests: • investors are income seeking and the firm is a cash stock • share price is held up by high dividend policy that will be difficult to reverse • profit growth is not expected

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
		• Total dividend to ordinary share- holders/market capitalisation × 100%	• potentially low level of retained earnings (check dividend cover)
	• Dividend cover (Dividend payout ratio is reciprocal of dividend cover)	• Earnings per share/ dividend per share • Earnings attributable to ordinary shareholders/ total dividend	The ability of the firm to continue paying its present level of dividend. A low dividend cover (high payout) ratio indicates: • high financial risk for investors because a fall in profit will threaten dividend and potentially therefore share price • high reinvestment of profits into the company, which may support growth.

- The figures may be massaged by the present management, or subject to questionable accounting treatments which can distort your analysis;
- It ignores the costs of changing the business. For example, a strategy or rationalisation of costs and assets will carry one-off costs of redundancies, disposals, etc. Also there may be asset write-offs to consider.

4.6 Assessing the business portfolio

Portfolio means 'collection'. A portfolio analysis can be useful in the following situations:

- Where the TOPCIMA Pre-seen involves a firm with several business divisions. These could be different industries or perhaps in different parts of the world. This was the situation confronting candidates in both the May 2002 and May 2003 exams under the old syllabus *Final Level – Management Accounting Case Study* Exam:
- Where the management of the firm are contemplating adding a new, and different, line of business to their current business. This was important in the November 2002 exam on Constro and also in the November 2003 exam on Homejay.
- Where the firm has a number of different products that it relies on for its earnings or is considering adding a product to this mix. This engaged candidates in the November 2001 and May 2004 exams.

4.6.1 The key issues in portfolio analysis

Business portfolio analysis was originally developed in the 1970s to mirror the portfolio analysis developed for financial strategy and investment analysis. According to the latter financial markets invest in shares as a bundle of investments with different returns, prospects and risks but seek to evaluate them in terms of their contribution to the returns, risks and prospects of the investment portfolio as a whole.

Early proponents of business portfolio analysis saw a parallel between the situation of the Wall Street fund manager and the board of a large firms looking down at their businesses. The board seeks to manage shareholder wealth by managing business investments to improve the financial returns of the overall corporation. Therefore, they concluded, it's important to look beyond the current performance of each business unit in isolation, as ratios do, and in addition consider how the business portfolio fits together and what its prospects are.

Portfolio analysis has since been adopted by many business functions including marketing and information systems. Each will have its own special areas of interest. However, as a management accountant sitting a final Test Of Professional Competence In Management Accounting you should focus yourself on the following issues:

- how well does the portfolio of businesses and products contribute to the current financial performance of the business?
- what is the rationale for management to have invested shareholders' funds in these businesses and how do they support each other?
- what are the prospects for each business or product and its implications for future financing needs or financial returns?
- what are the risks attached to each business and to the portfolio as a whole?
- is there a case for disposing of any of the businesses in the portfolio?

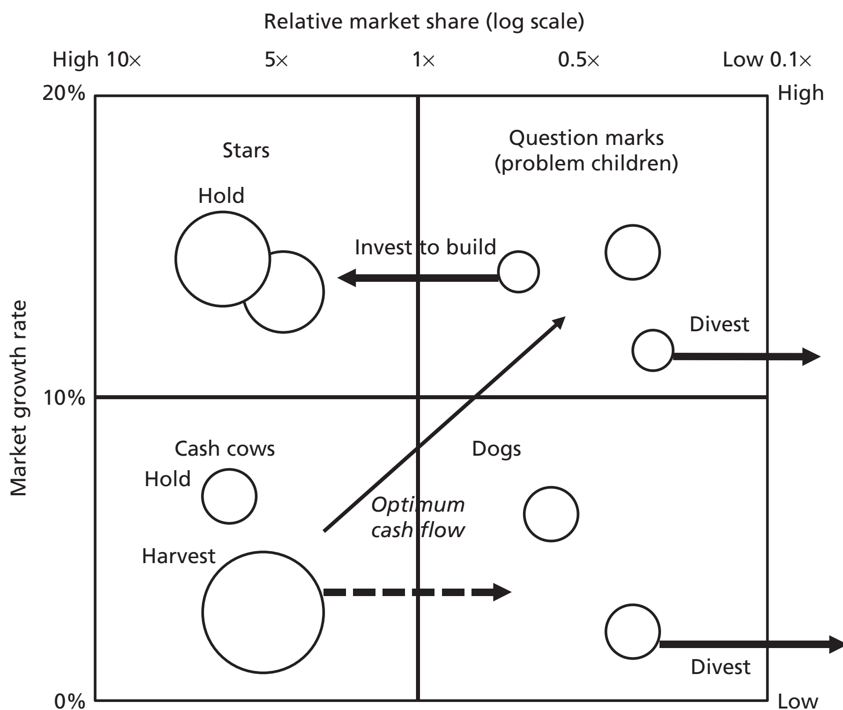


Figure 4.4 The BCG matrix

4.6.2 The Boston growth share matrix

The BCG model requires management to plot the position of their business units (or products) against two axes:

1. *Relative market share*: This is calculated as the firm's market share against their largest rival, so a firm with a 20% share of the market which has a rival with a 60% share would have 0.3 (20/60 = 0.3×) whilst the rival would calculate their relative share as 60/20 = 3×.
2. *Market growth rate*: This is the annual percentage change in sales volume in the industry as a whole.

This allows the business units to be plotted on a two-dimensional space as shown in Figure 4.4.

An additional factor is the inclusion of sales turnover in the model. The proportion of total group sales turnover accounted for each division is converted to the radius of a circle with its centre as the co-ordinates of the division.

High relative share brings several benefits:

- The enjoyment of lower unit costs and therefore higher current margins than competitors at the same price levels.
- the ability to be a price leader. If the firm decides to cut price other must follow to maintain their sales but in so doing may find themselves selling at below unit cost.
- The dominance of the market means the product will become the benchmark product, 'the real thing' against which others may be seen as pale imitations.

Even if you do not have market shares and market growth rates, you can still compare or liken different divisions or different products in the case that you are answering to the BCG matrix categories of Question marks (problem children) or Cash cows, for

example. These are commonly used and recognised business terminology and adds credibility and understanding to your answer if it is correctly applied to the case.

1. Question marks (problem children)

These products are in a high growth market that means that it is early in the product life cycle and therefore has the potential to repay present investment over its life cycle. Indeed the high market growth rate means that the firm will already be investing considerable sums in it.

The low relative market share however means that this business unit is unlikely to survive in the long run because it will have a lower cost competitor.

Management must decide between investing considerably more in the product to *build* its market share or shutting it down now before it absorbs any further investment which it will never repay. Investing to build can include

- price reductions,
- additional promotion and securing of distribution channels,
- acquisition of rivals,
- product modification.

2. Stars

Very competitively strong due to high relative market share although its current results will be poor due to the need to invest considerable funds into keeping up with the market growth rate.

The strategy here is to *hold* market share by investing sufficient to match the commitment of rivals and the requirements of the market place.

3. Cash cows

This is a mature product (low growth rate) which retains a high relative market share. The mature stage means that its prospects are limited to falling prices and volumes. Therefore, investment will be kept under strict review and instead the priority is to maximise the value of free cash flows through a policy of *harvesting* the product.

Harvest means to minimise additional investment in the product to maximise the cash the division is spinning off. This cash can be used to support the Question Mark products as well as satisfy demands for dividends and interest.

Holding may also be used for early-mature stage products where the market may repay the extra investment.

4. Dogs

Dogs come from two directions:

- former cash cows who have lost market share due to management's refusal to invest in it;
- former question marks which still had a low relative share when the market reached maturity.

In either case the BCG recommend divestment of the product or division. This can mean selling it to a rival, or shutting it down to liquidate its assets for investment in more promising business units.

In deciding whether or not to divest a dog the following considerations should be taken into account:

(a) Whether the dog still provides a positive contribution or not?
(b) What is the opportunity cost of the assets it uses? For example, the contribution from products that could be made using its factory or the interest on the net proceeds from liquidation of the SBU.
(c) The impact on the rest of the portfolio that would result from divesting the SBU. Is it essential to attract customers, for example?

In later versions the BCG introduced the notion of a *cash dog* to accommodate another strategy of creating a niche position for a dog product based on its nostalgia value (e.g. Mini cars) or because a group of loyalist customers remain who will continue to pay high prices for the product (e.g. hand-made cigars).

4.6.3 Directional policy matrix

Portfolio analysis seeks to guide management in the deployment of shareholders investment. The likely NPV from any investment undertaken in an industry will be the product of the competitive strength of the firm in that industry and the long-term outlook for the industry.

A limitation of the BCG matrix is its simple reliance on relative market share to denote competitive strength and on industry growth rate to imply future potential. Critics argue there is likely to be a lot more than these two involved in determining the value of an investment.

The directional policy matrix (or 'McKinsey/Shell Matrix' or the 'GE Business Screen' depending on which version you read) seeks to overcome this limitation by having the two broader axes as shown in Figure 4.5.

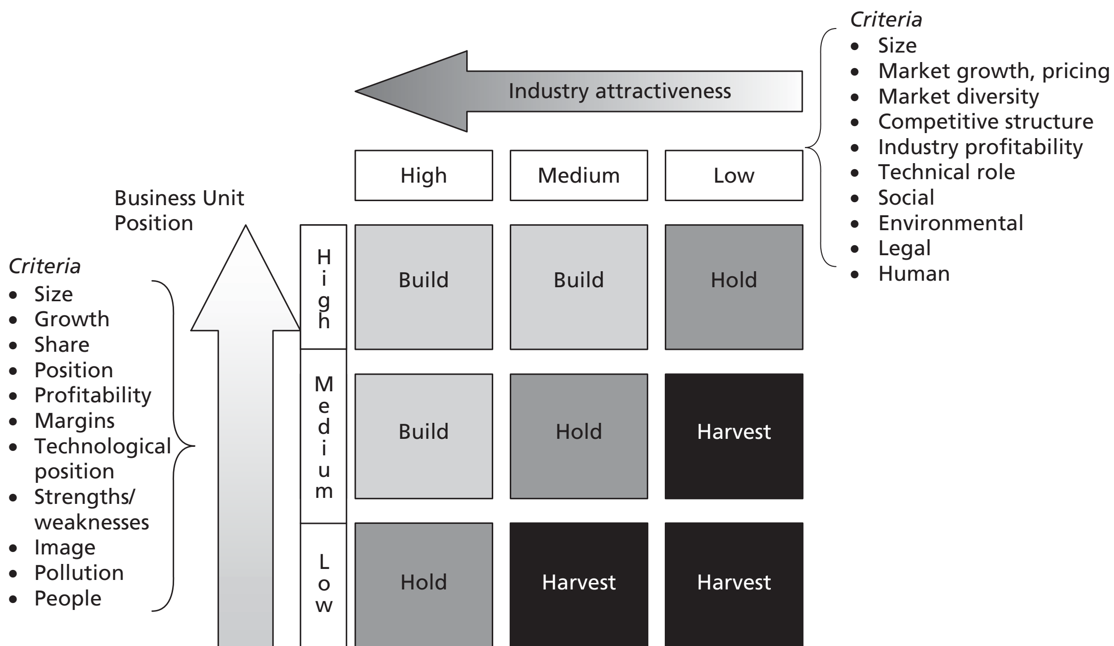


Figure 4.5 Directional Policy Matrix

Management consider each of the criteria for business unit position and for industry attractiveness and assign each business unit a score against it. Having considered all criteria, they calculate a general score for business unit position and for industry attractiveness and locate the division in the portfolio.

4.6.4 Other considerations in portfolios

Business portfolio analysis gained popularity in the 1970s. This was an age when diversification of the business (i.e. deliberately investing in dissimilar businesses and industries with the intention of reducing overall corporate risk) was in vogue as a strategy. Since the 1990's there has been a 'U-Turn' in strategic thinking in favour of honing a firm down to focus on core business and core competences (sometimes termed 'sticking to the knitting').

Diversified portfolios are frequently criticised for being:

- *Unnecessary*, because shareholders can diversify risk in how they construct their portfolio of shares.
- *Unwise*, because it frequently involves management in taking on lines of business they cannot run.
- *Value destroying*, because acquisitions rarely improve in value when purchased as part of a diversification strategy and shareholders mark down the prices of conglomerates due to not being able to evaluate the risks properly.
- *Self-serving*, because diversification is frequently undertaken to boost managerial prestige or provide opportunities for personal development at the expense of shareholders.

The scope of the techniques discussed above is also constrained by their origins as analogues to financial portfolio construction. In a share portfolio there are no business relationships between the assets held. This leads business portfolio analysis to ignore the interrelationships that might exist between business units or products. These could include:

- better utilisation and retention of a common customer base through offering a wider product range (e.g. supermarkets having divisions offering clothes, utilities and petrol in addition to food);
- better harnessing of distinctive competences such as technology (e.g. a plastics manufacturer operating divisions making data media, food packaging, adhesive tapes for parcels and sutures for use in first aid and hospitals);
- spreading of fixed costs across a more diverse range, and therefore greater volume of, products (e.g. a turbine manufacturer using its research and development and production technologies to make aero engines, turbines for power stations, marine engines and guided weapons);
- a division or product may be a small strategic marker to reserve the firm a place in a market with much greater potential (e.g. a firm having a small sales office in a developing economy which can be used later as a bridgehead for more business if the economy develops).

You should be able to demonstrate in your TOPCIMA exam answer that there are always advantages and disadvantages to diversification and you should come to a reasoned conclusion as to why you consider that diversification in the case that you are answering is recommended or not, with well reasoned and justified recommendations.

4.6.5 Using portfolio analysis in TOPCIMA

When assessing the businesses or products in the TOPCIMA pre-seen you should consider the following issues:

- How well are the businesses performing in their own right?
- Is the investment strategy being followed by management appropriate to the position of the division in the portfolio?
- Are there other strategic reasons for keeping any under performing businesses in the portfolio?
- Is the firm excessively dependent on a particular product or business division and what risks is this division subject to?

In your final report you should be prepared to back up recommendations for disposal, acquisition or development of a business unit or product by reference to its position in the portfolio and the strategic logic of your recommendation. You should additionally consider whether the proposed strategies do fit with the company's core competences or not and whether management has sufficient experience to manage the proposal.

Use the BCG in an appendix to identify the different products, divisions or businesses of the firm in the case.

4.7 Industry analysis

(1) Industry analysis seeks to understand the factors most likely to have an impact on the firm's present and future success. This in turn will affect:
   - the present financial results of the firm;
   - the likely success of its current or proposed strategies;
   - its future financial returns and therefore ability to keep shareholders and other providers of finance satisfied;
   - the decisions it must take to avoid threats or to capitalise on opportunities.

(2) In the TOPCIMA exam you are required to apply the following models specifically to the industry of the firm(s) in the pre-seen. Some of the data you need may be in the pre-seen material, and the rest you should research for yourself. You should also familiarise yourself with events in the industry by reading the business pages of the quality press.

4.7.1 Industry life cycle stage

A generalised account of the stages through which an industry passes from birth to death (Figure 4.6). The factors that drive industries through the life cycle are:

- *Technical innovation*: This creates new industries but at the same time can render old industries obsolete (e.g. as DVD grew so VHS declined).
- *Adoption of the product*: For example, in 1995 mobile phones were a growth product with about 15% of persons in developed economies owing a handset. By 2005 it will be a mature industry with about 85% penetration.
- *Fashion and taste for the products of the industry* (e.g. off-road MPV's were a growth product during the mid-1990s but by the end of the decade they had given way to small cars and pickups as the fashionable vehicle to own).

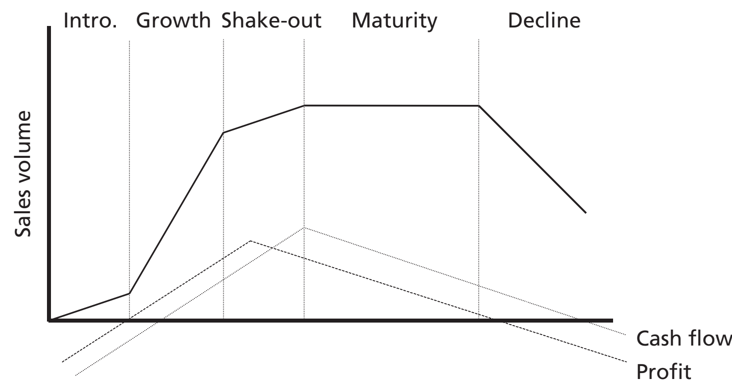


Figure 4.6 The product life cycle

- *Legislation and government policy*: For example, the liberalisation of financial markets in the UK created a boom in personal financial services from the mid-1980s. The market declined following a series of miss-selling scandals and the introduction of a tighter regulatory regime in the late 1990s.

To analyse the industry(s) covered by your TOPCIMA pre-seen material you should identify

- which stage the industry is at;
- how durable the industry is and whether the forces that developed it are likely to decline or supersede it soon;
- the financial and strategic implications to management of the current and future stages of the industry.

The main characteristics of each stage are explained in the following sections.

1. Introduction stage

A new product and hence will be unfamiliar to the market. Firms in this stage of an industry will need to invest considerable resources in developing and launching the product (including promotion, stock-building, staff training, etc.) without any guarantees that the product will succeed. Therefore

- strongly negative cash flows,
- high risk due to product novelty,
- single or limited product range to avoid confusing the customer,
- few if any competitors willing to take similar risks,
- high need to induce recognition and trial of the product,
- very high costs per customer.

2. Growth stage

Rapidly increasing sales due to acceptance of the product and a ‘bandwagon effect’ developing as buyers copy each other. The substantial investment needed to keep up with demand depresses cash flows. The most significant feature of this stage is increasing complexity as rivals enter the market and the range of products widens as producers seek to attract customers from each other with novel features

- negative cash flows,
- reducing risk due to product having achieved acceptance,
- market entry by ‘copycat’ or ‘me-too’ producers,

- growth sustained by attracting additional types of customers, sometimes through reductions in price or new product features,
- marketing focus switches to seeking to differentiate the firm's product and brand in the minds of customers.

3. Shakeout stage

The sales growth rate turns down (i.e. becomes *ex-growth*) due to the market having become saturated. Initially there will be an imbalance between supply and demand because participants will not have forecast the downturn.

- overcapacity creates stimulus for price-cutting;
- number of producers reduce due to failures or industry concentration;
- peak levels of profitability.

This is usually resolved by a wave of product or business failures or amalgamation of businesses through takeover or merger.

4. Maturity stage

Purchases settle down into a pattern of repeat or replacement purchasing. For fast-moving consumer goods (FMCGs) like canned foods, soft drinks and confectionery these may be habitual purchases. For durables such as televisions, computers, cars and furniture the frequency of re-purchase will be influenced by changing technical features, fashions and wearing-out of old product. The main features will be

- Reduction in investment in additional capacity leads to improved current cash flows.
- Gradual price decline as firms compete against each other for a larger share of a fixed-size market. During this stage buyer and supplier power (Porter) increase because of the large number of industry members to choose between.
- Firms seek to capitalise on product loyalty by launching spin-off products under the same brand name.
- Gradual fragmentation of the market as firms seek out buyer groups to monopolise with special value-added features on products (e.g. premium quality foods in addition to regular and budget lines).
- Peak profitability and least risk.

The later phases of the mature stage are often characterised by a second wave of consolidations as some firms pursue industry rationalisation to restore profitability. This has been noticeable in recent years in industries such as oil and banking.

5. Decline stage

The industry declines into obsolescence as technically better substitutes replace it. The existence of such substitutes will cause sharp profit reductions amongst producers of the product. Many firms will have already found alternative industries whilst those remaining will be looking for an orderly way to exit the industry:

- falling profitability and marginal cash flows;
- firms seek to leave industry.

There may be a last-ditch wave of consolidations amongst the few remaining firms in the dwindling industry.

When you are researching the pre-seen material for the case that you will be sitting, you should understand the industry life cycle for that industry. For example, the

May 2005 TOPCIMA exam on the recycling industry, it would be relevant to comment that this industry is relatively new and is still in its growth stage.

4.7.2 Five forces analysis

This analysis was developed by Professor Michael Porter (Figure 4.7). Argues that competition in an industry is determined by its basic underlying economic structure, the five competitive forces.

The collective strength of these forces determines the profit potential, defined as *long-run return on invested capital*, of the industry.

Porter identifies three successful types of strategy (or *generic strategies*) to deal with these forces:

1. *Cost leadership*: Management aim the cut the costs of providing services and products to below that of rivals.
2. *Differentiation*: Management aims to escape the pressure of price competition by developing product features or reputation of premium perceived value.
3. *Focus*: Improve long-run ROI by avoiding the margin pressure and high investment needed to serve a mass market. Instead seek to dominate a niche market.

To analyse the industry(s) covered by your TOPCIMA pre-seen material you should identify:

- whether the industry is presently subject to forces of significant strength;
- whether any of the forces are likely to grow or decline in strength in the coming years;
- the consequences of the above for long-run profitability and therefore the value of the firms in the industry;
- whether management is or can adopt competitive strategies to avoid the power of these forces and so restore its profitability.

You should be prepared to use Porter's terminology in your final report on exam day. A clear understanding of Porter's five forces and its application to the material will be rewarded providing its relevant.

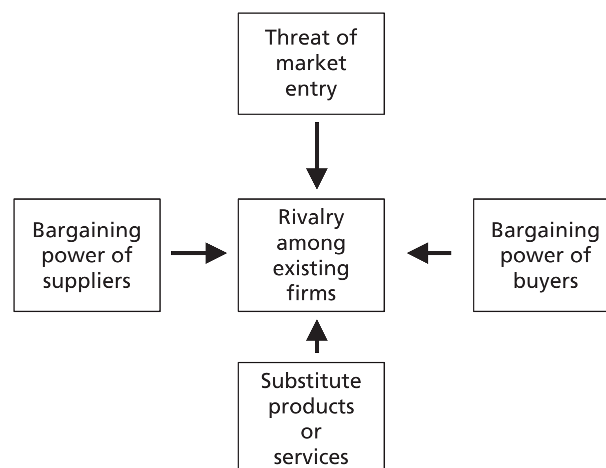


Figure 4.7 Porter's five forces model (adapted from Porter 1980)

Threat of entry

Influenced by

1. *Economies of scale* available to incumbent firms giving them the ability to charge prices below the unit costs of new entrants and hence render them unprofitable.
2. *Product differentiation*: Strong brands, unique product features or established good relations with customers that it will be hard for an entrant to overcome
3. *Initial capital requirements* that exclude poorer entrants or ones not prepared to take the risk.
4. *Switching costs*: One-off costs for a customer that deter them from switching to the new rival.
5. *Access to distribution channels* where established firms have locked in distributors and retailers by deals or vertical integration
6. *Government policy* forbidding imports or preventing rival firms from setting up in competition.

Rivalry amongst existing competitors

Cut-throat competition reduces profits for all in the industry. Porter suggests that the factors determining competition are:

1. *Numerous rivals of various sizes* encourage individual firms to reduce price to grab share.
2. *Low industry growth rate*, where growth is slow the participants will be forced to compete against each other to increase their sales volumes.
3. *High fixed or storage costs*: sometimes called operating gearing it puts pressure on firms to increase volumes to take up capacity.
4. *Low differentiation or switching costs* mean that price competition will gain customers and so be commonplace.
5. *High strategic stakes* where a lot depends on being successful in the market so firms fight for a share and to survive.
6. *High exit barriers*: Economic or strategic factors making exit from unprofitable industries expensive such as costs of redundancies or scrapping of dedicated assets.

Pressure from substitute products

Products from a different industry that satisfy the same need. The power of substitutes depends on:

1. *Relative price/performance*: If performance is similar but price is lower it is more of a threat.
2. *The extent of switching costs* (see above).

Bargaining power of buyers

Buyers use their power to trade around the industry participants to gain lower prices and/or improvements to product or service quality. Their power will be greater if:

1. *Buyer power is concentrated in a few hands*: This denies the industry any alternative markets to sell to if the prices offered by buyers are low.
2. *Products are undifferentiated*: This enables the buyer to focus on price as the important buying criterion.
3. *The buyer earns low profits*: In this situation they will try to extract low prices for their inputs. This effect is enhanced if the industry's supplies constitute a large proportion of the buyer's costs.

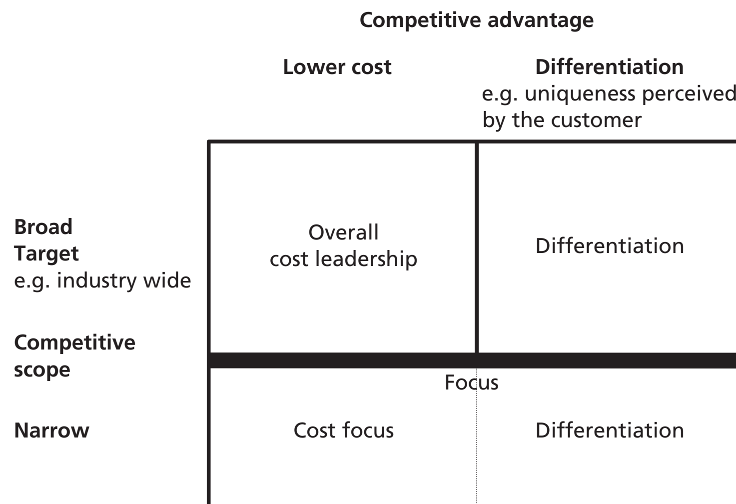


Figure 4.8 *Porter's three generic strategies model (adapted from Porter 1980 and Porter 1985)*

4. *Buyers are aware of alternative producer prices*: This enables them to trade round the market. Improvements in information technology have significantly increased this by enabling a reduction in 'search costs'.
5. *Low switching costs*: In this case the switching costs might include the need to change the final product specification to accept a different input, or the adoption of a new ordering and payments system.

Bargaining power of suppliers

The main power of suppliers is to raise their prices to the industry and hence take over some of its profits for themselves. Power will be increased by

1. *supply industry dominated by a few firms;*
2. *the suppliers have proprietary product differences*: unique features making it impossible for the industry to buy elsewhere.

4.7.3 Competitive position of the firm: three generic strategies

For a private sector organisation the object of competitive strategy is to maximise shareholder wealth. This requires that the firm makes a better long-term return on shareholders invested capital than the return achieved by rivals in the industry. Porter's three generic strategy model is a useful starting point for understanding a firm's competitive strategy (Figure 4.8).

Porter's strategic prescriptions are rooted in his analysis of the impact of five competitive forces on a firm's profits. He argues that a firm must adopt a strategy that combats these forces better than the strategy developed by its rival if it is to deliver superior shareholder value. According to Porter (1980) 'there are three potentially successful generic strategic approaches to outperforming other firms in an industry'. He terms these:

1. *Overall cost leadership*: Low cost relative to competitors.
2. *Differentiation*: Creating something that is perceived industry-wide as unique.
3. *Focus*: Serving a narrow strategic target more effectively than rivals who are competing more broadly.

Management must dedicate themselves to *just one* of the three types of strategy to risk dilution of their competitive advantages. This is the only way that firms can out perform rivals and deliver high or satisfactory returns to shareholders.

1. *Lower cost*: Achieve the industry's 'lowest delivered cost to customer' by analysis of the entire *value chain* to achieve substantial cost savings.
2. *Differentiation*: Premium perceived value in the eyes of the buyer.
3. *Focus*: Sometimes called a *niche* strategy this relies on the firm being able to address itself better to a segment of an industry than its broader scope rivals can. This enables smaller firms to survive by exploiting one of two failings by rivals:
   - *Underperformance*: They do not understand or make a product that fully meets the needs of the buyer in a segment.
   - *Overperformance*: The broad scope competitor is giving the segment more than it really requires and in the process is incurring extra costs.

Stuck in the middle: This competitive position is not recommended by Porter. Management's failure to make the firm either a differentiator or a cost leader leaves the firm 'stuck in the middle' both unable to access the high-volume customers who demand low costs and also the high margin customers who may be put of by its mass market offerings.

In TOPCIMA you can use Porter's model in several ways:

1. to help analyse the competitive position of rivals;
2. to analyse the current competitive position and strategy of the firm;
3. to decide on a competitive strategy for the firm;
4. to analyse the risks of the present strategy.

Porter suggest that each generic strategy carries intrinsic risks

(a) Differentiation:
- brand loyalty may fail if the cost differential between it and the cost leader becomes too great;
- buyer becomes more sophisticated and needs the differentiating factor less (such as ease of use or technical expertise);
- imitation reduces the differentiation of the brand.

(b) Cost leadership:
- technological change could eliminate low cost base or past learning effects;
- imitation of low cost techniques by industry entrants;
- product becomes out-of-date because firm won't invest in it;
- domestic inflation or exchange rate changes destroy cost advantage at home and abroad.

(c) Focus
- broad target firm develops economies of scale which overtake the cost focus player;
- differences between needs or tastes in the market narrow, for example, the invention of the word-processor destroyed the niche strategies of typewriter manufacturers;
- competitors find sub-segments within the focus segment and out-compete the firm;
- segment collapses and leaves the firm with no other source of earnings.

In the May 2003 Sparkle case on sports clubs, discussion on Porters model and differentiation would have earned good marks for understanding this theory and applying it to the case.

4.7.4 PEST Analysis

This model segments the environment of the industry into:

Political/Legal	Laws affecting the industry and political support for it
Economic	Economic outlook, costs of borrowing, exchange rates
Social	Social norms, fashions and make-up of the population
Technological	Impact of technology on costs and demand patterns

An alternative categorisation is DEEPLIST standing for:

Demographic	Composition, location and size of population
Ecological	Concern over preservation of natural environment
Economic	As above
Political	As above
Legal	As above
Informational	Impact of networks on work, leisure and trade
Social	As above
Technological	As above

This latter typology has the advantage of drawing particular attention to the some significant sources of turbulence in the modern business environment such as aging population and that coming from concern over the natural environment plus the impact of the third industrial revolution: that based on information technology.

It is not possible to cover all possible applications of PEST (or DEEPLIST) to industry in a Toolkit like this. You will need to look at the pre-seen and research these factors for yourself.

4.7.5 Globalisation

Globalisation refers to the ability of firms from any country to exploit markets or productive resources in other countries.

In the TOPCIMA exam this means that the industry you are faced with may be an industry in which there are increasing competitive challenges coming from abroad. Or perhaps major opportunities available to the firm in foreign markets, or the ability to transfer aspects of production abroad to gain skills or save costs.

The main drivers for globalisation are:

1. economic and political realignments (e.g. EU, NAFTA, MERCOSUR, ASEAN, APEC, etc.) creating zones of free trade between their memberships;
2. the impact of the World Trade Organisation in its policing and development of the General Agreement of Tariffs and Trade to reduce trade barriers through stamping out protectionism;
3. improved communications (telecommunications, travel and common languages) enabling easier co-ordination of offshore operations;
4. increased mobility of staff across national boundaries, often as employees of global firms. This transfers tastes globally;
5. convergence of tastes and lifestyles, such as due to the influence of common cultural drivers such as technologies, media, music and sports.

You should be prepared to assess the following factors:

1. the power of the drivers making the industry in the pre-seen into a global one;
2. the potential for firms from abroad to invade the market in the pre-seen;

3. the potential for the firm(s) in the pre-seen to penetrate foreign markets;
4. the potential for the firm(s) to move parts of its operation offshore to save costs and boost margins;
5. the danger that the firm(s) in the pre-seen may find themselves having to cope with competition from new rivals with very different technologies, working methods or levels of costs.

4.8 Conducting a position audit

CIMA defines a position audit as

Part of the planning process which examines the current state of the entity in respect of:

- resources of tangible and intangible assets and finance,
- products brands and markets,
- operating systems such as production and distribution,
- internal organisation,
- current results,
- returns to stockholders.

CIMA: Management Accounting Official Terminology

The position audit will be the basis of the marks allocated under the prioritisation criteria and will be worth around 10 marks. Your report should commence with a corporate appraisal of the company that includes the main points from the position audit. It is very important that you prepare a position audit that includes the unseen material given on the exam day.

4.8.1 The Ms model

A simple model that divides the items in a position audit into factors beginning with 'M

Manpower	The human assets of the firm such as their availability, skills, morale, relative costs and flexibility (e.g. ratio of full-time to flexible staff)
Management	The quality, expertise and experience of the top team. Is the firm well managed and does it have the skills and vision it will need to progress? (Section 4.9 explains how to conduct a management audit for TOPCIMA)
Money	The financial health of the business and the support management receive from its shareholders and bank. Key factors here are likely to be current results and the availability of capital to finance investment (Section 4.5 described how to conduct a financial appraisal for TOPCIMA)
Make-up	The organisational structure and culture of the firm. For example, is the firm centralised or not and how willing are business, unit managers and other staff to take responsibility? (Section 4.9 explains how to conduct an organisational audit for TOPCIMA)
Machinery	This covers the physical assets of the business. For example, their flexibility and the relative costs and quality of what they produce. In the case of property assets it would include location, appearance and functionality.

Methods	The processes adopted by the business. Issues here could include the extent to which activities are outsourced and whether the firm uses capital or labour intensive production processes. Just-in-Time systems are an important business method in many markets.
Markets	The firm's products and the markets it currently serves. The position audit should examine the relative quality and position of the firm's outputs and the extent to which it is exposed to threats from buyer power.
Materials	This covers the relationship the firm has with its suppliers. In modern manufacturing there has been a trend towards 'partnering relationships' with suppliers where the firm agrees not to shop-around for lower prices providing its suppliers work with it to improve quality and to reduce inventory costs. Some managers would regard reliance on a single supplier as a weakness and instead hope to see that the firm sources from a wide number of suppliers in order to enjoy better prices.
Management information	This evaluates the quality and timeliness of the information available to managers (and others) and its suitability for basing their business decisions on. Factors to consider here would be whether it is suitably structured to allow managers to see the effects of their actions, its intelligibility to the user and whether it contains any environmental and competitor information. As a CIMA candidate you should expect to be asked to pass judgement on the quality of the management accounting information available (e.g. cost and profit analysis). This is covered in more detail in Section 4.11.2.

4.9 Organisational and managerial audit

The need for you to assess the organisation and its management team may arise in TOPCIMA for several reasons:

- for a firm with a poor financial and competitive position it will help you decide how much of this is down to poor organisational structure or management and, if so, where to make changes;
- to assess the vulnerability of the business to the loss of particular individuals;
- to assess the suitability of the organisational structure and management team to taking the business into the next stage of its development;
- to recommend changes to the organisational structure and management team as part of a more general strategy.

4.9.1 Elements of organisations

There are numerous theories on what makes up an organisation and distinguishes one from another. Use the headings of the theories as check lists for things to consider in coming to an understanding of organisations.

Five systems of control, if configured properly, will help the organisation achieve its goals:

- *Task*: The ways job roles are defined and constructed. Distinctions here include between having 'programmed tasks' and 'un-programmed tasks'. The former are closely controlled by rules or the technology (e.g. factory production or a call centre) whilst the latter requires that the operative exercise more discretion (e.g. a professional consultancy or provision of an education service). The former is closely controlled and can permit low cost operation but may result in a lack of *flexibility* in an organisation such as in catering for non-standard requirements or when reducing headcount during bad times because staff cannot cover for absent colleagues.

- *People*: The quality and numbers of persons employed and how they interact. Under this heading will come considerations of skills, culture and the balance between full-time and flexible staff. People factors drive costs and quality, the ability to cope with growth or change and the costs (through redundancy or training) of changing the firm's direction.
- *Structure*: How the firm fits together. The basis building blocks are provided by divisionalisation: how teams are grouped (e.g. by function, region, customer, etc). Once grouped the next question is 'who-whom?': how do they report to management and what sorts of span of control and scalar chains result. This leads on to considerations of where power lies and whether it is centralised (e.g. at head office so that decisions are reserved for senior management) or whether it is decentralised (in which case business units are powerful and staff are empowered). Finally the systems of control should be considered. To what extent does this organisation adopt bureaucratic techniques of rules, standard operating procedures and formal meetings to decide things? Does it instead permit discretion to work teams in deciding how to do their work?
- *Reward systems*: How are individuals and teams rewarded and for what? Consider also whether the reward system is stick or carrot: primarily one of recognising high achievement or one that threatens low achievers. This is part of the *culture of control*. The dimensions to look for here are: whether rewards are for individual or group performance; whether they are primarily financial or whether instead they promise security, fulfilment and progression; whether they are given for short- or long-run performance; and whether they are within the control of the person receiving them. Managers and operative staff can be expected to do what they get rewarded for doing and avoiding what they get punished for. So to achieve a certain type of business performance (say cost consciousness, growth, quality, customer service or innovation) the reward system must encourage it.
- *Information and decision processes*: A reflection of power and empowerment. Who knows what, who takes which decisions and what processes are used? For example, the information and decision processes of a small entrepreneurial organisation will be the head of the entrepreneur with little consultation or formality of process. Very flexible and low cost but also runs the risk of wrong decisions and poor communication of decisions. A larger firm may use committees, formal planning and budgeting to enable detailed implementation and control. As a consequence it may sacrifice dynamism. The way a firm uses IT/IS will also have impacts on this aspect of organisation.

4.9.2 Chandler: structure follows strategy

According to Chandler organisations progress through four broad organisational forms as their strategies develop:

In TOPCIMA you should apply these models to the firm(s) in the pre-seen material and be prepared to consider and discuss:

- the *appropriateness* of the organisational form of the business to the strategy it is adopting, or to the strategy that you are recommending;
- the risks and drawbacks of the structure it is adopting at present.

Simple (entrepreneurial) structure (Figure 4.9)

Formation stage of the organisation is principally concerned with *resource gathering* such as getting initial capital and assets and building a team.

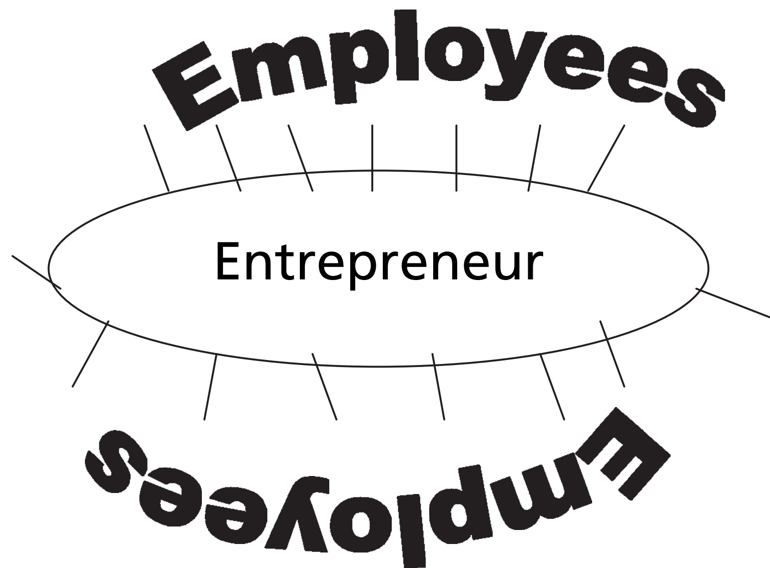


Figure 4.9 Simple/entrepreneurial form organisation

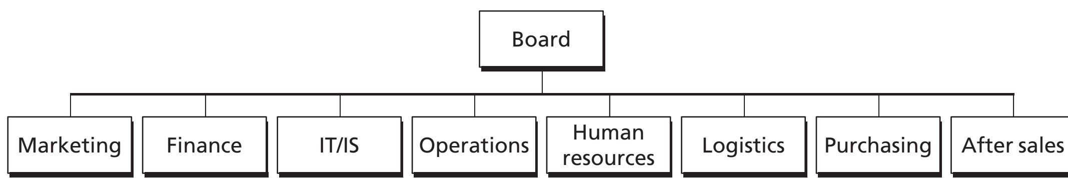


Figure 4.10 Functionally structured organisation

Usually the entrepreneur has a key skill set (e.g. solicitor, plumber, lorry driver, printer, farmer) which forms the core of business in its early days. Many small businesses remain at this stage.

Advantages	*Drawbacks*
Suits personal qualities and personality of entrepreneur	Lack of specialist managers leads to errors or waste
Avoids expensive control systems	Growth limited to personal capacity and vision of entrepreneur
Able to respond quickly to developments	Unattractive to external investors due to high dependence on entrepreneur
Entrepreneur understands the business	Lack of checks and balances from broad leads to costly errors in decisions

Functional structures

Growth and rationalisation stage. Business growth overburdens entrepreneur who gradually factors out parts of their role (say sales, then accounts, next operations) to other more specialist staff. This eventually creates entire business functions such as a finance function or a marketing function.

Each function will develop information and control systems for what it does and will become the subject of budgetary control systems (Figure 4.10).

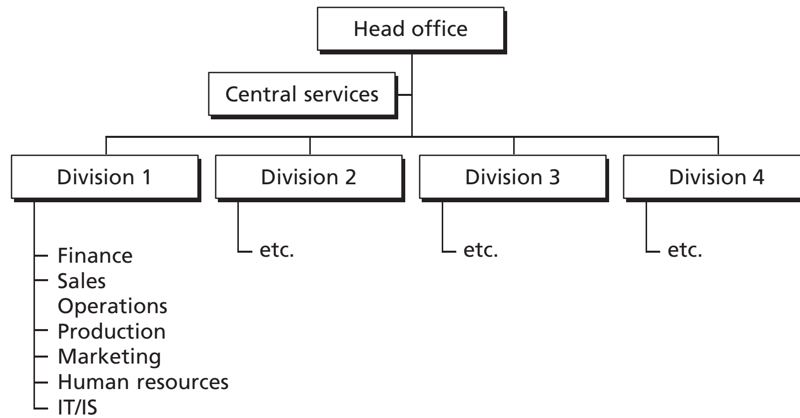


Figure 4.11 Multi-divisionally structured organisation

Advantages	*Drawbacks*
Permits senior management to focus on strategic issues	Senior managers overburdened with operational matters and may not use their management skills fully
Board in touch with and co-ordinates all functions behind strategic decisions	Senior management may neglect strategic issues in favour of running their teams
Simplifies control by providing clear structure of responsibility	Co-ordination between functions difficult due to the build up of 'functional silo mentality'
Specialists at senior and middle management level	Danger of functional interests disrupting corporate decisions
Clear career paths enables organisation to attract and retain good staff	

Multidivisional structure

Development stage in which separate business divisions are set up. This is to cope with greater physical distance from corporate centre (e.g. off-shore) or greater diversity in products, markets or processes to be managed.

This leads to need for additional control systems including:

- strategic planning systems,
- multidivisional control measures (e.g. ROCE, sales growth, etc.) (Figure 4.11)
- management recruitment and development.

Advantages	*Drawbacks*
Enables management to concentrate on its individual business area	Dynamic tension and confusion over responsibility versus autonomy
Easier measurement of unit performance because it has separate sales and costs	Conflict between divisions likely: for example trespassing on each other's business areas
Leaves corporate parent free to look after strategy	Problems over basis of inter-trading between divisions (transfer pricing) and allocation of central costs (overheads)
Provides a pool of general management expertise for the future	Co-ordination problems if too many divisions

Holding company structure

Diversification leads to the development of conglomerate firms and joint venture partnerships (Figure 4.12).

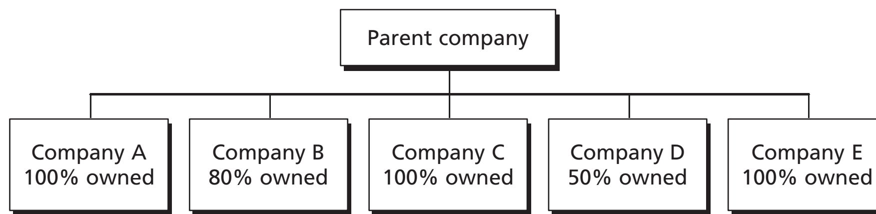


Figure 4.12 Holding company structured organisation

Advantages	*Drawbacks*
Low central overheads due to autonomy of units	Exposes corporate centre because it does not seem to add value. This invites it to meddle to show its value.
Spreads risks of holding company because its involved in several businesses	Risk of divestment of individual businesses reduces morale and trust
Easy to sell off divisions because they are separate businesses	Hard to pool skills and learning throughout the group
Facilitates decentralisation	No attempt to leverage group assets (or synergies) such as common technologies or customers
Avoids high degree of central recharges and transfer prices common to divisional form organisations	Difficulties of maintaining central control over the individual strategies of the divisions

Many of the FLCS and the TOPCIMA cases explain the current organisational structures and any recent changes. As part of your research on the pre-seen material you should understand the current organisational structure and any improvements or changes that could be made to enable the group to operate more effectively. These recommended organisational changes should be included in your answer, if they are still relevant after you have taken into account the new material presented to you in the unseen material on exam day.

4.9.3 Greiner's model of organisational growth

Greiner (1972) adapts an 'evolution of species' view of organisations to suggest that change will occur episodically as an organisation grows and develops as shown in Figure 4.13.

The rate of evolution is determined by the growth rate of the industry in which the firm operates. The points to note for TOPCIMA are:

- Firms will only grow if they are able to overcome the crises at each stage. In the pre-seen consider which stage the organisation is at and whether there are any signs of the end-stage crisis. Does management have what it takes to overcome it?
- The role of the corporate centre changes as the stages pass. At first it is the well-spring of creativity, next a leader, then a controller of devolved divisions, this is followed by its becoming a co-ordinator of powerful units and finally it merely facilitates collaboration. Once again, in pre-seen does the corporate centre have the right competences and approach for what it must do? What are the implications for corporate centre, its control systems and the senior managers mentioned of the changes to the next stage?

4.9.4 Modern organisational forms

Since Chandler's work several additional forms or organisational arrangement have been identified.

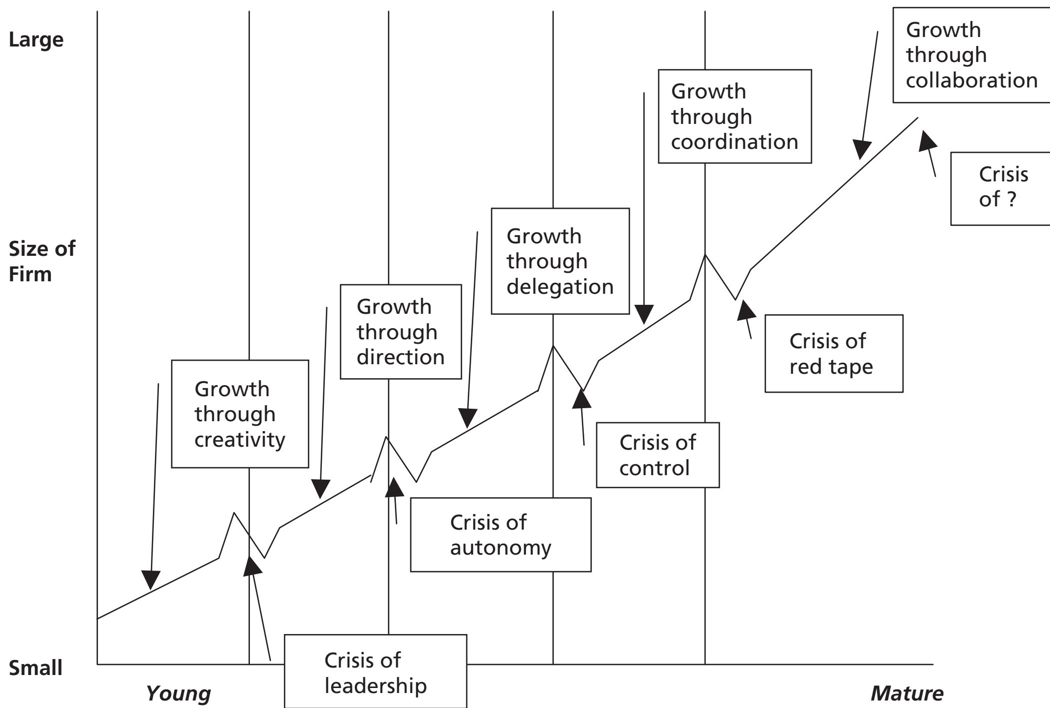


Figure 4.13 The five phases of growth
Source: Greiner 1972

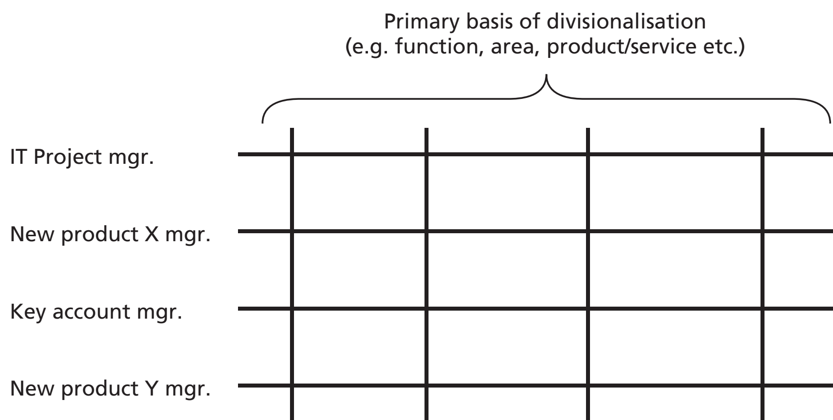


Figure 4.14 Specimen matrix structure

Matrix organisations

These were developed as a response to the rigidity of conventional divisionalisation.

Management leaves the current structure in place and superimposes on it a team of additional managers with special focuses. Typically these will be key account managers, brand or product line managers and special project managers. The result is usually drawn as a net (Figure 4.14).

The task manager has the authority to call upon support from the functional managers to carry out the project task. This includes the right to demand the support of staff from each department, intervene in decisions and affect budgets. The power of the task manager is entirely dependent on the support they receive from top management and their personal ability to build consensus. The term 'matrix structure' is misleading because in practice the

effect seems to be to create the chaos of ambiguous roles and muddied lines of reporting with inevitable conflict.

Advantages	*Drawbacks*
Better co-ordination of functional divisions	High degree of conflict between authority of task manager and autonomy of divisional manager
Task orientation overcomes functional rivalry	Unclear job and task responsibilities
Direct contact at meetings replaces bureaucracy	Unclear cost and profit accountability
Provides clear point of responsibility for the project	Lack of career for task manager who is outside of conventional hierarchy and depends on patronage of senior management

Virtual organisations

Sometimes called *network organisations* this form stems from the liberating potential of modern network information technologies for organisational arrangements (e.g. Davidow and Malone, 1993).

Modern networks link remote sites and this provides management with the opportunity to abandon the 'all under one roof' approach to employment and supervision that grew up with the factory system at the time of the industrial revolution of the late 18th century and intensified with the fashion for vertical integration of operations during the 20th century.

Common features are:

- Fixed functional departments abandoned in favour of multi-disciplinary teams focused on products, customers or aspects of the value chain. For example, a management accountant may cease to work for the finance function and instead become part of the customer support team.
- Team members may not be in physical proximity but rather communicate via firm's intranet. Their actual locations may be in different parts of the same building, in different countries or even working from home (teleworking).
- Some reliance on outside human resources such as special consultants or contract operative workers to make skills and costs more flexible.
- Factoring-out of the value chain via outsourcing to partners linked together by extranet technologies. This permits sharing of core competences and shifts fixed costs and risks to where they can be born more cheaply.

Advantages	*Drawbacks*
Greater organisational flexibility (costs and skills) due to abandonment of fixed roles and functions	Problems of maintaining control over remote staff
Improvement in customer end service due to replacing generalist skills of firm with a partnership based on the core competences of the partners	Erosion of firms core competences and culture as it becomes a network of contactors
Improvement in organisational learning through close collaboration of the networks. This stimulates innovation	Costly forms of control needed (e.g. legal contracts with partners)
	Danger of loss of confidentiality over firms operations
	Loss of security for staff and management may lead to loss of key personnel

4.9.5 Conducting a management audit

In the pre-seen material for past CIMA Case Studies there has often been quite detailed biographies of the management concerned. Candidates have been required to make assessments of them and to make recommendations for changes. TOPCIMA is likely to continue this tradition. Additionally your recommendations should include any proposed changes to the board or management team such as recruitment of non-executive directors or better senior managers (such as marketing, finance, etc.).

Assessing the top team – Belbin types

Belbin tells us that a top performing management team should contain a sufficient mix of managerial types to cover the following roles:

Type	*Features*	*Strengths*	*Weaknesses*
Company Worker	Conservative, dutiful, predictable	Organising ability, common sense, hardworking	Inflexible, dislikes new ideas
Chairman	Calm, self-confident, controlled	Welcomes contributors. Strong sense of objectives	Ordinary in terms of intellect and creativity
Shaper	Highly strung, outgoing, dynamic	Drive and readiness to challenge complacency and inertia	Prone to provocation, irritation and impatience
Plant	Individualistic, serious-minded, unorthodox	Genius, imagination, intellect, knowledge	Up in the clouds, ignores practical details
Resource Investigator	Extrovert, enthusiastic, communicative, curious	Able to contact people and explore new ideas. Responds well to challenge	May lose interest once the initial fascination has passed
Monitor-evaluator	Sober, unemotional, prudent	Judgement, hard-headedness, discretion	Lacks inspiration or ability to motivate others
Team worker	Socially orientated, mild, sensitive	Responds to people, promotes team spirit	Indecisive at moments of crisis
Completer-Finisher	Painstaking, orderly, conscientious, anxious	Follow through, perfectionism	Worries about small-things Won't let-go
Specialist	Single-minded, self-starting and dedicated	Provides knowledge & skills in short supply	Dwells on technicalities to frustration of others. Overlooks 'big picture'

For TOPCIMA consider:

- does the top team have the right mix of people?
- are the people with the important skills in the right positions to be able to influence things?
- what additional skills are needed or need to have more influence?

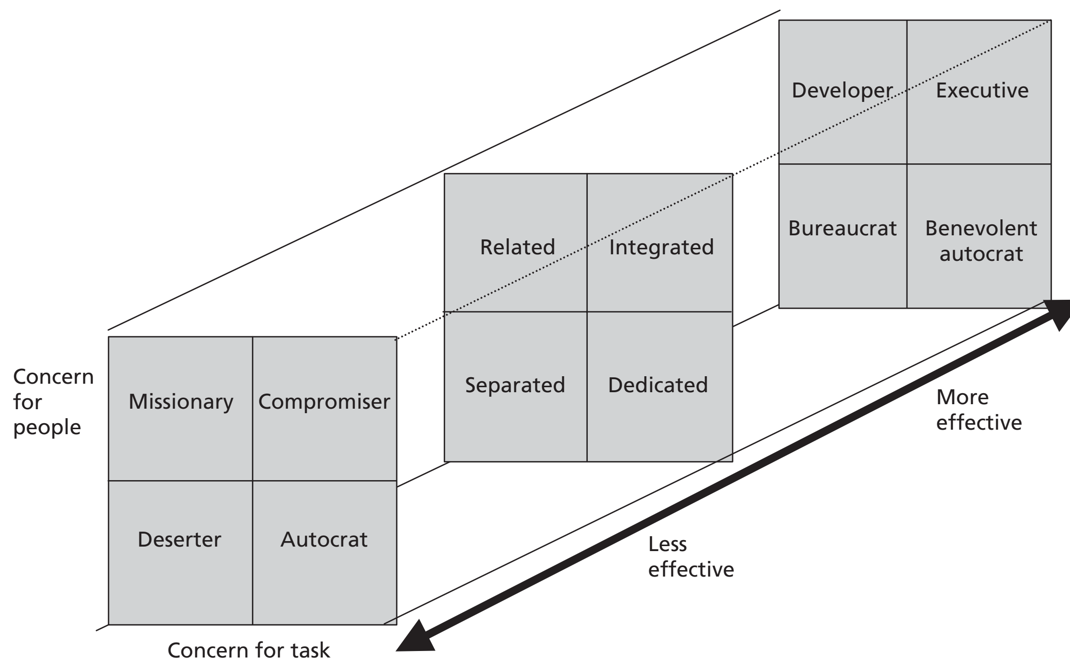


Figure 4.15 Reddin's three-dimensional model

Management style

Conventional wisdom might suggest that small businesses are run by *leaders* whereas large corporations are controlled by *managers*. It seems to suggest that in a large corporation the systems employed somehow become depersonalised with less opportunities for particular individuals to make their mark on events.

Modern thinking (and research) demonstrates that this is a myth of the textbooks. The top team, and in particular the CEO, do have the ability to affect things in a positive direction for the firm (e.g. Rupert Murdoch at News Corporation) or sometimes with less beneficial effects (e.g. Lord Simpson at Marconi).

Reddin proposes a 3D Model of managerial effectiveness (Figure 4.15). Based on the familiar Blake and Mouton grid it goes beyond being merely a typology of styles and instead focuses on potential effectiveness.

Understanding the effectiveness of management is the skill you will need to demonstrate to pass TOPCIMA.

Because TOPCIMA is not another examination in management theory like *Organisational Management and Information Systems* or *Integrated Management* (*Organisational Management* under the pre-2005 syllabus) you will not be required to describe this theory. Instead let us look for the symptoms and circumstances that cause a style to be effective or ineffective.

1. *Bureaucrat:* Conscientious manager who is mainly concerned with upholding rules and procedures to control situation. Only effective if the organisation is already successful and the business environment is not changing.
2. *Benevolent autocrat:* Knows how to get what they want without causing resentment. Low concern for people. This would be effective if the contribution and commitment of staff were of low intrinsic value to the business.
3. *Developer:* High concern for relationships and developing people based on trust. This would be effective in a knowledge-based business but costly in any other.

4. *Executive:* Manager seen as a good motivator, favours team management, treats staff as individuals and sets high standards. Clearly an ideal style for all situations.
5. *Deserter:* Lacks involvement and is passive or negative. Indefensible approach of no value to the business and should be eliminated.
6. *Autocrat:* Lacks confidence in others, unpleasant and only interested in immediate tasks. This slave-driver may think they are effective but only if they ignore the costs of sabotage, high staff turnover, control systems and missed business opportunities that no-one told them about.
7. *Missionary:* Mainly interested in preserving harmony. Danger that this precludes any change or downsizing. Should remember that 'nice guys (and firms) finish last'.
8. *Compromiser:* Poor decision maker, swayed by pressure and avoids hard decisions. Likely to leave the firm several steps behind the market and behind rivals.

Strategic Cultures

Culture is the patterns of values and beliefs in the organisation. Cultures will tend to both influence structure and be sustained by the structure. Culture can influence strategic decisions.

Miles and Snow (1978) identify four types of strategic culture which they believe stem from the attitudes and behaviour of top management.

(a) *Defenders:* Conservative with narrow areas of technical expertise and a preference for tried and tested solutions to challenges. Concentrate on internal efficiency rather than innovation.
(b) *Prospectors:* Innovative firms which seek for new markets and are prepared to undertake high-risk strategies. More concerned with innovation than internal efficiency.
(c) *Analysers:* have stable formal structures for assuring efficiency but also monitor competitors for signs of change. Tend to follow rather than lead strategic initiatives in their industry.
(d) *Reactors:* Unable to respond effectively to change pressures and adjustments are forced on the firm to avert crises.

These categories may help shed some light on the present strategic culture of the business and what the culture will need to be if the firm is to be successful in the future.

4.10 Critical success factors

These are the things that must go right in order for the firm to be a success in its industry.

(1) The CSFs will vary from industry to industry. In the TOPCIMA exam you will be given the industry context in the pre-seen material and will have time to research the real industry. Things to look out for are
- articles on struggling firms in the industry: what went wrong?
- articles on successful firms in the industry: what went right?
- general industry articles with a competitive analysis of the firms and their prospects.

(2) Critical success factors drive the long term shareholder value created by the firm. This is its return on employed capital. They can be identified by answering four questions:
- what factors drive costs in the industry?
- what factors influence the revenues the firm can generate?
- what drives asset investment?
- what poses risks for the firm (and hence will affect its cost of capital)?

4.10.1 Some suggestions on what to look out for

The following table expands on these by indicating what to look for in the industry and in the TOPCIMA pre-seen material.

Critical success factor	*Considerations*
What factors drive costs in the industry?	● if fixed costs are high this means that gaining sales volume is critical ● if complexity (e.g. special customisation of products or width of product range) is being used to gain orders it will drive overheads up. Firms must understand and allow for this (e.g. by using ABC/ABM) ● if economies of scale (volume) or economies of scope (breadth of product range) are available this makes relative size a critical success factor ● if market necessitates high spending on advertising, research and development or asset refurbishment in order to compete firm must be able to afford it ● where costs can be reduced by merger/acquisition the firm needs to gain size and be proactive in its own merger activity ● if costs are affected by exchange rates or availability of cheaper supplies or service provision abroad the firm needs to have foreign exchange hedging and cross-border supply chains
What factors influence the revenues the firm can generate?	● if the firm's product commands a premium price this means that promotion, consistent delivery of the promise of the brand image and technical quality are critical ● if the product competes by low prices it is critical that is market segment continues to feature high price elasticity of demand, that is has a substantial number of buyers willing to buy on price ● if revenue growth has been gained by accessing new customers and wider locations the marketing and logistic skills of the firm are critical ● if revenue growth has been accomplished by new products and exploiting the early product life-cycle it means that innovation and launch marketing are critical ● competitors and new entrants will put pressure on revenues and so it is critical that they be kept out.
What drives asset investment?	The critical success factors in industries subject to high ongoing asset investment are: ● ability to afford the costs of investment ● ability to project manage and implement investment swiftly and successfully Ensure that the firm's management (and you) appreciate that ● asset investment includes intangibles such as human resources and brands. Modern shareholder value techniques rework balance sheets to include these. ● in consumer industries their rising expectations will necessitate continuous improvement and updating of premises, customer service and facilities ● in technological industries there will be need for continuous investment in R&D and production technology ● sales growth drives asset investment if it needs extra production or distribution capacity ● industries utilising IT strategically will need to ensure systems are kept up to date. The progress of IT applications is swift and continuous.
What poses risks for the firm?	Risk is discussed in more detail in Paragraph 4.12. Here we are narrowing it down to the risk to business operations from the firm's competitive strategy. These are events that could close the business down or severely restrict its space to operate and its earnings. ● *Asset risk:* Factors that could result in loss of productive assets or their earning power (e.g. theft, destruction, legal challenges to their use) ● *Commercial risk:* Reduction of earnings below forecast due to loss of customer, failure of new products, out-competition by rivals ● *Operational risk:* Breakdown of ability to provide product/service leading to loss of earnings and potential costs of legal claims by customer, suppliers and staff ● *Financial risk:* Loss of value of investments due to volatility of markets, adverse foreign exchange movements or adverse interest rate movements.

4.11 Assessing info systems strategy

The learning outcomes of TOPCIMA are primarily concerned with strategic and business management decisions. Therefore, you should be prepared to make comments and recommendations on the following issues:

- the quality of the operational systems to support the transactions underlying the business strategy and to provide the information needed by management;
- the quality of information being provided to management and its suitability as the basis for decision making;
- the quality of the alignment between the firms information systems and its business strategy including whether management are making the best use of the potential of modern information systems;
- the risks attached to the firm's reliance on IT/IS.

It is crucial to the success of all businesses today and it can create or lose the company's competitive advantage. It's also a significant source of risk for the firm.

Your report should include some relevant comments on the firm's IT systems and IT/IS management and, where necessary, make recommendations for improvement.

4.11.1 Four levels of information system

Information systems operate at four levels in an organisation:

1. *Operational systems:* Support the day-to-day activities of the business. Examples include stock control, electronic point of sale, sales ledger, automated call routing, performance measurement systems.
2. *Knowledge work systems:* Decision support systems and workflow systems to provide information to and help knowledge workers to do their jobs. Examples include customer call records, stock availability, external databases, CAD, financial models and spreadsheets, intranet, knowledge management systems.
3. *Management information systems:* Summaries drawn from the operational and knowledge level systems that enable divisional managers to control their businesses. Examples include budget reports, sales data, competitor intelligence reports, performance measurement reports (e.g. balanced scorecards).
4. *Executive information systems:* High level, often graphical, summaries to enable senior management to assess the performance of the business and its competitive position. Distinctive features of information at this level are the much greater amount of external information, its use of soft and conjectural data (e.g. on competitors' intentions or potential changes in laws affecting the business) and its highly aggregated nature that enables senior management to concentrate on the 'big picture'.

As Figure 4.16 shows, the operational systems are dedicated to supporting the operations of particular business functions whereas at higher levels this information is aggregated and combined to enable management to take a view of the business as a whole.

4.11.2 Management accounting information

A key aspect of demonstrating competence as a management accountant will be your ability to assess the reliability and quality of the management accounting information available to management.

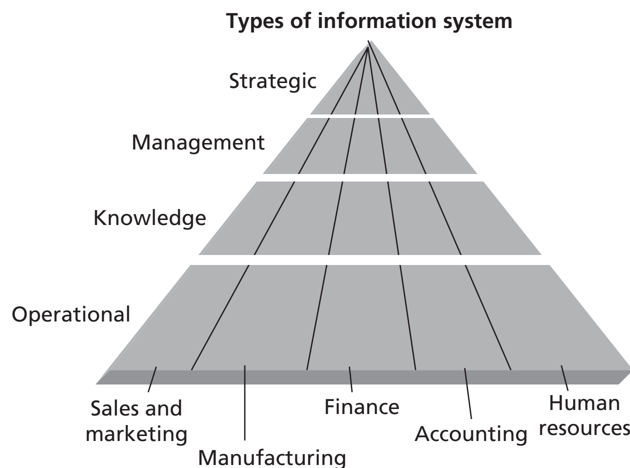


Figure 4.16 Four levels of information system

The power and comparatively low cost of modern IT/IS has greatly increased the *potential* for improving the financial results of a firm through better understanding of costs and revenue streams. Management cannot afford to be ignorant of these matters any longer. In tightening markets, it's vital that they fully utilise any savings that could be made, or enhance any revenue streams where possible. If they do not, then their rival firms will and this will ultimately lead the laggard firm to record comparatively poor financial performance.

Factors to consider include:

1. *How are costs attributed to lines of business?* Generally management accounting attributes costs to product lines to estimate contribution by product. Where a firm has diverse customers (say in terms of loyalty, volumes bought, location or methods of attracting and retaining them) it may be useful to carry out a one-off exercise to attribute costs to customer type (e.g. wholesale customers versus retail customers) to assess *Customer Account Profitability*.
2. *How are overheads and other fixed costs treated?* Conventional management accounting pools these costs and concerns itself with *allocating* them to divisions and products. There is little attempt made to understand the causes of them. Cost *attribution* involves understanding what causes these overheads and fixed costs. For example, a bank might conclude that all the fixed costs of its branch network are actually caused by a minority of customers who still require a branch to visit to exchange cash and receive a personal service; a mobile telephone supplier may realise that the majority of its advertising and promotion overhead stems from its attempts to sell air time to pay-as-you-go High Street consumers rather than from selling to corporate users. This would require an *activity based management* (or activity-based costing) analysis. This could identify the true value of each client or product. Perhaps it would increase profits by closing branches or by abandoning the pay-as-you-go market? By spreading fixed costs across all lines of business management is not in a position to understand the true profitability of each of the customers or products in its portfolio.

4.11.3 Some modern IT/IS applications

From your studies in CIMA you will be aware that IT/IS has moved beyond the simple mechanisation of former manual and bureaucratic tasks. Today it is responsible for a 'third industrial revolution' which will have profound consequences for the world of work and society as a whole.

The following applications should be recalled:

1. *Customer relationship management systems (CRM)* IT/IS configured to streamline and reduce the cost of customer service as well as improving the information content of such service. Examples of CRM include:
   - common database recording salient details of customer correspondence and conversations which can be used by anyone subsequently in contact with the customer;
   - expert systems and intelligent agents able to assess customer account behaviour and to alert management to intervene if erratic behaviour or patterns associated with loss of client emerge;
   - profiling of customers and their purchases and tastes; This enables recommendation of additional products or services to be targeted at the customer.
2. *Supply chain management systems (SCM)* network based technology that facilitates the co-ordination of the supply to the final customer from receipt of the order back the purchase of element.
3. *Enterprise resources management (ERM)* systems track all orders and components through a production process from arrival of initial order to final delivery. As well as controlling allocation of production resources it can also manage payments for sales and purchases, monitor inventory and provide forecasts of revenues and costs for budgetary control and cash flow purposes.
4. *E-commerce (E-Comm)* has effectively become a generic term for 'network-enabled business' and hence incorporates any of the applications above. Features that may be regarded as distinctively e-commerce include the use of websites to manage customer relationships (e.g. information provision and order taking), electronic transmission of funds, e-procurement (e.g. firms using purchasing exchanges to buy/sell commodity products such as oil, foodstuffs, logistics capacity) and virtual communities (e.g. on-line auctions, support groups, purchase aggregators). The extension of networks to 3G mobile phone networks and wi-fi technology, both of which can be accessed by portable wireless units (e.g. mobile phones and PDAs), has led to the growth of *m-commerce* (mobile commerce) in addition to the fixed line PC, interactive TV and intelligent appliance based versions of e-commerce.

4.11.4 Assessing the quality of IT/IS

The quality of information systems can be assessed against eight criteria (all commencing with a 'c' sound):

1. *Quickness:* How long does it take to process transactions or generate reports? This will be important for costs, customer service and ability of management to respond to developments.
2. *Capacity:* Does the system have enough slack to cope with the growth of the business or any fluctuations in demands upon it (such as seasonality in sales)?
3. *Capture:* How broad a range of data does the system capture? This could include, at operational level, compulsory fields in a customer order system, headings on a job application form, whilst at higher levels the range of benchmark or other external data should be considered. Although broader data capture increases processing and storage costs it is also necessary for better business decision-taking.
4. *Classification:* Is the data organised in a way that enables management to gain useful information? Modern multi-relational databases do permit much greater cross tabulation and

analysis of data (e.g. customers to products or faults to suppliers) to enable action to be taken. However if the way the data is initially classified is not standardised this becomes impossible (e.g. if different divisions assign costs to products in different ways then comparisons become difficult).

4. *Communication:* Is the information available to those who need it? Depending on the style of management adopted there may be a need for lower level managers or operative staff to have access to information normally sent only to senior management. This brings up a second aspect, the method of communication and whether it is timely and appropriate to the interest and understanding of the recipient.
5. *Collapse:* Are the information systems protected against failure? Normally this requires that the architecture be distributed to allow processing on other systems if one collapses. Management should have a disaster recovery plan.
6. *Cost:* This will include on-going costs of support, telecoms and updates but also the high depreciation intrinsic to IT investment. Does the information system represent a sensible level of investment? Obviously improving speed, scope and communications is possible with funds. You must be prepared to pass an opinion on whether the firm will gain an adequate return on such spending.
7. *Competence:* Finally does management have the necessary skills and organisational structure to make a success of its systems or should they be outsourced to experts?

4.11.5 Scaling frameworks for IT/IS

A *scaling framework* helps assess the amount of funding and management attention that should be devoted to IT/IS.

The considerations for you in analysing the TOPCIMA pre-seen material are:

- whether the scale of management and resource commitment is appropriate to the firm's operations and strategy;
- whether the firm has sufficient resources to support the IT/IS implications of management's strategy;
- whether it has the IT/IS expertise it will need to make a success of its strategy.

Earl's grid

This framework considers the level of investment appropriate for a firm's IS/IT (Figure 4.17). It points out that high technical quality, which will include capacity, speed,

Figure 4.17 Earl's Grid

access, range of applications and security, is likely to be expensive and only justifiable where it is of potentially high business value. This should be remembered and set against claims from management, particularly those from an IT/IS background, for greater financial commitment to IT/IS.

However Earl's grid alone does not give any guidance to what applications or situations may be of high business value. This requires the use of impact frameworks.

McFarlan's Grid

A second *scaling framework*, which, unlike Earl's grid, explicitly considers future as well as current business value. A similar model was developed by Peppard and called the Applications Portfolio (Figure 4.18).

McFarlan draws attention to the significance of IT/IS shifting from left to right across the matrix. This would imply that a management team accustomed to investing in IT/IS solely to support current operations would need to consider investing for future benefits as well. This is most marked if the firm is shifting from Support (low current importance and assumed low future importance) to Turnaround (low current value but high future value). This sort of repositioning affected many small traditional retailers with the advent of e-commerce, jobbing printers with the advert of desk top publishing, colleges seeking to embrace e-learning, or garage service providers as IT/IS became more important in the functioning of cars.

The questions raised by a shift across the matrix are:

- does the firm have the funding to support the necessary expenditure?
- will shareholders and other investors accept the fall in cash flows and gamble that higher investment implies?
- does management have the necessary expertise and organisational structure to manage IT/IS at a more intense level?
- does the risk management strategy of the firm allow for the sorts of risks such a move entails?

McFarlan identifies two forces driving the strategic role of IT/IS around the grid:

1. *Internal forces:* These include the strategies chosen by the firm (e.g. to deliberately embrace e-commerce) and/or the rising influence of groups within management committed to greater IT/IS (e.g. growth of dedicated IT/IS function)

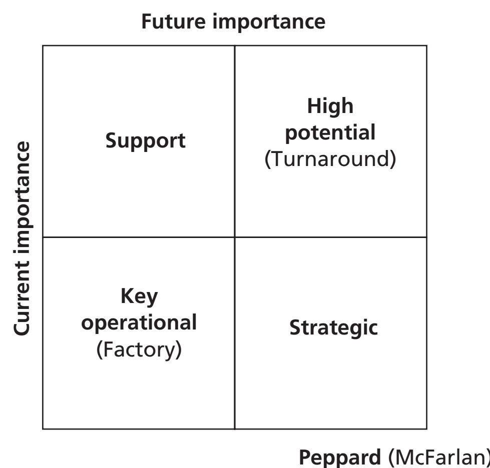


Figure 4.18 Applications portfolio

Information content of the value chain	Information content of end product or service: low	Information content of end product or service: high
high	1. Oil Refining	1. Banking 2. Newspapers
low	1. Cement	1. Perishables

Figure 4.19 Information intensity matrix

2. *External forces:* These include changes in customer demands (e.g. the assumption that it should be possible to order 24/7/365), the strategies of competitors and the arrival of new IT/IS applications (e.g. the development of the internet).

In TOPCIMA you should be prepared to identify the present role of IT/IS and consider whether there are forces driving it across the matrix and if so, whether the firm will be able to make the step change successfully. You should be prepared to advise management accordingly.

Porter and Millar: the information intensity matrix

A final scaling framework, which takes a different slant on the factors that determine the importance (or 'intensity') of IT/IS to the firm (Figure 4.19).

The model reminds us that IT/IS can have importance both in the product and also in the process of getting the product to market. Using the example of newspapers and banking, IT/IS is most important here because the product is information and the process of supply involves gathering information from diverse places and communicating it to where decisions can be made. Risk from security lapses or breakdown are also greatest here.

4.11.6 Strategic management of IT/IS

This involves three sets of decisions:

1. *Information systems strategy:* Identifying how IT/IS is to support the business strategy and information needs of managers.
2. *Information technology strategy:* Decisions on the hardware and software configurations that the firm will use.
3. *Information management strategy:* Who will manage the IT/IS for the firm and the methods they will use to ensure IT/IS aligns with the business strategy and operational needs. This includes project management.

Detailed knowledge of these was assessed in earlier papers (P4, P5 and P6) and covered in the *Study Systems* for these papers. A summary is presented here of the key points about alignment of IT/IS to business strategy (Figure 4.20).

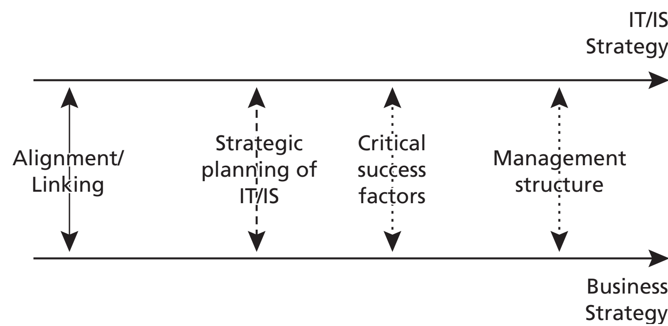


Figure 4.20 IT/IS alignment mechanisms

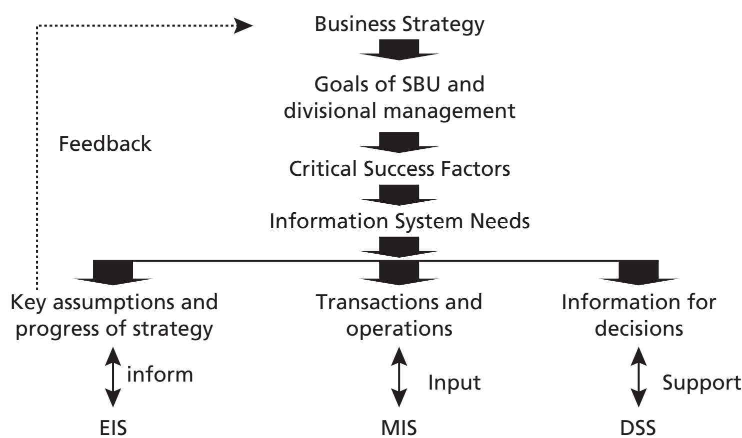


Figure 4.21 Critical success factor approach to IT/IS management

There are three methods of aligning IT/IS to current and future business needs:

1. *Strategic planning of IT/IS*: This involves IT/IS becoming a sub-set of the firm's strategic plans in the same way as HR, Finance and Marketing might be. Depending on the approach to strategic planning taken by the firm (e.g. top-down or bottom-up and whether it is done at corporate level or at business unit level) the opportunities presented by IT/IS for the strategy will be considered and the consequences of the adopted business strategy for IT/IS will be thought through.
2. *Critical success factors* is an approach in which IT/IS experts work with general and functional managers to identify how IT/IS can help then achieve the performance critical to the success of their department or division (Figure 4.21).

Figure 4.21 demonstrates that the goals of the SBU managers and divisional managers are derived from the business strategy. These are general business goals which, if they are to be attained, require that certain Critical Success Factors are in place. The IT/IS expert meets with the responsible management team and identifies ways in which IT/IS can help assure these. For example, it may be through providing operational and transactional systems (e.g. making check-out quicker, tracking stock better or improving efficiency of data input) or it may support and improve decisions at the knowledge, managerial or strategic levels.

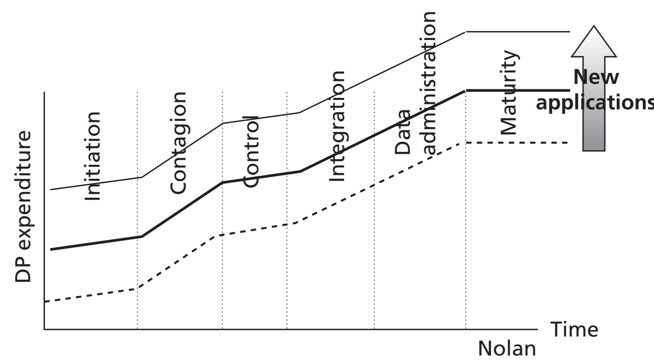


Figure 4.22 Nolan's six stage hypothesis

Management structures to align IT/IS to business strategy involves considerations such as:

- the degree of centralisation of IT/IS at corporate centre versus the decentralised approach of allowing business divisions to specify their own systems;
- whether there is a senior manager responsible for IT/IS. This will influence (and reflect) the degree of importance top management place on IT/IS in their business decisions;
- whether management decides to treat IT/IS as a service centre, a cost centre, a profit centre or indeed outsource it altogether;
- whether it will be run as a hybrid with routine operational applications managed one way but strategic ones operated through a different management structure.

A rough rule of thumb is that the more critical IT/IS is to business success the more it will be regarded as a core competence. This means it is more likely to be kept in-house, enjoy representation at senior management level and have its use rationed out using prices and the requirement that it make a profit.

A final model that can help you make sense of the issues in a TOPCIMA case is Nolan's six stage hypothesis (Figure 4.22). Although originally formulated in the 1970s to help understand the adoption and diffusion of early data processing systems this model has since been generalised into a way to understand waves of IT/IS applications that have occurred since such as office automation, intranets, mobile telephony and e-commerce applications.

1. *Initiation* stage is the first appearance of the technology in the firm. Using a contemporary example, some managers may have purchased a Personal Digital Assistant (PDA) and be showing it off to colleagues. There is no control over spending and senior management will not have noticed it.
2. *Contagion* phase is where more and more managers, and their subordinates, are requesting or buying PDAs because they are perceived to be useful or perhaps because they are a status item. Expenditure is rising sharply but most is 'off-budget'. There will be many different sorts of PDAs circulating around the firm and all carry data which must be secure.
3. *Control* occurs where management realise that a lot of expenditure and assets are now tied up in PDAs and also that risks are rising (e.g. loss of asset, key data being lost or leaked externally). So far the business benefits have been hard to see. Management clamp down on further spending and adoption of PDAs.
4. *Integration* is a stage when the technology is evaluated against the future plans of the firm and it starts to become part of the business strategy (or otherwise is jettisoned). If the

company is committed to teleworking then PDAs may be seen as better than laptop computers due to lower price, portability and increased functionality (telephony, photographic, video, sound etc) and so gradually laptops are replaced by a standard issue PDA. Training and support is given to users of PDAs.

5. *Data administration* is the point at which the technology switches from being something managed as a special project to something with set administrative procedures. Perhaps the firm will incorporate PDA expenditure into its budget forecasts and regulations will be issued on protocols for how they may and may not be used and what may be stored on them (just as the firm did before with mobile phones and the internet/intranet).
6. *Maturity* is where the application has reached steady state and is fully integrated with the business strategy and operations.

4.12 Assessing corporate risk

A model developed by The Institute of Risk Management *et al.* in their *Risk Management Standard* demonstrates the various sources of risk (Figure 4.23).

Risk can be understood in a number of different ways:

- *Risk as hazard or threat:* This entails a reduction in business effectiveness and financial return.
- *Risk as uncertainty:* This causes problems for decision-makers at strategic, managerial and operational levels.
- *Risk as opportunity:* This involves managing the upside of a risk to come out of it better than rivals.

The range of risks can be considered under the following headings:

1. *Business or operational risk.* Business or operational risk relates to the activities carried out within an organisation, arising from structure, systems, people, products or processes. Business or operational risks include business interruption, errors or omissions by employees, product failure, health and safety, failure of IT systems, fraud, loss of key people, litigation, loss of suppliers, etc. These are generally within the control of the organisation through risk assessment and risk management practices, including internal control and insurance.
2. *Financial risk.* Financial risk relates to the financial operation of a business, such as credit risk, liquidity risk, currency risk, interest rate risk and cash flow risk. Some of these risks arise from cultural and legal differences between countries, such as the demand in some countries for cash payments to arrange local sales. Obtaining money from customers in other countries or recovering the cost of lost goods in transit may also be difficult due to different legal or banking regulations. While these are typically outside the organisation's control, organisations can take action to mitigate those risks, for example by credit control procedures, hedging, export insurance, etc.
3. *Environmental risk.* Environmental risk relates to changes in the political, economic, social and financial environment over which an organisation has little influence. Environmental risks include legislative change, regulations, climate change, natural disasters, loss of business, competition, economic slowdown and stock market fluctuations. These are outside the organisation's control but can be mitigated to some extent through environmental scanning and contingency planning.

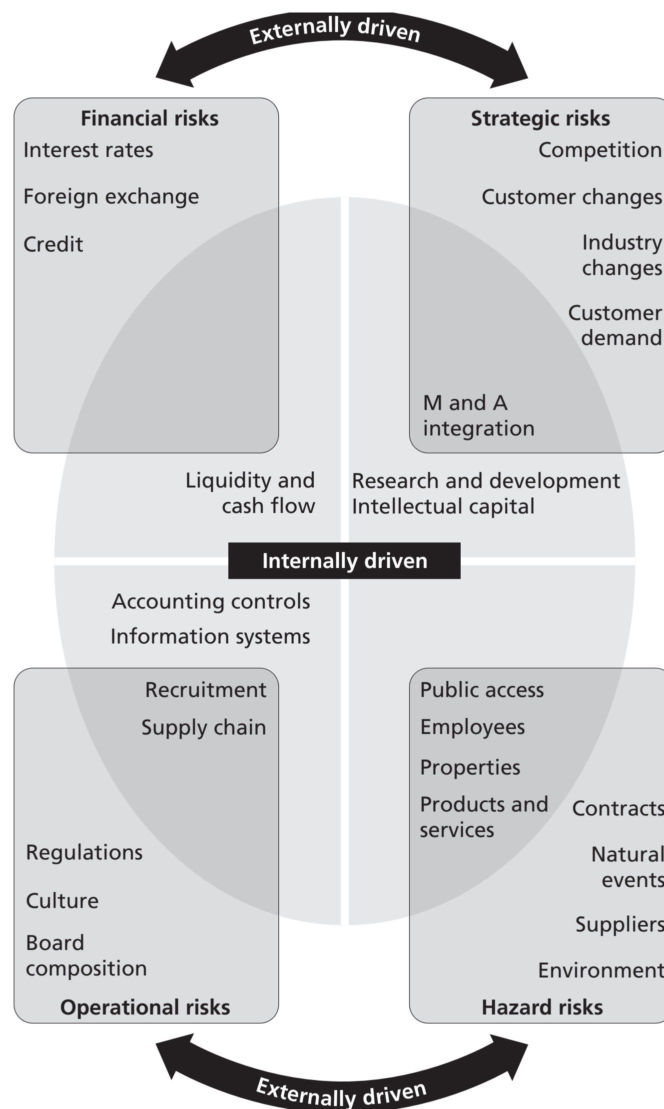


Figure 4.23 Sources of risk
Source: A Risk Management Standard IRM *et al.*

4. *Reputation risk*. Reputation risk is caused by failing to address some other risk. This is within the organisations' control but requires the organisation to take a wider view of its role in society and to consider how it is seen by its customers, suppliers, competitors and regulators.
5. *International risk*. Financial risks associated with international operations such as transaction (e.g. fraudulent client), translation (e.g. currency risk), economic (e.g. recession or tax changes) and political (e.g. change of policy towards overseas trade).

4.12.1 Risk management process

The Institute of risk management *et al.* have developed the model shown in Figure 4.24.

- *Risk assessment:* Analysis and evaluation of risk by identification, description and estimation.
- *Risk evaluation:* Estimation of probability and impact of risk to reveal its significance leading to a decision on whether each specific risk should be accepted or treated.

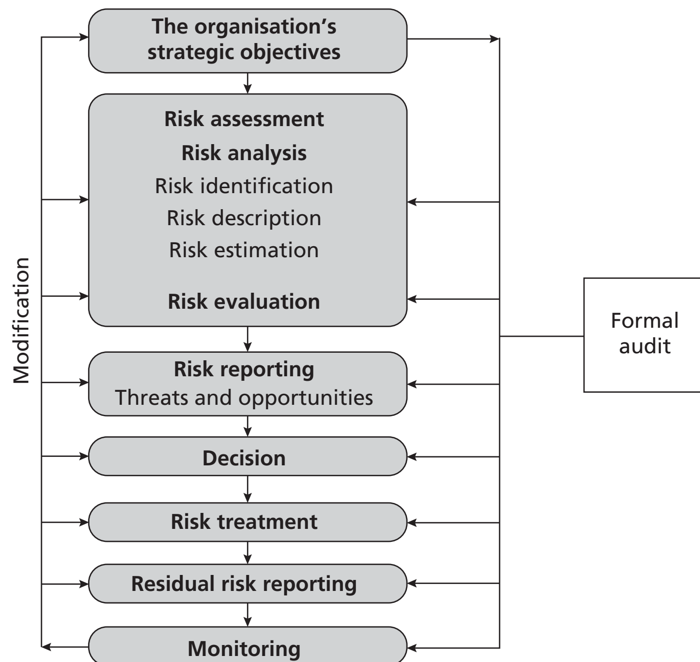


Figure 4.24 Risk management process
Source: A Risk Management Standard: IRM *et al.*

- *Risk reporting:* Regular reports to the Board and to stakeholders setting out risks, the organisation's policies in relation to them. This enables monitoring of effectiveness of policies.
- *Risk treatment* (also called risk response) is the process of selecting and implementing measures to modify the risk such as risk control/mitigation, risk avoidance, risk transfer, risk financing (e.g. insurance).
- Residual risk reporting draws board attention to any untreated risk.

4.12.2 Techniques of risk management

1. Identification of risk

- Risk can appear in different ways to different people according to their backgrounds and experience. This leads to collective techniques for risk identification such as brainstorming, stakeholder consultations and scenario analysis.
- Structured techniques include checklists, incident investigation, fish bone (breaking down a business process into its component parts to examine all the risks to that process).

2. Risk estimation

Risk estimation looks at the likelihood of occurrence and the possible impacts.

Methods include:

- scenario planning,
- computer simulations, for example, Monte Carlo,
- decision trees,

- sensitivity analysis,
- real option modelling,
- SWOT or PEST analysis,
- likelihood/consequences matrix.

3. Risk evaluation

Risk evaluation is concerned with making decisions about the significance of risks to the organisation and whether those risks should be accepted or whether there should be an appropriate treatment or response.

4. Risk reporting

This includes:

- A systematic review of the risk forecast at least annually.
- A review of the management responses to the significant risks and risk strategy.
- A monitoring and feedback loop on action taken and variance in the assessment of the significant risks.
- An 'early warning system' to indicate material change in the risk profile, or circumstances, which could increase exposures or threaten areas of opportunity.
- The inclusion of audit work as part of the communication and reporting process.

5. Risk treatment

Risk treatment selecting and implementing measures to modify the risk.

Risk response may be:

- *Avoidance:* Action is taken to exit the activities giving rise to risk, such as a product line or a geographical market, or a whole business unit.
- *Reduction:* Action is taken to reduce the risk likelihood or impact, or both.
- *Sharing:* Action is taken to transfer a portion of the risk through for example insurance, pooling risks, hedging or outsourcing.
- *Acceptance:* No action is taken to affect likelihood or impact.

4.13 Assessing cost of capital

4.13.1 Importance of cost of capital

The principal uses of the cost of capital in TOPCIMA are:

(a) to provide a discount rate for project appraisals using discounted cash flow methods;
(b) to use as basis for business valuation (see Section 4.15)
(c) to utilise in measuring shareholder value or for setting divisional performance measures related to shareholder value.

4.13.2 Cost of equity

The cost of equity (or K_e) is the rate of return payment that management must make on the equity in the company if shareholders are to keep their funds in the company.

Assume the situation where a firm financed entirely by equity (i.e. zero capital geared) and where K_e is 15%. In this case management would use K_e:

- as the discount rate for project appraisal, that is, so that any new assets purchased would have to demonstrate a positive NPV after deduction of 15% p.a. for the capital used;
- as the hurdle rate for performance evaluation of divisional managers that is, they would be required to show that they were achieving at least a 15% return on the legacy assets in their divisions;
- as shareholder value measures, that is, the management of the firm would seek to ensure a positive economic profit (otherwise called a residual income or, following some adjustments, Economic Value Added®[3]) after multiplying divisional and overall group assets by 15%. In the case of a division with assets of $20m it would need to show an income in excess of $3m (i.e. $20m × 0.15).

Cost of equity can be derived in two ways:

1. dividend valuation method,
2. capital asset pricing model (CAPM).

Example

A firm's shares trade at $1.75. Its most recent dividend was $0.10. Historically dividends have grown at 5%.

The market rate of return is 11% whilst the risk free rate is 5%. The industry equity beta is 1.

Using DVM

$$P_0 = \frac{D_0(1 + g)}{K_e - g}$$

and reformulating it as

$$K_e - g = \frac{D_0(1 + g)}{P_0}$$

$$K_e - g = \frac{0.10(1 + 0.05)}{\$1.75}$$

$$K_e = 11\%$$

Using CAPM

$$r_f + \beta_e (r_m - r_f)$$
$$5\% + 1(11 - 5)$$
$$K_e = 11\%$$

In this case the required rate of return for the shareholder is 11%.

The above approaches have a number of practical difficulties:

- *Problems with divided:* Growing firms may not have paid any dividends (so $D_0 = 0$) or they have recently paid their first dividend ($g = \infty$). In these situations the model cannot be applied to the firm. K_e can only be assessed by applying the model to a similar firm in the same industry and generalising it by assuming that shareholders in either firm require the same rate of return to compensate them for the risks of their investment.
- *Problems with share price:* In the above example P_0 is assumed to be a market price of the share and hence incorporate all the knowledge about the future prospects and risks of the business. Once again a new or growing firm may not have a share price due to not yet being quoted on a public market.

[3] Economic Value Added (EVA) is a registgered trademark of Stern-Stewart New York.

- *Problems with beta coefficient:* A beta coefficient is an index of the *unsystematic risk* of the equity, that is, the volatility on its value compared to the volatility in the value of equities as a whole. The above example used a beta of 1 which means that the shares moves up and down imperfect unison with the general value of shares in the stock market (the so called *market risk* or *systematic risk*). Betas are more readily available for standard large industries like telecommunications or construction because there are many firms and also there are a lot of shares traded. However, for emerging industries or niche industries (such as biotechnology research or auction houses) there are not likely to be such reliable betas available and so users are forced to make generalisations from similar, but not identical, industries (in the above example say pharmaceuticals and retailing sectors).
- *The impact of the strategy being followed:* A firm's K_e probably relates to its current line of business and hence the risks and returns intrinsic to its current industry. If however the cost of capital is being used to evaluate an investment in a new line of business (or new country perhaps) than it should be evaluated using a K_e appropriate to the risks or the new industry.

4.13.3 Cost of debt

At its simplest the cost of debt is the post-tax cost of the interest upon it (since unlike dividends to equity, interest payments are tax deductible).

Examples

Suppose a company issues debt at par (i.e. receives \$100,000 for each \$100,000 bond it issues) with a coupon rate of 8% in a country with 30% tax rates.

$$K_d = 8\% \, (1 - 0.30)$$
$$= 5.6\%$$

The situation is complicated where the firm has issued debt at a discount (i.e. below par) because in addition to the coupon interest it must also take into account the increased redemption value of the bond.

Suppose a firm issues its 8% coupon rate debt, redeemable in 5 years time at a discount of 5% to par (i.e. it receives \$95,000 for every \$100,000 of debt it sells). Tax is 30%.

Here the after-tax cost of debt will be given by the formula:

$$95 = 8(1 - 0.3) \times \text{AF } 5@K_d + \frac{100}{(1 + K_d)^5}$$

K_d can be obtained by interpolation using two different assumed rates for the annuity factor (AF).

	Cash flow	*AF @ 10%*	*PV*	*AF @ 5%*	*PV*
Year 0	95,000	1	95,000	1	95,000
Year 1–5	(8,000)	3.791	(30,328)	4.329	(34,632)
Year 5	(100,000)	0.621	(62,100)	0.784	(78,400)
			2,572		(18,032)

$$K_d = 10\% - \frac{18,032}{18,032 + 2,572}(10\% - 5\%)$$

$$K_d = 10\% - 4.38\%$$
$$K_d = 5.62\%$$

4.13.4 Weighted average cost of capital (WACC)

This is the percentage rate of return that must be achieved to add shareholder value taking into account all the various sources of finance used by the firm. It is the weighted average of the costs of the individual courses of capital using market values.

Example

A firm has a capital structure made up as follows:

Equity: 2,000,000 shares with a market price of \$1.62 and a K_e of 8%

Debt: 12,000 bonds with a market value of \$98 and a K_d of 6%

The WACC is calculated as

$$\frac{(2{,}000{,}000 \times \$1.62 \times 8\%) + (12{,}000 \times \$98 \times 6\%)}{(2{,}000{,}000 \times \$1.62) + (12{,}000 \times \$98)}$$

$$= \frac{32{,}976{,}000}{4{,}416{,}000}$$

$$= 7.47\%$$

The WACC is the more usual basis for calculating the cost of capital because most corporate treasurers will ensure they have a mixture of debt and equity in the balance sheets of their companies to reduce the overall cost of capital.

But the WACC has a number of limitations stemming from its dependence on a *pool of funds* concept. Put simply it assumes that new projects (and existing assets) are financed from a homogenous reserve of funds the costs of which will remain unchanged by alterations in the amount of funds used and variations in the sorts of businesses they are used to support.

The WACC is therefore not an appropriate cost of capital under the following situations:

- where the funds are being used to support operations or assets exposed to significantly different risks from those faced by the majority of the firm's business;
- where raising the extra funding will significantly change the capital structure (notably the debt/equity ratio) of the firm;
- where the amount of funds being raised is a significant addition to the total capital employed by the firm.

Under these situations it is usual to use the marginal cost of capital.

You may be given a discount rate to use in the pre-seen or unseen material. You should always use this rate in your calculations. Do not waste time in the exam room trying to calculate a different cost of capital or in trying to prove the rate you have been given.

However, additional credit will be given for comments or arguments about why this rate might be too high or too low providing this is backed up by reference to the theory here.

4.13.5 The marginal cost of capital

This assesses the impact on the costs of capital of raising funds for a project. This will include the costs of the capital raised for the project but also include the impact on the costs of existing capital due to changes in the risks faced by the firm and changes to its capital structure.

Example

A firm operates solely in one country making a basic industrial material. Presently its financing is made up as follows:

Equity: 2,000,000 shares with a market price of \$1.62 and a K_e of 8%,
Debt: 12,000 bonds with a market value of \$98 and a K_d of 6%.

As calculated in the example above, its cost of capital is presently 7.47% on capital of \$4,416,000.

Management decides to diversify the firm by buying a chain of leisure centres in an overseas market for \$3,450,000 paid for in debt issued at par. As a consequence of the greater risks and capital gearing K_d for the firm as a whole rises to 8% and the original K_e of 8% rises to 10%.

The firm has raised an additional \$3,450,000 of capital but it must now make a return of \$69,408,000[4] and not the \$32,976,000 previously.

Therefore the marginal cost of capital for the project is

$$\frac{\$3{,}450{,}000}{(\$69{,}408{,}000 - \$32{,}976{,}000)} = 9.47\%$$

[4] (2,000,000 × \$1.62 × 10%) + (12,000 × 8%) + (\$3,450,000 × 8%).

4.13.6 Adjusted present value (APV)

This is an appropriate approach to evaluating a strategy or project involving diversification.

The formula is

APV = Base NPV + side effect of financing

- calculate the base NPV of the diversification project using the CAPM approach using the beta of a firm already in that industry (this would be given in the pre-seen or unseen TOPCIMA material if it was required);
- allow for any side effects of finance such as tax shield on debt introduced and add this on to the base NPV;
- the APV should be positive if the project is to be accepted.

4.13.7 Real options theory

This is another approach to strategic investment. It is an alternative to traditional NPV evaluations for where investments are being made under conditions of high uncertainty. It suggests that management could mimic the sort of investment behaviour of investors in derivative investments such as futures and options covered in the *CIMA Risk and Control* syllabus.

Traditional NPV takes all the cashflows of a project over its lifetime and discounts them back. In a strategic decision these cashflows are far from certain and so very high required rates are applied. The effect is that tentative strategic investments come up showing negative NPVs and are not undertaken.

Real option theory seeks to take the project apart by pointing out that a small level of investment in a project is rather like paying a deposit to secure the right to subscribe for future financial benefits if matters go a certain way (just like the premium on an option).

Consider a firm thinking of entering a line of retail for the first time. Instead of conducting an NPV on building a chain of shops across the country the theory time-slices the investment decision by pointing out that the first investment is buying the land to build the

shops on. Once the firm owns the land it has a number of options (i.e. decisions which can be taken at a later date):

1. *The expansion option* which means to go ahead and build the shops and perhaps buy more land too. This decision could wait until the future became clearer.
2. *The abandonment option* is where management decides not to build the shops after all, perhaps because of a recession in the economy. The firm would forfeit some of the money they spent buying the land. However this loss was worth it because it did buy them the opportunity to participate had the economic circumstances been more favourable.
3. *The timing options*. This suggests that there may be points in the rolling-out of a project at which management can decide to delay or to bring forward further investments. This will affect the NPV of the project.
4. *Strategic investment options*. These are follow-on opportunities over which the firm has an option if it makes the original investment. These spin-offs are added into the core investment appraisal as a series of 'what-if' analyses to try to get a full view of the potential value of the investment.

The effect of real options approach is to give a *true NPV* for a project calculated as follows:

True NPV = Crude NPV + NPV of expansion option + NPV of abandonment option + NPV of timing option + NPV of strategic option

4.14 Conducting a corporate appraisal (SWOT and Gap analysis)

Corporate appraisals have two elements:

- a SWOT analysis,
- a Gap analysis.

The most commonly used corporate appraisal method in TOPCIMA exams appears to be a SWOT analysis. Candidates can (and should) prepare a SWOT to help them understand the pre-seen material and to understand the weaknesses of the company and the opportunities facing the company or the industry in which it is operating in.

If you include a SWOT analysis in your answer, you must ensure that it has been updated to include material that has been given to you in the unseen material on exam day.

For example if you prepared a SWOT with a Weakness stating that the company's Chairman was ineffective, but the unseen material included that a new Chairman had been appointed (as in the Homejay November 2003 case) this would reduce the marks awarded for the SWOT. You MUST update your SWOT for data in the unseen material for the SWOT to earn reasonable marks.

4.14.1 Conducting a SWOT analysis

The TOPCIMA exam is likely to require you to make recommendations about what to do with the organisation in the pre-seen material. This will require you to base your advice on an analysis of its present position.

The approach recommended here is to prepare a SWOT analysis using the pre-seen material, which can be adapted or modified in the light of any additional unseen material on exam day. This SWOT analysis should appear in two places in your final report:

1. As a cruciform chart in the appendix to your report. This will be brief bullet points showing the breadth of issues that you have noted.
2. As the second section of your report, immediately following the introduction, in which you will highlight the most important conclusions from the SWOT in terms of its implications for the business (Figure 4.25).

1. *Strengths and Weaknesses are usually internal and specific to the firm.* A strength is something that, from the information in the pre-seen material, you consider the firm is good at or it is a resource it can call upon to reach its goals. They are sometimes termed *distinctive competences*. A weakness is generally a resource shortage or inadequacy which renders the firm vulnerable to competitors.

   A quick recap through the mental checklist of the 9 M's model will give you some ideas.
2. *Opportunities and threats are generally external to the firm.* Opportunities and threats are strategic challenges to the firm. Again these may be obvious to you from the pre-seen material or perhaps from your own research into the background of the industry.

   Here frameworks like PEST and five forces can help.

   Ensure that these are 'clear and present' opportunities and threats that you can back up with data from the case or other source. Too many candidates seek to pad out their SWOT analysis with various generic threats like 'there could be a takeover bid' or 'interest rates may rise' without bringing forward any evidence that this is a possibility.

   Also avoid confusing opportunities with strategies. The best way to do this is to ensure that nothing you write could have the words 'management could' put before it.

Your SWOT could include under the heading of Threats any external industry problems, if, for example, the industry as a whole is under price pressures, or is in the decline stage of

Figure 4.25 The cruciform chart

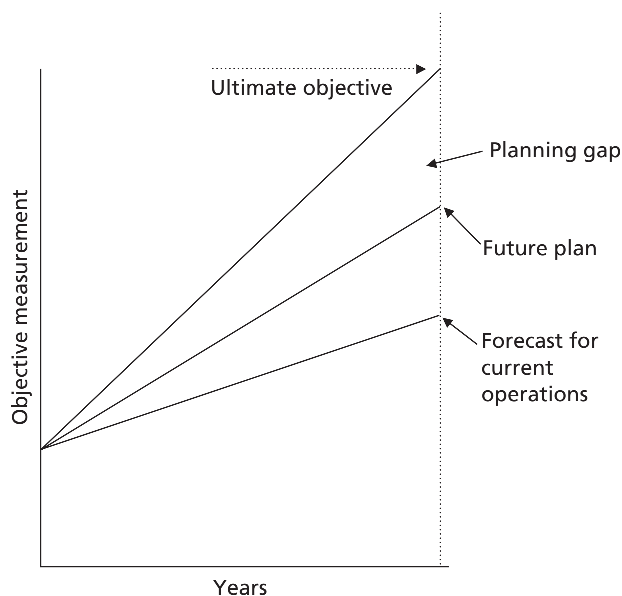


Figure 4.26 Gap analysis

its life cycle. Alternatively another threat is that of obsolescence if other companies are introducing superior products or services which could affect the sales and profitability of the company in the case, or impending changes in EU or UK legislation that could affect the company.

4.14.2 Gap analysis

A gap analysis (Figure 4.26) can only be carried out if the pre-seen material or unseen material gives an indication of the strategic goals of management.

In past CIMA cases these goals have appeared in the following ways:

- as statements of intent at floatation of the firm,
- in the records of planning meetings,
- in a 5-year plan for the firm.

Figure 4.26 shows the firm's performance towards a single objective. In TOPCIMA there may be several objectives sought by management simultaneously. For example, in a past CIMA case the strategic objectives for one firm were:

- to achieve a certain number of outlets within 5 years,
- to maintain a given ROCE,
- to have the largest market share in the industry.

You should be prepared to express an opinion on the following matters:

- Does the forecast performance of the firm show that it's likely to reach its strategic objectives in all areas?
- Are the strategic objectives still realistic and relevant?
- What will be the likely effect on stakeholders, in particular shareholders, of missing the objectives?

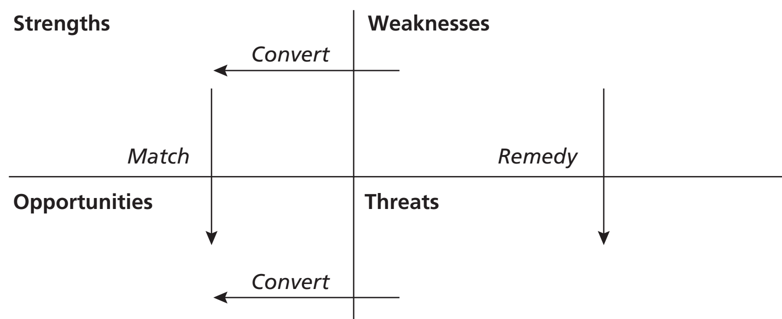


Figure 4.27 Strategic fitting

Internal factors / External factors	Strengths (S)	Weaknesses (W)
Opportunities (O)	SO Strategies	WO Strategies
Threats (T)	ST Strategies	WT Strategies

Figure 4.28 TOWS matrix

4.14.3 Getting from corporate appraisal to strategy

Frequently the corporate appraisal can throw up appropriate strategies (Figure 4.27). Here are some techniques that can help with that process:

1. Matching, converting and remedying

- *Matching*. The firm should build on those strengths that enable it to take advantages of the opportunities in the market place.
- *Converting*. This is a more complex process in which management question their interpretation of a factor as a threat or weakness and consider whether it can be re-interpreted or turned to its advantage (sometimes called *flipsiding the negative*).
- *Remedy*. Removing weaknesses that leave the firm exposed to threats or unable to grasp opportunities is a priority for strategic action.

2. TOWS approach

This uses the extended matrix shown in Figure 4.28.

Strategic options are identified in the four internal quadrants:

- *SO Strategies* – ways in which the business could use its strengths to take advantage of opportunities;

- *ST Strategies* – considering how to use company's strengths to avoid threats (It can be hoped that rivals will be less able to do this and hence they will suffer deteriorating relative competitive performance.);
- *WO Strategies* – attempting to take advantage of opportunities by addressing weaknesses;
- *WT Strategies* – primarily defensive and seek to minimise weaknesses and avoid threats.

3. Closing a planning gap

The strategies which may be used to fill the remaining gap are classified as:

(a) *Efficiency strategies:* Designed to increase profits (or throughput) by making better use of resources or cutting them.
(b) *Intensive strategies:* These exploit the firms existing products and markets further.
- *market penetration* to increase sales to existing markets;
- *market development* to find additional markets for the products;
- *product development* to find additional products for the firms existing customer base.

(c) *Diversification strategies:* These aim to reduce the risks of the business or increase its growth prospects by taking it into new industries.

4.15 Business valuations

Business valuation has been a common theme in past CIMA case studies. It can be of use in several situations:

- to evaluate an approach of takeover bid from another firm. Are they offering enough?
- to set a potential price for shares that will be issued in a floatation to issued to new investors
- to set a value on shares to see how well an unquoted company has performed to date
- to set a price to buy back shares from a shareholder who wishes to exit the company.

4.15.1 Two approaches to business valuation

Business valuation is not an exact science. Rather it is a matter of judging where a firm's value lies between two methods of valuation:

- asset-based methods,
- earnings-based methods.

4.15.2 Asset-based methods of business valuation

A simple approach is to value the firm at its net assets value. This takes the view that anyone who buys the company will in fact have purchased assets to a particular value, less liabilities such as debt or creditors.

Example

The following items are extracted from the balance sheet of a company:

Fixed assets	$380,000,000
Current assets	$120,000,000
Current liabilities	$103,000,000
Long-term debt	$98,000,000
Called up share capital ($0.50 shares)	$200,000,000
Net asset value of company	$299,000,000
Value per share	$299,000,000 (200,000,000/0.5) = $0.75

Asset-based valuation methods suffer from the following limitations:

1. *Net asset values are not reliable*. A predator buying another company may do so to get its assets. However, the book value of the assets may not convey their true value to the predator. The true value could be their *replacement value* (i.e. how much it would cost the predator to buy them on the market) or their *net realisable value* (i.e. how much the predator would earn if they liquidated the assets).
2. *Method ignores valuable intangible assets*. A predator may seek to buy a firm to get access to its staff skills, customer contracts or brands. These are valuable but for good financial accounting reasons do not appear on the balance sheet.
3. *Method ignores earnings potential*. The management of a successful firm can take ordinary assets and earn supernormal profits on them. For example, a modern thriving club may be located beside an old-fashioned hardware store in a High Street. According to a real estate surveyor both properties have the same asset values, but because the club generates a much better income than the store it is worth more.

Asset valuations should be regarded as a floor or minimum value for a firm.

4.15.3 Earnings-based methods of valuation

1. Dividend yield approach

Here the firm is valued according to the annuity value of its dividends using the formula

$$\text{Market value} = \frac{\text{Dividend}}{\text{Dividend yield}}$$

The dividend yield of a similar firm is calculated and applied to the firm for which a value is sought.

Example

Company A has a share price of $1.28 and a dividend of $0.32. Company B pays a dividend of $0.17. It has 22.2m shares in issue. What is the value of B?

Dividend yield for A	= $0.32/$1.28	= 25%
Value of B	= $0.17/0.25	= $0.68 per share
Total value	= $0.68 × 22.2m	= $15.1m

In effect this is the same thing as using the formula

$$\text{Value of firm} = \frac{\text{Dividend}}{K_e}$$

that is, it values the firm as the annuity value of its dividend assuming that the dividend yield it has taken from the other firm equals K_e for the industry.

2. Dividend growth approach

This accepts that in most cases firms are expected to pay higher dividends in the future because the firm is growing.

$$\text{Value of firm} = \frac{D_0(1 + g)}{K_e - g}$$

where g is the forecast growth rate of dividends estimated from past history or by application of *Gordon's growth model* where $g = b \times r$ in which b is the retention ratio and r is the rate of return on retained earnings.

Example

A company paid a total dividend of $230m last year. This represents a 5% increase on the previous year. The industry has a K_e of 12%

$$\text{Value} = \frac{\$230\text{m}(1 + 0.05)}{(0.12 - 0.05)}$$

$$= \$3{,}450\text{m}$$

This approach assumes that the firm will be able to grow its dividends at 5% per annum in perpetuity and, despite its growth, that K_e will remain unchanged. Both are probably unrealistic assumptions.

This approach breaks down in the following cases:

1. Where the firm does not pay a dividend. Microsoft was formed in 1983 but did not pay any dividend until 2002 yet clearly it had a very high value during the intervening years.
2. Where the growth rate of the firm's dividend exceeds K_e. In this situation the denominator becomes a negative and therefore gives the firm a value of infinity.

3. Earnings growth approach

The dividend valuation approach effectively values the firm from the point of view of its existing shareholders. These shareholders are not able to determine the dividend payout decided by management. This is, however, a useful figure for understanding the minimum price that is likely to be acceptable to the target's shareholders.

Another firm which takes control of the board of a firm can enjoy the entire earnings stream and not just the dividend. Therefore, the dividend valuation model is subtly adapted:

$$\text{Value of firm} = \frac{E_0(1 + g)}{K_e - g}$$

Where E_0 refers to the total earnings attributable to ordinary shareholders. There may be arguments for using the profit before interest and tax instead. For example, if the acquiring firm enjoys a K_e below the acquired firm's cost of debt it would presumably redeem the debt with equity and avoid the interest payments. Similarly is its cost of debt were lower it might be able to refinance the debt at lower interest. Finally its tax rate could be different from that of the target company.

4. Price earnings approach

The formula for this approach is

Value of firm = maintainable earnings × price earnings ratio

Maintainable earnings are a floor level of future earnings which actual earnings are not expected to fall below.

Operating profit less tax is the basis for this calculation.

The price earnings ratio will be a ratio from another firm in the same industry, assuming one exists.

Example

Company A has earnings after interest and tax of $755m and balance sheet debt of $238m at an interest rate of 15%. Company B is in a similar industry to Company A and has a PE ratio of 17. What is the likely value of Company A?

Maximum value of Company A is $755m × 17 = $12,835m

The balance sheet debt is ignored and not deducted from the value. This is because the interest on the debt has already been deducted from profits before arriving at the $755m. The valuation assumes that anyone who acquires Company A will simply maintain the debt out of earnings in the same way.

However, if there are any reasons to believe that a firm's debt has been used to purchase a wasting asset (such as a renewable license to exploit a resource) then it seems likely that interest will not be repaid out of sustainable earnings but rather the capital sum will need to be written off over time. In this situation, it is prudent to deduct the debt from the valuation.

This valuation method makes a number of assumptions that should be highlighted if you choose to use it in your TOPCIMA exam:

- It depends on how similar the industries of the two firms are. Clearly if Company A is in a more risky industry than Company B we should use the potential PE of the joint company. This is because the higher risk if the combined company will increase K_e and so depress the P/E ratio.
- It assumes that the share price of the acquiring company is set by a liquid market in its shares and hence, according to the efficient market hypothesis, its price reflects its future earnings power.
- It assumes that the management of the two firms will be able to grow earnings at the same rate as the management of the acquiring company could.

Where a company is not listed it is possible to generate a share price by applying a 'proxy' P/E from a listed company in the same line of business. However, some deduction from the resulting value should be made to reflect the non-tradability of the share.

5. Discounted cash flow approach

This values the business at the present value of its free cash flows and is based on the assumption that the stock market will arrive at a value for a share that is equivalent to the present value of its free cash flows.

A free cash flow is the cash profits of the firm. However, there is considerable disagreement about what this may include or exclude in practice. A rough rule of thumb is:

Operating profit

- less interest,
- less tax,

- plus depreciation and amortisation,
- plus increase in provisions for tax or doubtful debts,
- less any increases in fixed or working capital = free cash flow.

The second issue concerns how far ahead to forecast these free cash flows. If they are expected to continue indefinitely at their present amount per year then valuation is simply an annuity value

$$\frac{\text{Current annual free cash flow}}{\text{Cost of capital}}$$

Otherwise it is usual to adopt one of the following approaches:

- discount the free cash flows from the present business plan to arrive at a present value and then add on a notional amount for the earnings for the years after the plan;
- assume and annuity value for a set number of years corresponding to the lifecycle of the product or industry.

A final issue is arriving at a suitable discount rate. This was discussed in the section on the cost of capital above.

6. Valuation to include synergies

Some acquisitions are carried out with the intention that the resulting group of companies will have higher profitability than the sum of the profits of the constituent parts. Summarised as *the 2 + 2 = 5 effect*.

Potential synergies include

- elimination of the fixed costs of duplicated assets (e.g. factories, offices etc.);
- reduction in operating costs due to combination of administrative functions;
- greater capacity fill through better loading of assets (e.g. instead of two firm's with half-full lorries there will be one firm with half as many lorries, each running fully loaded);
- increased sales revenues through cross selling to common customers;
- higher prices if the strong brands of one firm can be conferred on the mundane products of the other.

To calculate the *maximum* value of a company where synergies are available you should use the increase in group earnings post acquisition as the basis for valuation.

Example

Company A seeks to acquire Company B. Both are logistics firms.

Company A presently has turnover of $1397m, post tax profits of $293m and long term borrowings of $217m at 7%. It estimates its WACC at 8%.

Company B presently has turnover of $987m, post tax profits of $187m and long term borrowings of $300m at 8%.

Company A has estimated the following data about Company B:

- it has a chain of warehouses which could be sold for $280m within a year of acquisition and all functions absorbed within A's, own warehouses at an increased cost of $28m. B's warehouses presently cost $132m per year to operate, and closure would lead to redundancy costs of $117m;
- it's administration costs of $200m could be reduced by 50% if it were to adopt B's computerised ordering systems;
- reducing competition from company B will increase prices of logistics contracts by 12%.

What is the maximum price that A should pay for B?

Combined profit of A & B ($293 + $187)	$480m
Increase in profit from 12% rise in revenues	
0.12(1397 + 987)	$286m
Increased profits due to transfer of warehousing (132–28)	$104m
Reduction in administration costs (0.5 × 200m)	$100m
Reduction in interest costs (300 − 280) × (8%−7%)	$0.2m
Total group sustainable earnings	$970.2m
less existing earnings of Company A	$293m
Increased earnings	$677.2m
Assume earnings continue 10 years at WACC of 8% AF =	6.145
PV of increased earnings	$4161.4m
plus net proceeds from disposal of warehouses	
($280 – $117) × 0.926	$150.9
Total value	**$4312.3m**

Of necessity these calculations can be rough and ready and shareholders in A might question why they are paying 23 times current earnings for B. Of course Company A would not offer $4,312.3m for B but something less in the hope that the synergies here would come to its own shareholders rather than all being given to the shareholders who are selling B.

4.16 Generating strategic options

The following models can be used in two ways to help you pass TOPCIMA:

1. The pre-seen or unseen may contain information on strategic options being considered by management. These models will help you critique these options.
2. You may be required to recommend options of your own. These models may help you generate them.

4.16.1 Choice of generic strategy

Porter's prescriptions for generic competitive strategy were reviewed in Section 4.7.3.

The point to recall here is that high levels of profitability are believed to result from a firm dedicating itself to one of the generic strategies.

4.16.2 Product market strategy – the Ansoff matrix

Demonstrates the choices of strategic direction open to a firm in the form of a matrix (Figure 4.29).

1. Market penetration strategy

Firm increases its sales in its present line of business. This can be accomplished by

- price reductions,
- increases in promotional and distribution support,
- acquisition of a rival in the same market,
- modest product refinements.

Markets \ Products	Present	New
Present	Market penetration	Product development
New	Market development	Diversification - related - unrelated

Figure 4.29 The Ansoff product-market scope matrix

These strategies involve increasing the firm's investment in a product/market and so are generally only used in markets which are growing and hence the investment may be recouped. In this respect, the strategy is similar to the *invest to build* and *holding* strategy discussed by the Boston Consulting Group.

2. Product development strategy

This involves extending the product range available to the firm's existing markets. These products may be obtained by

- investment in the research and development of additional products;
- acquisition of rights to produce someone else's product;
- buying in the product and 'badging' it;
- joint development with owners of another product who need access to the firm's distribution channels or brands.

The critical factor to the success of this strategy is the profitability of the customer group for which the products are being developed. Also the firm's present competitive advantages in serving the market must confer on to the new good. These can include:

- customer information that allows accurate targeting,
- established distribution channels,
- a brand which can be credibly applied to the new product.

3. Market development strategies

Here the firm develops through finding another group of buyers for its products. Examples include:

- different customer segments: for example, introducing younger people to goods previously purchased mainly by adults;
- industrial buyers for a good that was previously sold only to households;
- new areas or regions of the country;
- foreign markets.

This strategy is more likely to be successful where

- the firm has a unique product technology it can leverage in the new market;
- it benefits from economies of scale if it increases output;
- the new market is not too different from the one it has experience of;
- the buyers in the market are intrinsically profitable.

4. Diversification strategies

Here the firm is becoming involved in an entirely new industry, or a different stage in the value chain of its present industry.

Ansoff distinguishes several forms of diversification:

1. *Related diversification*. Here there is some relationship, and therefore potential synergy, between the firm's existing business and the new product/market space.
   (a) *Concentric diversification* means there is a *technological* similarity between the industries, which means that the firm is able to leverage its technical know-how to gain some advantage.
   (b) *Vertical integration* means the firm is moving along the value system of its existing industry towards its customers (*forward vertical integration*) or towards its suppliers (*backward vertical integration*). The benefits of this are assumed to be
   - taking over the profit margin presently enjoyed by suppliers or distributors;
   - securing a demand for the product or a supply of key inputs;
   - better synchronisation of the value system;
   - reduction in buyer or supplier power.

   However, it also means increasing the firm's investment in the industry and hence its fixed cost base.
2. *Unrelated diversification*. This is otherwise termed *conglomerate growth* because the resulting corporation is a *conglomerate*, that is, a collection of businesses without any relationship to each other. The strategic justifications advanced for this strategy are:
   - to take advantage of poorly managed companies which can then be turned around and either run at a gain to the shareholders or sold-on at a profit;
   - to spread the risks of the firm across a wide range of industries;
   - to escape a mature or declining industry by using the positive cash flows from it to develop into new and more profitable areas of business.

4.16.3 Strategic development and risk

Developing a firm beyond its present product/market space exposes it to a combination of four sorts of risks. These risks are particularly acute where diversification is concerned because of the simultaneous novelty of both product and market.

(a) *Market Risk:* The firm has entered a new market where established firms already operate. The risks here are
- not correctly understanding the culture of the market or the needs of the customer;
- high distribution costs due to lack of economies of scale;
- failure to be seen as credible by the buyers in the market due to lack of track record or brand;
- exposure to retaliation by established firms with more entrenched positions.

(b) *Product Risk:* The firm is involving itself in a new production process, which is already being conducted by rival firms: The risks this poses are:
- higher production costs due to lack of experience;
- initial quality problems or inferior products causing irreparable harm to reputation in the market;
- lack of established production infrastructure and supply chain relations which will make costs higher and may limit product innovation and quality.

(c) *Operational and managerial risk:* This boils down to the danger that management will not be able to run the new business properly. This carries with it the second danger that management will also be distracted from running the original business effectively too.

(d) *Financial risk:* This relates to the share price of the business. Shareholders are generally suspicious of 'radical' departures (and particularly diversification) for the following reasons:
- the product and market risks lead to volatile returns;
- the firm may need to write off substantial new net assets if the venture fails;
- the investment needed will reduce dividend and/or necessitate new borrowing;
- a diverse and unique portfolio makes it harder to compare the firm to others in the same industry when trying to evaluate its risks and returns.

The effect will be for the share price to decline to reflect the uncertainties created by the strategy.

4.16.4 The expansion method matrix

Lynch (1997) presents the alternative growth strategies as shown in Figure 4.30.

1. Internal development (organic growth)

Here the firm grows by using its own capital sources to invest in new capital assets, product development and staff development. The principle benefits of this approach are:

(a) firm does not need to assimilate the differing personal, cultures or operating systems of another organisation;
(b) investment can be controlled and incremental unlike acquisition when the firm must commit substantial funds in an all-or-nothing gamble;
(c) provides development and learning opportunities to staff;
(d) avoids the need for a goodwill premium at acquisition; instead assets are acquired at just their market value;
(e) demonstrates to investors the ability of management to grow their own business and create opportunities. This should improve the share price.

The drawbacks are

(a) firm will not at first enjoy the economies of scale and experience effects available to rivals;
(b) market entry may be too slow if the industry is developing quickly;
(c) increases the number of firms in the industry which increases complexity and may provoke hostile responses from established firms;
(d) firm may lack access to key resources or customers if the industry features complex long-term supply contracts.

Geographical location	Company: Internal development	Company: External development
Home country	Internal development	Merger Acquisition Joint venture Alliance Franchise/license
International	Exporting Overseas office Overseas manufacture Multinational operation Global operation	Merger Acquisition Joint venture Alliance Franchise/license Turnkey

Figure 4.30 Lynch's expansion method matrix (adapted from Lynch 1997)

2. Mergers and acquisitions (external growth)

Benefits of a firm pursuing strategic development into a product/market space by mergers or acquisition are:

(a) firm acquires the goodwill (expertise, contacts customers and reputation) of the acquired firm;
(b) eliminates a potential rival in the market;
(c) swifter access to the industry than internal development;
(d) possibility of some risk spreading if the acquired company has businesses in unrelated areas;
(e) lower commercial risk because the target will have already established itself in the industry;
(f) possibility of acquiring assets cheaply if the target is undervalued by investors, for example, due to poor present management.

Drawbacks of acquisition led growth are:

(a) difficult to arrive at the correct price for the acquisition due to lack of financial information, bid fever and possibility of third parties bidding against the predator;
(b) high cost of integrating systems of work, management controls, human resource procedures and information systems;
(c) need to rationalise operations will incur costs of redundancies, asset disposals, cancellation of leases and supplier contracts;
(d) failure of most mergers and acquisitions to realise the benefits originally envisaged;
(e) problems of uncontrolled staff losses and falling morale due to rationalisation programme and clashes of culture amongst staff from senior management down;
(f) very high initial capital costs because the predator must compensate the target's shareholders for at least the expected present value of the profits from the target;

(g) excessive reliance on external growth will depress the predator's share price because investors cannot assess the level of future earnings of the business without knowing what the next acquisition will be;
(h) high degrees of share price volatility fuelled by bid rumours;
(i) failure to win a bid will leave the impression that the predator's strategy is failing.

3. Joint development strategies

These involve the firm working with another firm under an arrangement of greater or lesser formality.

1. ***Joint venture***. The partners form a separate company in which each holds an equity stake. Usually management is provided by the parties to the agreement and is able to draw on the expertise of the parties.

   Benefits are
   (a) reduces risk because the firm's capital commitment is halved;
   (b) each party gains access to the competences of the other;
   (c) avoid developing the opportunity separately and ending up in competition;
   (d) partnership with firms in host economies allows foreign firms a route into otherwise protected markets.

   Drawbacks are
   (a) disputes over operational matters such as use of trademarks, pay levels and approach to markets;
   (b) possibility that partners will gain confidential information about each other which may be used to compete elsewhere or if the venture breaks down;
   (c) disputes over the amount of effort being put in, the allocation of partners costs and the division of rewards;
   (d) lack of support from joint venture management from parent companies because neither feels they own it.
2. ***Strategic alliances***. Two or more firms agree to work together to exploit common advantages. The precise arrangements will differ from merely an informal agreement between management, through a legal arrangement, to a cementing of the relationship with the swapping of equity.

   The benefits are similar to joint ventures but in addition a strategic alliance is often used to allow smaller firms to present an effective alternative to a large dominant player in the market.

   However there are some special difficulties:
   (a) ambiguity in the alliance agreement or the breakdown of trust between partners will jeopardise the alliance;
   (b) some informal alliances risk breaking laws against collusion and cartels;
   (c) because partners remain essentially separate many alliances fail to achieve the integration and commitment necessary to gain significant strategic advantage.

The May 2004 case on Ofood4U introduced an opportunity for a strategic alliance in the unseen material and candidates were required to calculate the NPV of the proposed strategic alliance and to comment on whether this was a suitable expansion strategy for Ofood4U. Answers were generally disappointing as many students simply commented on the financial results and not the long term strategic effects, and risks, of the proposed strategic alliance. This expansion strategy has been examined once, and therefore it could come up again!

3. ***Franchises***. Here the firm expands its business by granting other firms the right to use its business systems.

   The firm (the *franchiser*) will provide a variety of supports to the buyer of the business package (the *franchisee*). These may include
   - management training,
   - a set of procedures and instructions for supplying the product/service,
   - central marketing support (e.g. inclusion in national advertising),
   - inputs such as materials or products to sell-on,
   - technical and business consultancy,
   - staff training programmes,
   - preferential access to capital.

   In return the franchisee will provide
   - an initial lump sum to buy the franchise,
   - a share of earnings (usually turnover),
   - specific payments (e.g. for training).

   The benefits of franchising to the franchiser include
   (a) quicker business expansion than would be possible using its own management and financial resources;
   (b) reduced risk due to the capital having been provided by the franchisee;
   (c) retains the dynamism of local management because they run their own business;
   (d) control over the activities of the franchisees to the extent provided for in the franchise agreement;
   (e) reduced costs of control due to franchise manager being responsible for finances, assets and staffing.

   The drawbacks of franchising include
   (a) reduced profits because they must be shared with franchisee;
   (b) need to monitor franchisee to assure consistency of product service (quality, pricing, product range, sales methods);
   (c) danger that poor franchise performance will harm the parent's brand;
   (d) problem of protecting intellectual capital from being copied by franchisees who later become rivals.

   Licenses are very similar to franchising in their financial aspects. However, the degree of central control and support is usually less. Licenses include:
   - the right to exploit a natural resource (e.g. a logging license);
   - the right to use a brand or image on a product;
   - the right to produce a product using the licenser's recipes and brand names (e.g. computer manufacturers installing Windows XP).

4. ***Agency agreements***. These are usually restricted to marketing and product support arrangements. They are particularly useful in the following situations:
   - where the customers like to compare a range of products and take advice (e.g. financial services, carpets, software);
   - the sales volumes are too low to justify a dedicated distribution channel (e.g. specialist holidays);
   - the sales are enhanced by social and family networks (e.g. cosmetics, children's books and toys).

   The agent receives a set of samples, literature and product training. They also receive a commission from their sales that are supplied from the parent company.

Agency agreements have a number of problems:

(a) the danger that the product will be miss-sold by agents anxious for commissions;

(b) the firm fails to build a relationship with the customer, or gain data, because this would undermine the agent and make them suspicious of being cut out;

(c) the danger that agents will desert the firm and take the best customers with them.

4. International growth strategies

1. *Exporting strategies*. The firm sells products made at home to buyers abroad. Often this starts with the receipt of a chance order or perhaps poor sales at home force the firm to export or perish.

   As a strategy it has a number of advantages over other international growth strategies:

   (a) firm can make use of any economies of scale it enjoys to compete in the foreign market (and home market too);

   (b) no need for any extra fixed capital investment;

   (c) does not expose the fixed capital investments of the firm to risk;

   (d) helps to insulate the firm from recessions in their home economy.

   The disadvantages are

   (a) distance from the customer means customer relationship cannot be developed nor goods customised;

   (b) increased working capital needed to support stocks in transit;

   (c) the firm exposed to foreign exchange risk which will affect its earnings or the competitiveness of its prices;

   (d) firm has less information about the credit status of the customer.

   By establishing an overseas office or appointing an agent the firm can overcome some of the problems of lack of customer contact or the need for minor modifications.

2. *Overseas Manufacture*. This strategy has two aspects:

   (a) The firm arranges for its products (or some parts of them) to be manufactured abroad and then imported back to its home economy.

   (b) The firm arranges for its products to be manufactured in a foreign country for sale there.

   In both cases the firm is involved in *direct foreign investment* because it is purchasing productive capital assets in the country. This brings certain advantages:

   (a) firm can benefit from lower costs of local economy (labour, buildings and inputs);

   (b) reduced transportation costs;

   (c) reduced foreign exchange exposure because production costs are now incurred in the same currency as the good are paid for in;

   (d) because it provides jobs the firm may gain access to markets previously closed to foreign goods;

   (e) cheaper goods bolster margins in home markets.

   The drawbacks are

   (a) Assets exposed to risk in the foreign economy (e.g. war, sequestration, sabotage, or collapse of the local market).

   (b) Firm may have difficulty obtaining its profits due to currency controls or punitive taxation on exported dividends.

   (c) Absence of an exit route if production depends on a license because if the firm wants to sell the factory the national government can decide who it goes to (and the price) because it's worthless without the license.

3. *Multinational operation.* Two features setting multinational enterprises (MNEs) apart from other firms with foreign trading activities:
   (a) It has a deliberate policy of coordinating its value-adding activities across national boundaries.
   (b) It *internalises* the cross-border trades (i.e. it does not rely on a market to carry them out but rather uses its own bureaucratic processes).

   The advantages of this arrangement are
   (a) The firm can take maximum advantage of natural resources and lower production costs.
   (b) The firm is insulated from the effects of hostile governments or trade unions in any specific country because it can always switch (or threaten to switch) output elsewhere.
   (c) The firm can manage its taxation by arranging to make its profits in low tax economies.

   The main drawback is that the multinational is often viewed with suspicion by the governments of host countries because of its foreign ownership and high-potential power.
4. *Turnkey operations.* These are factories and facilities in foreign countries with which the home firm can establish production contracts. When the firm requires output it exercises the contract (i.e. it turns the key). This is sometimes termed *contract manufacturing*.

4.17 Sources of business finance

(1) TOPCIMA may require you to comment on the ways in which a firm is financed or to suggest ways it could improve its financing or raise more capital.
(2) The principal sources of finance will be reviewed in this section. Broadly they can be divided into two forms:
   - *equity capital:* investors buy a share in the business;
   - *debt capital:* the firm takes on a legal obligation to repay interest and capital.

4.17.1 Issuing equity to raise capital

The main equity markets available to UK firms are:

- *The Official List:* Admission to this allows a firm's shares to be traded on the 'main market' of the London Stock Exchange. Listing costs are many hundreds of thousands of pounds and the requirements for entry, administered by the United Kingdom Listing Authority, are stringent and include a 3-year trading record (except new technology stocks which can join techMARK with 1-year's record), that no person or connected persons should hold more than 30% of the equity and that at all times at least 25% of the shares should be in public hands in order for a liquid market to exist. These requirements and initial costs that run into several millions of pounds effectively prohibit small and young companies from joining.
- *The Alternative Investment Market (AIM):* A cheap and less regulated market operated by the London Stock Exchange where small and young companies can have their shares traded. There is no minimum size nor minimum trading record. There are no restrictions on the percentage of shares that can be closely controlled. Although cheaper than a full listing it will still cost between £250,000 and £1,000,000 to achieve admission.
- *Private markets:* Some brokers operate screen-based markets (e.g. Ofex) where shares can be traded on a matched trade basis. Effectively this is a bulletin board where buyers and sellers of a stock post offers and bids and conduct matched trades.

Some global firms elect to have listings on several markets (say London, New York and Tokyo) for the following reasons:

1. to broaden the shareholder base to get a better price for shares;
2. to gain access to more capital than the domestic market alone can provide;
3. to raise greater global awareness of the company.

The process for gaining a listing (or designation on AIM) is:

1. Appoint a sponsor: This will be a member firm of the London Stock Exchange such as a large bank or brokerage. They will:
   - advise on method of floatation and issuing of shares;
   - ensure directors and firm is of sufficient quality to join the market;
   - arrange a broker and market maker to hold stock and buy and sell it;
   - advise on price and timing of floatation;
   - arrange for underwriting of shares (i.e. standby buyers who to agree to buy at a minimum price if the float is under subscribed).
2. Produce a prospectus outlining history of firm, trading record, future plans and reasons for seeking finance.
3. Engage solicitors, accountants/auditors and registrars acceptable to investors and the market.
4. Decide method of selling shares and issue price.

Issue methods include:

1. *Offer for sale:* Shares are advertised at a set price and buyers subscribe for them. Alternatively in and *offer for sale by tender* buyers write in and bid for set amounts of shares at a price of their own choosing. Shares are then allotted starting with the highest bidder and working down.
2. *Introduction.* This raises no capital but merely allows the shares to be traded on the market. It can be a good exit route for otherwise locked-in shareholders.
3. *Placing:* The sponsoring broker arranges for the shares to be sold to their own private clients. This saves money on advertising and gives a more certain value for the shares. It can also avoid the shares falling into hostile hands.

4.17.2 Venture capital

Specialist firms well-connected to banks and networked well into the business world who rely on their judgement to make deals to provide equity capital for start-up businesses and developing or recovering businesses. The high risks lead these equity investors to expect a 500%+ return within 5–10 years from the sale of their equity

- in a floatation,
- in a trade sale of the business to another firm.

Average investment is £5–10m for which very high-annual rates of return are required (e.g. up to 80% ROCE) in order to ensure the EPS rises sufficiently to give a large capital gain on sale of the shares.

VCs will often effectively control the company by:

- allocating themselves special voting rights,
- selecting the Chairman and several of the non-executives,

- building in further releases of equity to themselves if the required ROCE is not hit in order to maintain earnings at the expense of other shareholders,
- providing the means by which a bank will agree to provide debt to the firm, based on the participation of the VC.

Equity may be provided for a number of purposes:

1. Seedcorn capital – to support a new business concept by financing R&D or writing of a business plan (in the dot.com era this was called 'incubator capital').
2. Start-up capital – investment in initial capital assets to start production.
3. Development capital – fast growth companies with negative cash flows will use this to continue building their businesses.
4. Management buy-outs (MBOs) – members of the management team gain capital and buy the firm from its present owners.
5. Management buy-ins (MBIs) – an outside team of managers, often known to the VCs, borrow the money and purchase the business from its present owners.
6. Buy-in management buyout (BIMBO) – a hybrid of an MBO and an MBI.

4.17.3 Raising debt capital

Methods are:

1. *Corporate bonds:* Sometimes called *loan stock* these are a long-term contract to borrow money in return for a periodic payment of interest and eventual repayment of capital. *Debentures* are bonds secured on specific assets or on a floating charge over a group of assets.

   Bonds often carry covenants constraining management: for example, from issuing further debt; paying dividends above a certain level; disposing of assets or breaching certain financial ratios.

   Specific forms of bond include
   - *Deep discounted bonds* which carry very little coupon interest but which are sold at a substantial discount to face value to give a large capital gain at redemption. This enables firms with little or no free cash flows to borrow without struggling to pay the interest.
   - *Mezzanine debt* (or junk bonds): Pay high rates of return because they are issued by firms with little collateral and are hence high risk.
   - *Convertible bonds* (or equity-linked bond): In addition to carrying interest, this bond also gives the holder the right to exchange them for a set number of shares at a future date. The hope value of the equity leads lenders to accept a lower rate of interest than they would seek for a plain bond.
   - *Foreign bonds* (or eurobonds): These bonds are denominated in a foreign currency. Firms that receive revenues in the same foreign currency may prefer these in order to hedge some of their foreign exchange risk by matching the servicing currency for debt to their earnings currency.
2. *Commercial paper:* Sometimes called *commercial bills* these are short-term IOUs issued by a firm under a revolving underwriting agreement with a bank. They are issued at discount to redemption value and the holder makes a capital gain at maturity. They principally finance cash flow needs.
3. *Project finance:* finance raised specifically for a discreet project and hence separate from the financial structure of the rest of the firm. This insulates the parent company from some of the risks of the project and also avoids a risky or unusual project pulling up the

WACC of the whole firm. It also provides a vehicle for attracting funds from sources with a special interest in a project such as a key supplier, the World Bank or a sovereign government in the project's home country.

4. *Sale and leaseback:* Firm sells assets such as buildings, cars or machines to a finance house and then leases the use of them back. This releases a cash sum that can be ploughed into the business (or to pay a dividend if the firm is struggling). The drawback of this method is that the firm will now have to make a perpetual payment for the use of the assets which, although tax deductible, will still reduce distributable profits. Therefore, it is critical that the released funds can be invested in projects with a higher rate of return than the effective cost of the lease.
5. *Bank loans:* The most common form of debt finance for firms. Usually between 5 and 20 years with a floating or fixed charge against assets of the firm and liable to a fixed or floating interest charge.
6. *Bank overdraft:* This carries a high rate of interest and can be called in at very short notice. It should only be used for financing short-term cash flow needs.
7. *Trade Credit:* Provided by suppliers of materials, stocks or services. This initially seems free credit but recipient firm that relies on this may find itself tied to a particular supplier or forced to accept less good prices or early payment discounts on invoices.
8. *Debt factoring:* Firm seeks to liquidate its trade debtors by assigning them to a discount to a finance house in return for an initial cash sum. This sum increases with the quality of the debtors assigned and under a recourse factoring arrangement the sums ultimately received by the firm will only be what debtors pay, less an administration fee to the finance house. Non-recourse factoring arrangements shift the risk of non-payment to the debt factoring house but this will involve a smaller amount of cash being paid for the debts when they are assigned.
9. *Leasing:* Paying for the use of an asset, which remains owned by the finance house. With *finance* leases the firm is obliged to continue to pay for the use of the asset whether it needs it or not. An *operating* lease holds out the prospect of returning an asset if it is not needed which can help reduce the fixed cost base of a firm.

4.18 Evaluating strategic options

In TOPCIMA you may be called upon to comment on the appropriateness of a strategy being suggested by the board. Alternatively you may decide to argue for a strategy you have thought-up yourself.

To do either you must evaluate strategies against three criteria.

4.18.1 The three criteria for strategic choice

Johnson and Scholes (1997) outline three tests for assessing whether a strategic option should be undertaken:

1. *Suitability test.* This considers whether the option is the right one *given the circumstances of the firm.* This boils down to its fit with the SWOT analysis and its accordance with the firm's mission.
2. *Acceptability test.* Considers whether the option will gain the support it needs to be successful. This involves an assessment of the likely response and power of key stakeholders such as
   - shareholders,
   - management,

		Level of interest	
		Low	High
Power	Low	A Minimal effort	B Keep informed
	High	C Keep satisfied	D Key players

Figure 4.31 Mendelow's power-interest matrix

- customers,
- regulators and government,
- employees,
- suppliers.

3. *Feasibility test*. This considers questions such as:
   - the reliability of the data or assumptions that support the strategy;
   - the availability of resources or competences to make a success of the strategy;
   - the firm's track record in similar strategies.

4.18.2 Stakeholder mapping

Mendelow (1991) proposes the diagram shown in Figure 4.31 to help analyse stakeholders:

Scholes (1998) suggests the following strategies to deal with stakeholders in each quadrant:

Box A	*Direction*. This means their lack of interest and power makes them malleable. They are more likely than others to accept what they are told and follow instructions
Box B	*Education/Communication*. The positively disposed groups from this quadrant may lobby others to support the strategy. Also if the strategy is presented as rational or inevitable to the dissenters, or a show of consultation gone through, this may stop them joining forces with more powerful dissenters in C and D
Box C	*Intervention*. The key here is to keep the occupants satisfied to avoid them gaining interest and shifting into D. Usually this is done by reassuring them of the likely outcomes of the strategy well in advance
Box D	*Participation*. These stakeholders can be major drivers of the change and major opponents of the strategy. Initially there should be education/communication to assure them that the change is necessary followed by discussion of how to implement it

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Reading and Analysing The Pre-seen Material

5

5.1 Introduction

This chapter illustrates the analysis techniques that can be used for the pre-seen material using two past CIMA cases:

- Global Stores Inc (FLCS May 2002) in Sections 5.2–5.7;
- Sparkle (FLCS May 2003) in Sections 5.8–5.13.

The analysis of each of these two cases will also extend into analysing and discussing the unseen material and the requirement for each case.

You should focus on how all of the techniques that you have learned and revised in Chapters 3 and 4 can be applied to yield perspectives and insights into these cases.

By understanding these techniques and how to apply them to these two FLCS cases, it will enable you to confidently use these techniques in the TOPCIMA case that you are preparing for.

CIMA recommend that you practice on around three cases before you work on the pre-seen material for the case that you plan to sit. In this chapter are two past CIMA cases that have been analysed for you, so that you can learn and appreciate the amount of research and preparation that is necessary for the TOPCIMA exam.

5.2 Global Inc pre-seen material (*FLCS* May 2002)

The Global pre-seen material is given below, with an analysis of it given in Sections 5.3 and 5.4. The unseen material and the requirement are given in Section 5.5. Do **NOT** cheat and look at it yet – analyse and understand the pre-seen material first!

Global Incorporated

Introduction

Global is a well established and substantial supermarket group incorporated and based in the country of Westland, with its headquarters in Midcity. It has developed from what was once, early in the twentieth century, a family grocery business, to a company owning a large number of high street grocery stores, which prospered as transport of manufactured foods became cheaper. It used its ever-increasing volume requirements to buy at lower prices than its much smaller rivals. Strategy was initially driven by cost leadership. Prior to the development of supermarkets, it was one of the largest grocery retailers in the world.

The initial development of self-service groceries was ignored by Global, which regarded personal customer service as significant, and the potential labour savings as irrelevant. Its immense buying power led to very satisfactory profits. However, developments in Westland moved in ways that Global did not anticipate. Labour became more expensive in conditions of full employment after the Second World War, with increasing legislation protecting employee rights. The personal service on which Global had prided itself was being priced out of the market. The leverage of its vast buying power over domestic suppliers became less effective under successive anti-trust legislation, which constrained buying power to reflect real differences in costs incurred by the suppliers. Under this legislation, other customers could demand comparable prices, unless the suppliers could show differences in cost arising from variations in manufacture, packaging and distribution. Perhaps more important for the longer term, customers regarded the new self-service stores as modern and preferable, and the Global stores as old-fashioned and dull.

Market Stores, which is also incorporated and based in Westland, had originally been a smaller rival of Global, but had been an early developer of self-service grocery stores. It continued to innovate, developing larger stores. It found that labour savings increased, and that a wider range of groceries and general merchandise could be sold in these stores without excessive stockholding costs. The customers liked this, and were also attracted by the first out-of-town stores, which were even larger, and provided easy and free car parking for customers, avoiding town centre congestion. Customers were no longer limited to buying what they could carry away by public transport; they could, if they wished, fill their cars.

Market Stores has continued to innovate in retailing, introducing additional facilities and services into its stores, such as post office boxes, cash-point banking facilities, baby-changing facilities, mother and baby parking facilities, home-delivery service, special food counters (such as fresh fish), in-store bakery, pharmacy, coffee shop, loyalty card discount schemes, petrol stations.

The market in which Market Stores and Global operated changed into one in which, with the development of a "one-stop shop" pattern, customers could buy most or all of their weekly food and other regular requirements in a single visit. The market comprises a large number of local catchment areas within which customers can reach a supermarket in a relatively short time. In some cases, these catchment areas overlap.

By the time that Global started to assess developments by Market Stores, and recognised that the market for groceries may have changed, investors had been attracted to Market Stores because of its high growth rate and attractive margins. Market Stores used its resulting high share price to acquire a number of smaller groups, and to raise new capital to continue to build out-of-town stores. Every time Market Stores reviewed its building programme, it commissioned larger stores.

Global had responded to the developments by Market Stores, and followed it in converting stores to self-service, and in building out-of-town stores. But this was initially done on an experimental basis, to see if there were genuine savings to be achieved. Development did not occur on the same scale as, or with the speed of, Market Stores. Global did no more than follow Market Stores in selling a much wider range of products. Nor did Global do more than

follow Market Stores in the introduction of bar coding of products and prices and the introduction of electronic point-of-sale (EPOS) technology.

Market Stores had, many years ago, overtaken Global to become the largest and most profitable supermarket group in Westland.

Global and Market Stores – financial information for years ended during 2001

	Global	*Market Stores*
Sales	\$43·9 billion	\$211·4 billion
Profit after tax	\$1·43 billion	\$7·10 billion
Shares	900 million	4,700 million
Earnings per share	\$1·59	\$1·51
Information at 31 January 2002:		
Share price at 31 January 2002	\$34·96	\$56·65
Price / Earnings ratio	22·0	37·5
Market capitalisation	\$31·46 billion	\$266·3 billion

Note: Figures are given in billions unless stated otherwise. One billion = 1,000 million

The latest published quarterly "like for like" sales growth figures (that is, for comparable stores, excluding new openings) show that Market Stores is growing at a rate of over 5% each year in these terms, whilst Global is achieving under 2%. To this must be added the vast area of new sales space being built each year by Market Stores. It is also expanding overseas very rapidly, and is rumoured to be likely to make further acquisitions.

Analysts working for consumer organisations broadly agree that Market Stores, with its greater turnover leading to immense purchasing power, buys more cheaply than Global. It can match selling prices or sell even more cheaply without damaging margins. Measurements of this are disputed, and confused by the number of special promotions that Global normally operates to stimulate customer interest. Measurement is also confused by quality issues; Global targets more affluent customers than Market Stores, and claims to place more emphasis on quality.

A greater proportion of Market Stores' sales comes from very large out-of-town superstores, while a considerable proportion of Global's sales are generated in smaller stores in central locations. Market Stores is believed to have a significantly higher spend per customer visit.

Global has also come under pressure from other fast-growing competitors, which have either prospered by being more "up market", in an era of growing affluence, or have built very strong regional market shares. Some of these now appear to be able to buy at least as effectively as Global.

Preparations for a strategy meeting

Gabriel Eisenstein, Chairman of Global, has asked the members of the board of Global and the senior managers to attend a meeting to review strategy.

Global's board members and senior management

Members of the board:

Gabriel Eisenstein	Chairman, non-executive director
Carl Frosch	Non-executive director
John Falke	Non-executive director
Alfred Strauss	Non-executive director
General Thomas Frank	Non-executive director
John Parker	Chief Executive Officer and President
David Cohen	Finance Director
Jack Louis	Operations Director, Westland

The senior management:

Charles le Grand	Vice President, Information Systems
James Stuart	Vice President, Purchasing
Arthur Miller	Vice President, International
Susan Hageman	Vice President, Human Resources

Profiles of Global's board members and senior management

Gabriel Eisenstein, the non-executive chairman, was formerly the senior partner of Eisenstein & Co, Merchant Bankers, who act for Global, and have done so for very many years, in its relatively few acquisitions and more frequent fund raising requirements. He had become aware of increasing investor dissatisfaction with the limited progress made by Global, and the adverse comparisons being made with Market Stores, and other competitors. He realised that raising more capital on attractive terms was going to be quite difficult, and that, without a very good case being made by the company, the main institutional investors might refuse to participate.

Carl Frosch is a non-executive director, and a former partner in Frosch & Frosch, legal advisors to large corporations. He had discussed the position of Global with the Westland anti-trust authorities, and received clear, but unwelcome, advice. Acquisitions in Westland would only be permitted on a limited scale, even though Global is now much smaller than Market Stores. Global may be permitted to buy stores in areas where it has few stores, but would at best be allowed to increase the number of stores owned by no more than 10% each year. If more acquisitions were proposed, it may be forced to sell stores to balance its presence in other areas where it dominates the market. The political and regulatory environment is generally unfavourable. The farming lobby claims that supermarkets exploit farmers and discriminate against small local suppliers. The environmental lobby complains that the growth of out-of-town superstores leads to increased car usage.

John Falke is the president of Universal Insurance, which is a major investor in Global, holding 5% of the share capital and a significant amount of loan stock. He is a non-executive director of Global. He had met his fund management team, and had been advised that it wished to reduce its holding in Global, which the team considered to be significantly overweight in view of the limited growth prospects. He considered that, if this is the best policy for Universal Insurance, either he would have to force changes at Global which would make it a more attractive investment, or resign from its board.

Alfred Strauss is a non-executive director of Global, and was formerly the partner within Global's auditors with responsibility for Global. He is concerned that, while Global's accounts met all relevant standards, and presented no problems to his former firm, he would have preferred a more conservative view to be taken on certain issues. In particular, he is concerned that Global appears to depreciate investments in store fittings and information technology more slowly than

Market Stores. He is also concerned by differences in accounting for pension liabilities, as Global has proportionately many more long-service employees than Market Stores.

General Thomas Frank had recently retired from the army, and had accepted an invitation to become a non-executive director of Global. He was busy trying to find out quite what his responsibilities were, and in which way he could contribute. However, he found the aims and strategy of Global to be unclear, despite his separate discussions with the other directors and many of the senior managers.

John Parker is 60. He has been Chief Executive Officer (CEO) of Global for four years, the culmination of a lifetime working for the company. His career had started as a trainee in a grocery shop. He had risen from a store manager to a regional manager, and eventually progressed, via Human Resources, to the post of Vice President, Westland Retail Operations, prior to becoming CEO. He is well known locally as the (non-executive) chairman of the Midcity Football Club. He is known nationally as a past chairman of the Retail Business Federation, and has often appeared on television to comment on possible regulation of the industry, and new developments. He is concerned that the growth of Market Stores continues to outstrip that of Global but could not see any easy answer in terms of improving operations in Westland. He liked the present Global supermarkets just the way they were – many long-service staff that he knew by name, customers he could talk to. He was pleased he had been able to persuade the board last year to increase job security and pension benefits for long-service employees.

However, he recognised that something had to be done to please the investors and raise the share price. He thought he might have to re-consider his ideas, if changes to the supermarkets could attract new customers into the stores. He had discussed his personal financial position with a financial advisor from the auditors, and it was clear that he needed a contract renewal in June 2003 to take him up to retirement at 65. He also needed a significant profit from his share options if he were to enjoy the sort of retirement income he envisaged. His share options, granted when he was appointed, were at present worthless, as the current share price was well below the option price.

David Cohen had been appointed Finance Director two years ago, having previously been an audit partner with the auditors, but not directly concerned with the Global audit. He found the accounting system to be rather old-fashioned. He hoped to develop a new integrated system as part of any (much overdue) information systems update. He understood the concerns expressed by Alfred Strauss regarding depreciation and pension liabilities. He felt uneasy in discussions with the institutional investors and financial analysts, who were always seeking "guidance" on likely future statements on profits, though profits had been stable and predictable. When asked further questions about future plans, he did not respond. The accounts for 2001 were still not finalised, but he had circulated, before the meeting, a summary statement, showing very limited progress in a difficult market. (This financial statement is given as *Exhibit 1.)*

Jack Louis had been appointed as Operations Director, Westland four years ago. He is responsible for controlling the stores through a structure of regional offices, and has responsibility for sales policy and sales promotions in Westland. Previously he had been Vice President, Purchasing for eight years. While he has been in the company all his working life, he does not share John Parker's view of present operations. If he had the opportunity to succeed John Parker as CEO, he would like to cut staff considerably and close many of the smaller stores. He would like to carry out such a policy now, but sees no prospect of gaining support.

Charles le Grand had been appointed Vice President, Information Systems two years ago. He had previously held a similar position with a major European supermarket group, where he had installed new advanced systems. He had been appointed by Global with the implied brief to modernise its systems, but he was uncertain whether he could persuade the board to authorise the very considerable investment required. Part of the problem related to the limited success to date of the on-line home shopping development in Westland.

James Stuart was Vice President, Purchasing. He had moved into this role four years ago after a career in purchasing with other major groups. He found that Global valued relationships with old established suppliers, and that other senior managers and directors tended to intervene to

protect their old friends whenever he wished to change suppliers. He felt that he was achieving little, and would not be averse to a move to another group, that would allow him more latitude to make an impact. He felt there was scope for reducing buying prices with firm management. Even 1% would be very big money.

Arthur Miller had joined Global two years ago as the first person to hold the appointment of Vice President, International. At 40 years, he was the youngest of those to attend the meeting. His career had been in supermarket management and regional management, including three years in Canada. He found the present overseas operations to be "a dreadful muddle", with no clear strategy, and no clear rationale for why the various investments had been made. Some investments had been sound and traded profitably. Others were at best marginal. All were quite small. While overall they added up to 12% of Global's turnover, they contributed less than 2% of the profit. Global's market share did not exceed 3% in any of the international markets in which it traded. He did not think he could recommend selling the present portfolio until he could be clearer regarding his next possible personal move. Ideally, he would sell most of the present overseas stores, retaining only the most profitable operations, and then persuade Global to make a really major overseas investment. If he succeeded, he could see a seat on the board, and the prospect of becoming CEO in due course. If there was any opportunity at this meeting, he was going to press for new investment in international operations.

Susan Hageman had been Vice President, Human Resources, for ten years, but had not been involved before in a meeting such as that planned. She was uncertain of quite what to expect, but was preparing papers on matters that concerned her, in case there was an opportunity to raise them. In particular, she wished to raise the case for a policy of allowing early retirement for some long-service employees to provide scope to recruit younger staff, especially from ethnic minorities, even though she did not think the CEO would be enthusiastic. She would also like to get involved with Global's operations outside Westland, to achieve a universal employment policy. It appeared that in many countries, staff enjoyed far greater job security and holiday entitlements than did Global staff in Westland.

The non-executive directors' dinner

The non-executive directors had all travelled to Midcity, where Global had its headquarters, the night before the meeting. As the CEO was away at a Retail Business Federation dinner in another city, they found it convenient to eat together and discuss problems.

Gabriel Eisenstein made it clear that something must be done – the company could not carry on drifting. A radical improvement in performance was needed to gain market support. Given that Global had always filled major posts from internal candidates whenever possible, he suggested that the meeting would be a good opportunity to look at an overall succession plan.

John Falke said that he thought that institutional investors would support any major acquisition in Westland, provided that it was secured by a sound property element in the valuation. He expressed disappointment that Carl Frosch's explorations suggested limited scope to acquire further supermarket businesses in Westland. However, there would be support for investment in another type of retail business or other service industry, such as hospitality, in Westland, if there were a clear business management plan to convince the analysts. Retailing, he stated, was a difficult industry in which to establish and retain a clear competitive advantage.

Alfred Strauss commented on stretched resources and the possible need, in a year or two, for a rights issue to maintain the present business, unless profits improved or working capital was considerably reduced, or investment in existing stores cut back.

General Frank, asked for his preliminary views, said that none of the senior management team that he had met to date had obvious leadership qualities – but that it would be interesting to see their performance in the meeting.

The strategy meeting

The Chairman outlined the problem of needing to raise earnings and show a positive trend. He considered that greater growth was needed to boost the share price and enable future rights issues.

The CEO, reporting on current trading and short-term forecasts, indicated that like-for-like sales in the current quarter were expected to rise by up to 2%. However, Market Stores was showing a much stronger trend, and may be growing by 5% to 7% each year in terms of like-for-like sales. Including the new stores being built each year, Market Stores is growing in total at well in excess of 15% each year. Global profits would probably be no more than static at best, and may fall slightly. He regarded maintaining the dividend as a priority, even if it meant restraining investment.

Alfred Strauss commented that this could only lead to a further fall in the share price.

The Chairman opened up the meeting, seeking suggestions for the way ahead.

The Operations Director, Westland stressed the problem of keeping the major supermarkets and superstores up-to-date and constantly refurbished to compete with Market Stores. With the large number of stores, it was difficult to achieve the target of modernising each store every seven years. If necessary, to have sufficient funds for this refurbishment, he was prepared to see the closure of some of the smaller, older stores, though this would involve significant personnel redundancies.

Both the CEO and the Vice President, Human Resources stressed the importance of having due regard for employees in difficult times, and protecting their interests as far as possible. Global had a deserved reputation as a good employer; this could easily be lost.

Questioned by Alfred Strauss, the Finance Director confirmed that some 20% of Global's more than 2,000 stores in Westland made no significant profit. The Vice President, Purchasing commented that the additional volume from this 20% of the stores helped towards obtaining the best purchasing terms. The Operations Director, Westland suggested that, without this volume, the number of suppliers could be reduced and the supply chain simplified. He continued by saying *"If we have learned anything from our exercises in activity based costing, it is that overheads are driven by complexity. The more complex the operation, the more non value adding co-ordination costs there are. The way ahead is to focus on core products, reducing the number of product lines and the number of listed suppliers. If we force suppliers to compete to remain Global suppliers, we could capture more of the value chain from our chosen suppliers, recovering our marketing costs and our sales data costs".*

The Finance Director raised the question of whether pressure should be put on suppliers to provide extended trade credit to finance refurbishment. Carl Frosch wondered whether the anti-trust authorities would accept this, but thought that it could be possible, provided that the credit taken did not extend beyond that taken by close competitors. This information was not available, and needed to be investigated. The CEO and the Vice President, Purchasing both commented on the long-term loyalty and support of many suppliers who had worked with Global, in some cases for fifty years.

The development of on-line home shopping was discussed. The Vice President, Information Systems stated that, after initial difficulties, the system was fully operational and reliable, but major investment was required to achieve a "state of the art" system. He commented that it appeared that all key dates had been met, and that sales targets had been achieved. The Operations Director, Westland commented less favourably. There were still significant numbers of queries that had to be resolved on the telephone with customers. The system costs and system support staff costs were high. There was also the problem that using store staff to pick orders from supermarket shelves placed irregular loads on store staffing; this was not practicable when the stores were busy. Home shopping orders were then delayed, which led to more queries. Questioned by the Vice President, Information Systems, he confirmed that the frequent delivery delays were caused by operational and staffing problems in stores, rather than information system problems. There was a separate problem that also affected this issue. The basic information on sales by product was still very slow, and Purchasing, waiting for this

information, was unable to prevent a high level of stock-outs. This problem particularly affected special promotions and products sold at exceptionally low prices which are widely advertised. He agreed to circulate a note of the problems after the meeting. (This is given as *Exhibit 3.)*

A related issue caused some inconclusive discussion. Both the Operations Director, Westland and the Vice President, Information Systems commented that, on their reading of the original justification for on-line home shopping, it should have been in profit by the time present sales levels were reached, but that the current reports showed significant losses. The Finance Director said that this was a matter of the allocation of overhead costs for the information system and the stores. He was asked to provide a clear report and a post audit report on the project for a subsequent meeting. It was considered undesirable to proceed too far with this venture without knowing whether it was profitable.

The Vice President, International suggested that sales growth rates in a number of countries were more attractive than those in Westland, and that trading profits were potentially significantly higher. He considered that it would be sensible to go for a major acquisition which was big enough to make a significant difference to Global's earnings, rather than a series of small investments like the present scattered Global international operations. Challenged by both the CEO and John Falke on whether this was a high-risk strategy, he commented that "doing nothing" in Westland also appeared to be a high-risk strategy, with very limited possible outcomes. He presented some brief statistics on the market and the competing stores in Eastland, and was asked to provide further data.

The question was raised of who would manage the acquired company. The Vice President, International stressed the need for good local management, by local nationals, who understood local customers and tastes. The CEO stressed the desirability for top jobs to be held by Westland nationals to ease communication with head office.

General Frank suggested that a major acquisition within Westland should be considered. However, no-one present had any clear ideas of potential acquisitions or synergies. This was left for further investigation.

Summing up, the Chairman commented on the need for all ideas to be followed up for a further meeting as soon as more data was available. He stated that he would discuss with the CEO what information would be immediately available for prompt circulation, and a programme for collating further relevant information for another meeting in two to three months' time.

Immediately after the meeting

The non-executive directors decided that it was too late to travel from Midcity, and that it would be useful to discuss outcomes with John Parker, the CEO.

Gabriel Eisenstein made it clear to John Parker that there was no prospect of a contract renewal for him unless immediate action was taken to improve Global's earnings. The share price had fallen over the past two years from over $50, reflecting the lack of growth. Proposals had to be found that would appeal to the financial markets; it was no use being sentimental about long-serving employees or old-established suppliers when the group itself was running into difficulty.

Gabriel Eisenstein then discussed the further information requirements, and agreed that basic data regarding the Eastland market should be circulated to those at the meeting.

The document circulated a few days after the meeting, comprising the data for Eastland Supermarket Groups, is given as *Exhibit 2.*

Other required information should be distributed before the next meeting. The methods of obtaining this, and the timetable, were discussed and agreed.

John Parker then left and the non-executive directors continued their discussions.

General Frank commented that there was limited indication of possible innovative thought from most of those present, apart from the Vice President, International. But he recognised that

speaking out in the presence of one's immediate superior, and possibly being seen to criticise him, could be very difficult, especially in a very traditional organisation.

Exhibit 1

Summary financial statement circulated by David Cohen

Global's draft summary data for 2001 – subject to audit

Year ended 31 December	*2001*	*2000*	*1999*
	$ billion	*$ billion*	*$ billion*
Sales	43·90	41·50	38·40
Cost of goods sold	34·60	32·54	29·80
Gross profit	9·30	8·96	8·60
Store and administration costs	5·89	5·64	5·52
Depreciation	0·92	0·91	0·79
Interest	0·35	0·34	0·37
Profit before tax	2·14	2·07	1·92
Tax	0·71	0·68	0·63
Profit after tax	1·43	1·39	1·29

At 31 December	*2001*	*2000*	*1999*
	$ billion	*$ billion*	*$ billion*
Fixed assets	7·56	7·40	6·96
Current assets	9·08	8·28	8·17
Less current liabilities	(4·61)	(4·11)	(3·69)
Net current assets	4·47	4·17	4·48
Total assets less current liabilities	12·03	11·57	11·44
Long-term liabilities	4·56	4·40	4·58
Shareholders' equity	7·47	7·17	6·86
	12·03	11·57	11·44

Exhibit 2

Basic financial data for the top 5 Eastland supermarket groups for years ended during 2001

Supermarket group:	*A*	*B*	*C*	*D*	*E*
Sales	€34·10 billion	€28·26 billion	€16.86 billion	€13.36 billion	€7.56 billion
Profit / (loss) after tax	€1·28 billion	€0·44 billion	€0·49 billion	€0·37 billion	€(0·03) billion
Shares	7,140 million	1,950 million	2,560 million	1,020 million	490 million
Earnings per share	€0·179	€0.23	€0.19	€0·36	€(0·06)

Information at 28 February 2002

Share price at 28 February 2002	€3·40	€5·40	€3·65	€5·20	€1·67
Price / Earnings ratio	18·9	23·5	19·2	14·4	–
Market capitalisation	€24·28 billion	€10·53 billion	€9·34 billion	€5·30 billion	€0·82 billion

Exchange rate: assume €1= $0·86

Summary balance sheet information at year-end dates in 2001

Supermarket group:	*A*	*B*	*C*	*D*	*E*
	€ billion	*€ billion*	*€ billion*	*€ billion*	*€ billion*
Fixed assets	16·40	10·91	7·17	14·78	1·53
Current assets	2·76	6·04	1·66	3·74	0·94
Less current liabilities	(7·21)	(7·09)	(3·84)	(4·38)	(1·07)
Net current assets / (liabilities)	(4·45)	(1·05)	(2·18)	(0·64)	(0·13)
Total assets less current liabilities	11·95	9·86	4·99	14·14	1·40
Long-term liabilities	3·25	1·81	0·92	7·88	0·24
Shareholders' equity	8·70	8·05	4·07	6·26	1·16
	11·95	9·86	4·99	14·14	1·40

Summary profit and loss account information for years ended at dates in 2001

Supermarket group:	*A*	*B*	*C*	*D*	*E*
	€ billion	*€ billion*	*€ billion*	*€ billion*	*€ billion*
Sales	34·10	28·26	16·86	13·36	7·56
Profit / (loss) before tax	1·75	0·71	0·73	0·52	(0·14)
Less tax	0·47	0·27	0·24	0·15	(0·11)
Profit / (loss) after tax	1·28	0·44	0·49	0·37	(0·03)

Statistics – Eastland Stores (figures for years ended during 2001)

Supermarket group:	*A*	*B*	*C*	*D*	*E*
Eastland total stores	697	470	249	488	1,319
Eastland superstores *	297	304	242	160	–
Eastland sales **	€29·8 billion	€20·2 billion	€16·2 billion	€12·8 billion	€7·56 billion
Employees (thousands)	225	197	109	87	60

* Superstores are large out-of-town stores. The number is included in the total number of stores above.

** Eastland sales exclude overseas sales by the groups.

Percentage of own brand products sold (figures for years ended during 2001)

Supermarket group:	*A*	*B*	*C*	*D*	*E*
Percentage of own brand products sold	53	62	31	45	48

Latest quarterly data on like-for-like sales

Supermarket group:	*A*	*B*	*C*	*D*	*E*
Percentage increase / (decrease) in like-for-like sales, over 1 year	4·4	6·1	5·2	4·2	(5·1)

Total growth: latest quarterly data

Supermarket group:	*A*	*B*	*C*	*D*	*E*
Percentage increase / (decrease) over 1 year	9	8	12	7	(3)
Estimated market share	25	18	15	10	6

Home shopping

Eastland on-line sales (€ billion)

1997	*1998*	*1999*	*2000*	*2001*	*2002 forecast*
0·9	1·9	5·3	7·7	10·6	13·9

On-line sales as a percentage of total sales are at less than half those in Westland but are growing rapidly as Internet access increases. Most are made by supermarket A, with a store-based distribution system. Other supermarkets are mainly still experimenting, in some cases with dedicated warehouses being used for order picking and delivery. One minor supermarket group, with an overall market share of well under 5%, probably has some 15 to 20% of the on-line market.

Exhibit 3

MEMORANDUM

To: *Members of the Board, Global*

From: *Charles le Grand, Vice President, Information Systems*

Date: *4 March 2002*

Subject: *Information Systems and Home Shopping*

The present apparent losses on home shopping reflect some operational problems, and some poor accounting.

The original proposals, years ago, assumed that picking (selecting from the shelves the items ordered by customers and packing them) would be done in slack time by "free" store staff. The cost was ignored. Picking is done on the basis of when staff have spare time, but is charged to the Home Shopping cost centre, thus reducing the cost of normal store operations. If dedicated staff were engaged, it would cost the Home Shopping cost centre no more than is charged by the various stores, and picking would be done when required. However, store managers would be under further pressure to control their costs by reducing store staff.

The original proposals considerably underestimated the stock-out problem. This has always existed, because the main stock control systems are over 20 years old. The problem is made worse by the heavy use of special promotions, advertising a limited range of products at low prices, which leads to erratic demands on suppliers. The main accounting and stock control system is so slow that the home shopping data is often used to "forecast" the main system output, especially in providing early indications of the success of the various promotions.

Queries arising from stock-outs have added significantly to system costs. Customers complain if a product is out of stock and a substitute product is delivered.

On present volumes, the home shopping is unprofitable, but this ignores any customer gain achieved by Internet shoppers also visiting stores. We know that on average Internet customers have higher average incomes and spend more per visit.

5.3 Analysis of global pre-seen material

5.3.1 Précis of main points of each page

Work methodically through the pre-seen and make a précis of the main information and points.

Page	*Main information*	*Significance*
2	• Global is a supermarket group based in Westland • It grew in the age of the supermarket which gave way to one-stop shops • Global lost out to Market Stores which is more innovative, out of town, larger and with a larger product range • Investors prefer Market Stores' growth and margin	• Management of Global were slow to respond and lacked innovation • Investors disappointed with Global when compared to Market Stores

Page	*Main information*	*Significance*
3	● Global overtaken by Market Stores ● Global smaller than Market Stores (11% of size market cap. and 20% by turnover and profit). Lower P/E (22 against 37.5) ● Market Stores earns more due to lower costs and higher spend per customer than Global ● Market Stores like for like growth greater than Global's (5% v 2%) higher quality, regional and more innovative stores pressuring Global ● Chairman concerned over future strategy	● Market stores winning fight for investors and customers ● Global needs strategy to restore its fortunes
4	● Investors unhappy and considering selling Global stock ● Therefore hard to raise capital ● Global hemmed in by anti-trust laws (max 10% pa growth by acquisition ● Board senses urgency of situation	● Possibility of significant share price falls if major investor (Universal) sells its 5%
5	● Balance Sheet may be unreliable due to overvalued fixtures and understatement of pension liabilities ● Parker (CEO) seems lost for answers to problems and his future is unclear ● Accounting systems poor ● Investors and analysts showing signs of concern about future profits ● Cohen (FD) has poor relation with investors ● Financial returns for 2001 are poor ● Louis (Ops Director) wants change but lacks board support ● Global must cut costs	● Global may be about to release bad news to investors. This may affect the Unseen material ● Further evidence of investor unrest ● Parker and/or board suppress alternative views. Poor corporate governance?
6	● On-line shopping not successful ● le Grand (VP Inf. Sys.) can't get capex approved ● Stuart (VP Purchasing) powerless to change suppliers and wants to leave Global ● Miller (VP International) sees lack of critical mass as reason for failure of foreign stores ● Miller wants to use success of international as ladder to CEO role. Wants investment ● Hageman (VP Human Resources) wants diversity, young staff and better staff benefits ● Eisenstein wants management succession plan ● Falke says investors will support property-based acquisitions ● Frosch favours diversification into hospitality due to Global's problems in retail	● No clear consensus on ways forward ● Expect to be asked to evaluate these strategic suggestions in exam
7	● Strauss indicates cash shortage in 1 or 2 years ● Lack of leadership quality on board ● Need to maintain dividend to protect share price ● Louis suggests store closures (20% make no profit – Cohen: increase supply chain costs – Louis) ● Parker and Hageman concerned over policy on redundancies ● ABC work has queried direct product profitability of wider range ● Suggestion of exploiting supplier credit to finance refurbishment	● Will shareholders provide more cash? ● Potential of downsizing to save costs but will cost money in short run ● Why has FD not acted before on knowledge that 20% of stores and some products are unprofitable? ● Rationalisation is potential strategy for Global
8	● Home shopping needs improvement ● Indication of IT problems affecting supply chain to stores, stocking and home shopping	● Variety of potential strategies which may need to be evaluated in exam

Page	*Main Information*	*Significance*
	• Profit of home shopping not clear due to muddled cost allocation • Miller favours building up Eastland operation by acquisition • No clear strategy emerges from meeting so another meeting called for 2–3 months time	• Future strategy meeting coincides with exam date (March 2002 + 2 months = May 2002)
9	• Parker warned to improve Global or lose job in June 2003 • Eisenstein foresees 'difficulty' and is getting tough • Frank likes Miller	• Possible management replacement here?
10	• Calculate financials later	
11 & 12	• Data on potential acquisitions in Eastland	• Need to assess targets ready to recommend in exam
13	• Home shopping inefficient because store based • Stock control systems 20 years old & inefficient leading to stock outs • Value of home shopping hard to assess	• Raises possibility that IT/IS strategy may be part of requirement on day of exam

5.4 Apply technical knowledge to Global

Working through the techniques covered in Chapter 4 the following additional insights can be gained:

Technique	*Section*
The four elements of strategy (competitive, financial, investment and risk)	5.4.1
Using ratios to conduct a financial analysis of a company's position	5.4.2
Assessing a business portfolio	5.4.3
Industry analysis	5.4.4
Position audit	5.4.5
Conducting a managerial and organisational audit	5.4.6
Critical success factors	5.4.7
Assessing information systems strategy	5.4.8
Assessing corporate risk	5.4.9
Assessing the cost of capital	5.4.10
Conducting a corporate appraisal (SWOT analysis)	5.4.11
Business valuations	5.4.12
Generating strategic options	5.4.13
Sources of business finance	5.4.14
Evaluating strategic options	5.4.15

5.4.1 Four elements of strategy

Global is caught in a vicious spiral. Its *competitive strategy* is failing to deliver the margins and growth required by investors. Stores are in the wrong place with narrow product ranges and poor levels of spend per customer. Some stores are unprofitable. The poor margins have led to *financial strategy* problems reflected in the low P/E and increasing investor concern culminating in share price falls and an unwillingness to provide further funding. This has led to a conservative *investment strategy* with stores looking run down and poor IT systems. Some evidence of poor investment decisions such as international operations and muddled entry into home shopping. *Risk management* compromised by lack of independence of board and seeming dominance by Parker (although later comments by Eisenstein and Frank suggest this may be changing).

5.4.2 Financial analysis

Using the data on pp. 10 and 3 (of the seen material) the following information can be extracted:

Ratio	*2001*	*1999*	*Comments*
ROCE (PBIT/TA-CL)	21%	20%	Some improvement so should have led to higher share price if P/E constant
ROCE (PAT/TA-CL)	11.9%	11.3	ditto
EPS	$1.59	$1.43	Assumes 900m shares in 1999
Gross margin %	21%	22%	Slight fall suggesting higher purchase prices or lower sales price
Net margin PAT/Sales	3.3%	3.4%	Slipping slightly (Market Stores 3.4% in 2001)
Admin costs/sales	13.4%	14.4%	Improving so why is net margin down?
Depreciation/sales	2.1%	2.1%	
Marginal tax rate	33.2%	32.8%	Some small depression of net margin but uncontrollable
Asset/turnover Turnover/TA-CL	3.65 times	3.35 times	Another improvement
Gearing Debt/Debt + Equity	38%	40%	Gearing falling
Current ratio	1.98	2.21	Slight fall. Not good use of working capital since many retailers have current ratios below 1
Interest Cover	7.1 times	6.2 times	Improving

Conclusion is that Global is in an improving financial shape. This makes lower P/E and consequent falling share price hard to understand. Investor sentiment seems to assume that Global's earnings and profitability are set to fall.

Note: The data on page 10 is subject to audit. Could investors already have anticipated changes to these figures such as asset write downs and pension costs, which would reduce PBIT?

5.4.3 Business portfolio

Not easy to apply due to lack of data. However, it is noticeable that Global has a low relative market share in both Westland (only 11% of sales of Market Stores) and also overseas (never more than 3% share). Market growth rate in Westland seems below 10%: for example, Market Stores' like-for-like growth only 5–7% per annum (p. 7).

This suggests that Global will lack ability to achieve costs reductions equal to Market Stores and positions it as a Dog.

Noticeable that the relative shares of Eastland Stores are much closer (p. 12).

Clearly Miller's call for an acquisition in Eastland could be self-serving given that he sees it as a route to CEO of Global.

5.4.4 Industry analysis

Industry life cycle stage seems to be decline for 'supermarkets' as out of town stores take over. This is unfortunate for Global because it operates supermarket formats principally. This said there are also references to niches available in convenience stores and 'up-market stores'.

Possibility that home shopping could hasten decline of conventional retail industry seems to have been overplayed.

Five forces is difficult to apply here although competitive rivalry is clearly intense and supplier power is alluded to with mention of farming lobby (p. 4) and home shopping is a substitute. Doubtful these will impact too badly on the profitability of the retail industry.

Competitive position of Global is clearly 'stuck in the middle' between the overall cost leader (Market Stores) and certain differentiators alluded to in p. 3 as well as niche players with strong regional market shares. According to Porter this position is one of low profitability in the long run.

PEST and globalisation is not readily applicable to the pre-seen material except to make the point that home shopping is becoming more popular as the Internet and e-commerce become more accepted.

5.4.5 Position audit

Using the Ms model we note the following:

- *Manpower*: Staff are older and will be expensive to make redundant or encourage to retire early.
- *Management*: We have doubts about the pro-activity and independence of the board and the benevolent autocratic style of Parker. Global seems to recruit internally and as a consequence may require new blood and new ideas.
- *Money*: Firm is short of capital sources and shareholders are unhappy. We are told it will need an injection of cash within the next 2 years.
- *Makeup*: The culture seems to be a reactor culture (Miles and Snow) with management seeming to prefer to rely past recipes for success to pull them through (e.g. low price specials to attract custom).
- *Machinery*: Obviously the stores need a facelift.
- *Methods*: The home shopping seems chaotic due to utilising store-based picking.
- *Markets*: As mentioned already. Global may lack access to the high spend customers due to lack of stores and/or its brand being associated with cheapness. The only exception to this is home shopping where, we're told, it leads the market and which gives access to higher spending customers.
- *Materials*: Global seems too wedded to a small number of suppliers which may constrain quality, choice or cost reduction.
- *Management information*: Firm has looked at ABC but findings not clear. Apparently poor customer information due to poor point of sale and 20 year old machines which could not run a CRM.

5.4.6 Organisational and managerial audit

There are suggestions, by Hageman, that the staff at Global are older and less innovative than they need to be. Other than this there is little organisational information beyond the implication that there are three divisions, stores, home shopping and international and several functional elements, HR, Finance, Operations, Info Systems and Purchasing. Two things stand out:

- there is no marketing function;
- only operations and finance have board level representation.

The top team seems dysfunctional for the following reasons:

- many of the non-executives seem to have come from organisations with which Global has a business relationship and hence may not be independent;
- none of the non-executives have other relevant retailing experience. Instead they are all professional advisors except Frank who has a military background;
- Global's tradition of promotion from within means a lack of new thinking and instead rewards obedience and conformity (note how Hageman seems to wish to echo Parker who, had previously been in HR then Operations before becoming CEO; perhaps she hopes to repeat his rise to power?);
- the managers with ability and experience are presently kept one step below the board and this dis-empowers them and leaves them frustrated.

Parker seems to be an autocrat and this is stifling innovation and discussion. The group would be better able to change if he were removed which is perhaps what Eisenstein intended when he informed Parker that his contract would no be renewed.

The organisational culture is probably best described and a *Defender* culture with no real strategic direction being evident. Again Eisenstein seems to want to change this.

5.4.7 Critical success factors

Revenues in retail are clearly driven by like-for-like sales growth. Stimulating this means increasing footfall in the stores and increasing spend per visit by customers, for example, by encouraging trading-up through providing higher value ranges or multi-buy incentives. The pre-seen tells us that Global is poor at both of these.

Costs are driven by the costs of goods and staffing costs. The case tells us that Global cannot get the same deals from suppliers as Market Stores due to its lack of size. The staffing policies being advocated by Hageman and Parker will increase staffing costs without delivering revenue benefits. Finally the poor IT systems may be allowing costs to rise without control due to stock management problems and also, as the ABC study indicates, not handling extra lines of stock in a cost-effective way.

Fixed asset investment will principally be store fitments, IT and logistics. According to the case Global will need more finance shortly and so may have a capital shortage not be able to afford substantial improvement in these assets. Current assets will principally be stock, which the case suggests may not be financed well. For example Global's loyalty to traditional suppliers may extend to not extracting longer credit terms, whilst IT/IS problems may leave Global with stock imbalances and perhaps wastage.

Global does not appear to have any operating or commercial risks in the short term although obviously it will need to deal with the encroaching competition referred to in the case. Its main risk would seem to be coming from the dissatisfaction of its shareholders.

5.4.8 Information systems strategy

This seems to be a major weakness of Global. The systems are 20 years old and there is evidence they're not effective. There seems to be faults at several levels of the system from operational (the stock and e-commerce aspects) through managerial (the problems assessing the costs of expanding product ranges and assessment of the profits of home shopping) to executive levels (Cohen's inability to give forecasts to investors).

The systems are not able to integrate the supply chain (SCM) nor provide the sort of customer data that other stores may have (CRM). The e-commerce system also seems

ineffectual. For e-commerce to be successful, and for Global to compete effectively, their system would need major enhancements.

Using Earl's grid it should be renewed (high business value and low quality). McFarlan would scale it as presently Factory (or Peppard's 'Key Operational') which suggests that an obsolete system should be replaced to ensure operations are effective. However external drivers such as the uptake of e-commerce and the use of information by stores means it may well be Strategic. The question is whether Global can afford, and generate the management support needed, for this higher degree of commitment. The experience of le Grand suggests this will be a battle.

Porter and Miller draw attention to role of IT/IS in the value chain or supply chain, which reinforces this point.

An IT/IS strategy is needed but given that Global is still trying to decide a business strategy this will need to wait until after the next Board meeting. Le Grand indicates that the Board will not authorise 'very considerable investment' in IT/IS. This implies that, according to Nolan, IT/IS may be at the control stage for home shopping but at the data administration stage for stores.

5.4.9 Risk

The case does not give examples of particular risks. The principle control problems seem to relate to the lack of good corporate governance as has already been analysed above. Additionally, the other main risk facing Global is the competitive environment in which it operates.

5.4.10 Cost of capital

A rough cost of equity can be derived from the dividend growth model as follows.

Dividend can be calculated as the difference between profit after interest and tax and the change in shareholder equity. Assuming that dividends are paid after year end then:

1999 dividend was \$1.29b − (\$7.17b − \$6.86b) = \$0.98b
2000 dividend was \$1.39b − (\$7.47b − \$7.17b) = \$1.09b

Therefore using 2000 as the basis

$$K_e - g = \frac{D_0(1 + g)}{P_0}$$

$$K_e - g = \frac{1.09\,(1 + 0.11)}{\$34.96}$$

$$K_e = 14\%$$

This is a rough guide because the 2001 share price has been used in the absence of a 2000 price.

Given that in 2001 interest was \$0.35b on debt of \$4.56 this implies a gross cost of debt of about 7% and a post tax cost of 4.69% (tax rate is 0.71/2.14 = 33%).

Therefore a rough WACC is given by:

$$\frac{(7.47 \times 0.14) + (4.56 \times 0.0469)}{7.47 + 4.56} = 10.47\%$$

This is lower than the 11.9% ROCE calculated earlier but does show that Global is coming close to not adding shareholder value.

5.4.11 Corporate appraisal – SWOT analysis

This SWOT analysis is based on the pre-seen material only and it is very important that the SWOT analysis that you incorporate into your answer on the exam day is updated for new information given in the unseen material.

Strengths:

- profitable store group;
- good supplier relations;
- free assets suitable for borrowing against;
- home shopping pioneer.

Weaknesses:

- weak board,
- poor competitive performance against Market Stores,
- poor investor relations,
- autocratic CEO,
- weak FD,
- 20% (400) stores make only marginal profit,
- lack of significant share of overseas markets,
- declining margins,
- poor IT systems,
- ROCE close to cost of capital,
- potential understatement of pension liabilities,
- potential overstatement of assets.

Opportunities:

- increased uptake of home shopping;
- expand product range;
- finance available to expand stores by acquisition (e.g. Eastland).

Threats:

- shareholders may dump shares;
- increasing competition from Market Stores and other rivals;
- loss of some managers (e.g. le Grand);
- auditors may qualify or force revision of draft accounts.

5.4.12 Value of Global

Market capitalisation stands at $31.46b.

Value using Market Stores P/E = ($1.59 × 37.5) × 900m = $53.66b

This suggests that Global could be a bid target for Market stores providing:

- Market Stores does not have the 10% maximum anti-trust limit on acquisitions or that Global wouldn't increase Market Stores' outlets by more than 10%;
- Market stores believes that Global has a strategic value to it (unlikely due to format of Global).

5.4.13 Strategic options

Competitive strategy:

- Global is no longer a cost leader so could reposition itself as,
- regional convenience store (differentiation focus),
- high-quality provider (radical break with tradition),
- town centre 'shop from work' store.

Product-market strategy:

- Market penetration – increase like for like sales and/or acquire rival stores.
- Product development – increase range of products (clothes, furniture, durables, cosmetics & pharmacy).
- Market development – overseas expansion (e.g. buy Eastland Store).
- Diversification – hospitality management.

5.4.14 Sources of finance

Presently Global appears to have positive cash flows. We are told that it can raise finance for acquisitions providing there is a property element. This indicates that finance and additional finance will need to come from debt (e.g. debentures secured on assets) or possibly from sale and leaseback of existing stores.

In either case shareholders will need to be reassured that the earning from the acquisitions will repay the interest on the debt plus yield some free cash flow to enhance shareholder value.

Considering the potential acquisition target in Eastland it should be noted that the ROCE of each can be calculated as:

	A	*B*	*C*	*D*	*E*
ROCE pre-tax profit/debt+equity	14.6%	7.2%	14.6%	3.7%	(10%)
ROCE post-tax profit/debt+equity	10.7%	4.5%	9.8%	2.6%	(2.1%)

These should be compared with Global's own ROCE (calculated at about 20% using PBIT or 11.9 using post-tax profit). It can be seen that investing in these stores would be provide less return than investing in further stores in Westland. Presumably being overseas stores might also imply higher risk too. Consequently undertaking investments in acquisitions that provide a lower return at a higher risk is not likely to be consistent with maximising shareholder wealth.

5.4.15 Evaluating strategic options

Presently the options implied in the pre-seen material are:

- improve margins by selecting new suppliers,
- closure of stores in Westland,
- sale of overseas operations to consolidate by buying a larger store group in Eastland,
- introduce enhanced staff benefits policies,

- diversify into hospitality management,
- improve or discontinue home shopping (neither is specifically mentioned but its clear a decision will need to be taken).

These can be evaluated using the three criteria suggested by Johnson & Scholes:

Option	*Suitability*	*Acceptability*	*Feasibility*	*Preliminary verdict*
Improve margins by selecting new suppliers	• Would increase profits by 1% of purchases e.g. 2001 = \$0.34bn savings and lead to a 16% increase in pre-tax profits and in EPS • Essential if Global is to keep pace with price-leader Market Stores	• Parker wishes to maintain links to traditional suppliers and will resist • Increase in distributable earnings of \$0.22b (\$0.34 × 1 − 0.33) and assuming a PE of 22 will increase market capitalization by \$4.84b (15%) • Relatively low risk strategy providing suppliers accept it	• Global's IT/IS may not be sophisticated enough to permit such cost reductions • Suppliers may agree to support Global more to avoid being left with just Market Stores in the future if Global fails • Global has the management expertise in James Stuart	This strategic option should be pursued by global
Closure of stores in Westland	• 20% of stores (400 in total) make little or no profit. Suggests They will make losses in coming years • Global may need extra finance within a year or so. Shop sales could provide cash injection But • Poor understanding of cost drivers may mean that stores could be rendered profitable by revised stock lines • May be needed to provide basis of home shopping • Will cost Global redundancy pay • Will crystallise any overvaluation of assets and force write-off on balance sheet	• May harm staff morale to sack staff as it contradicts reputation as good employer • Parker likely to resist out of loyalty • Preferred option of Jack Louis • Shareholders may accept closures as sign of tough management getting to grips with problems • Shareholders may mark down shares as redundancy costs and write-offs hit the profit and loss and balance sheet	• Lack of precise data makes final decision impossible • Cash flow impact of redundancy pay and pensions may worsen cash position of Global • May need to proceed gently to avoid large impact on fragile financial position of Global	Further investigation of this option is needed and decision should be deferred

Option	*Suitability*	*Acceptability*	*Feasibility*	*Preliminary verdict*
Overseas consolidation	• Lack of critical mass in overseas markets (<3%) means stores doomed to lose out in cost/price competition • Potential value of assets \$1.49b (12% of \$43.9b × group asset turnover of 3.5 times • Any cash realised could help to improve Global's financial position • Some Eastland stores have large market shares (25% to 10%) But • Eastland stores have lower PE and ROCE than Global • New overseas operations may divert attention from dealing with problems in core business	• Preferred option of Arthur Miller to boost career • Shareholders may be left worse off due to lower ROCE and lower growth business (lower PE)	• Finance for acquisition possible providing collateral available • Escapes Westland anti-trust regulations	Not a good use of management and finance at a difficult time for Global
Enhanced staff benefit policies	• Will increase costs in a time when Global needs to cut costs • Will make it more expensive to close stores and make staff redundant • Will accentuate any shortfall in balance sheet for pensions etc. • Goes against modern thinking on HR which emphasises need for staff flexibility	• Favoured by Parker because his pension is presently poor • Favoured by Hageman (to increase role?) • Unlikely to be accepted by Eisenstein who is focusing on improving results	Global cannot afford this without risking a serious run on its share price as profits fall	Reject this option
Diversify into hospitality management	• Global has no experience in this area	Shareholders are unlikely to welcome diversification	No information on costs or revenues so cannot assess	Reject as unnecessary diversion from the

Option	*Suitability*	*Acceptability*	*Feasibility*	*Preliminary verdict*
	• Will not help improve results of core business			job in hand
Home shopping	• May help leapfrog over Market Stores at lower capital costs than expanding store network • High potential future volumes • Cost effective way to increase stock range without having high inventories at store level • Global already has reputation and brand • BUT • IT/IS will need significant improvement to make this work better • No clear information on costs and revenues from home shopping means not possible to assess profitability	• Will be supported by Charles le Grand • Board seems unhappy to authorise further IT/IS expenditure • Potential opposition from Jack Louis due to effect on staffing and stocks at store level	• Global has a manager able to make success of IT/IS side of home shopping • Finance needed for new systems could be hard to raise because Falke suggests extra funding will need property and not a wasting asset like IT/IS	Global should commission a detailed feasibility study into the costs, timing and financing of a better home shopping system

5.5 The Global unseen and requirement

5.5.1 Potential playouts and possible unseen materials

The extent of the analysis above demonstrates how far it's sensible for you to go before the day of your exam. As you can see, there are some clear potential options for the firm and you will have come to a view on these. In the exam you may be given extra information that you will use to confirm or change your preliminary conclusions.

Of course, the exam may well contain information and events that you could not possibly have foreseen. There is no point in guessing the outcome because you'll almost certainly guess it wrong.

5.5.2 Dealing with the unseen and requirement

In the analysis of the Global pre-seen material, the above paragraphs have shown the sort of analysis you should aim for with any case that you are preparing for.

However let's look at how the Global case turned out.

[This page is detachable, for ease of reference]

Global Incorporated – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 15– 19.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

Gabriel Eisenstein has asked for a report from McCain & Co, a firm of strategy consultants. As one of their consultants, prepare a confidential report advising the Chairman of Global on the future development of the company. This should include comments on Global's problems, potential developments in Westland, the feasibility of the possible acquisition of either supermarket group B or supermarket group D in Eastland, and recommendations for future policy.

Global Incorporated – Unseen material provided on examination day

Various directors and senior managers have been asked to put their proposals in outline form to the Board for the next strategy meeting. You, as a consultant with McCain & Co, have been given copies of the various proposals made by the Board members and senior managers. These are documented as Exhibits 4 to 9 inclusive, and are shown on pages 15 to 19. You have also received notes of previous strategy meetings and related documents.

Exhibit 4

MEMORANDUM

To: *Members of the Board, Global*

From: *Jack Louis, Operations Director, Westland*

Date: *16 May 2002*

Subject: *Developing Westland Operations*

I propose that we should simplify operations. I have estimated the effect of the proposals on operating profits and my thoughts are as follows:

- Close down home shopping.
- Close down information systems development, and save the costs.
- Close down all unprofitable or marginally profitable stores in Westland. This will mean shutting at least 400 stores with a present turnover of $2·9 billion. It is unlikely to produce any cash after settling contractual obligations to employees and under the leases. A loss on book values of $1·7 billion is anticipated.
- Having closed down many smaller stores, review head office functions, and see what can be decentralised to the stores, and what else can be closed down in head office – a target would be saving $100 million a year.

To move forward we should:

- Set tough targets for Purchasing, to save at least $1 billion in 2003, and $2 billion in 2004. They should be given freedom to change from many old suppliers, and will probably have to import much more.
- Make as many small acquisitions as possible.

My calculations on small acquisitions are that we could borrow and spend up to $1 billion each year without upsetting the anti-trust authorities. We could borrow the money at 6%, as we would be acquiring property that the bankers would regard as good security.

Prices for small store groups may be quite high – we may find ourselves paying up to 30 times current after-tax profits. We should be able to produce rapid increases in profit from better buying and stronger management, especially if we free up management time by disposing of, or closing, our poorer stores.

I would set targets for earnings from acquired stores:

- In the year of acquisition, having covered all reorganisation costs, to make profits at 50% of pre-acquisition profits;
- In the next year, to make 150% of pre-acquisition profits;
- In the third year, and onwards, to make 200% of pre-acquisition profits.

To put this in figures, our first year's $1 billion would probably buy historical after-tax earnings of about $35 million, $50 million before interest and tax. We could only hope to make half of this in the first year after acquisition.

In the second year, we would make $75 million before interest and tax, and in the third year $100 million.

Each year we could make further similar acquisitions, adding to profit. There are still plenty of good independent stores and small groups of stores out there to buy as the families that own them want to sell up.

Exhibit 5

MEMORANDUM

To: *Members of the Board, Global*

From: *Charles le Grand, Vice President, Information Systems*

Date: *16 May 2002*

Subject: *Home Shopping Operations*

I have again reviewed the current home shopping operation.
There is no point in closing down the present operation. There would be no real saving, unless store staff could be reduced, which could be slow and difficult, as many of the stores with significant home shopping volumes are failing to meet their in-store customer service standards. The software and systems would have to be written off at a cost of $150 million. I am told that there would be little loss on the sale of the delivery vehicles.

We have two development options:

1. Develop a better accounting and stock control system for the stores. This could take three years to develop and install and cost up to $500 million.

2. Develop a different approach to home shopping with dedicated warehouse "picking centres" in selected locations. This could provide a radically better service to customers, and build up greater volumes than the present in-store system could handle. This would require an investment of at least $2 billion, would not be profitable until after three years from a launch decision, but would then show estimated profits of 25% each year.

Exhibit 6

MEMORANDUM

To: *Members of the Board, Global*

From: *Arthur Miller, Vice President, International*

Date: *16 May 2002*

Subject: *Future International Operations*

I propose:

1. That most of the present international operations should be sold as soon as feasible. The Canadian operations, which are modestly profitable, should be retained. Others should be sold to anyone who will take on the staff contracts, supplier contracts, and leases. If all can be sold, this would potentially release funds of approximately $1 billion. There would be a loss on the disposals of around $500 million compared with the book values. There would be no significant ongoing effect on Global's profit, though there will be exceptional costs in the year of sale approaching $100 million. If the sale of any operation is not feasible, it may be cheaper to continue trading than to close, but this requires further investigation.

2. The preferred route forward is to invest in Eastland. This may be "now or never". The market is highly concentrated. If any of the existing major players are bought by Market Stores, or possibly by some very large foreign group, late entry may be very difficult. Both possible acquisitions, B or D, are quite attractive in various ways. I would prefer to see the acquisition of B.

I attach the report from Arbuthnot Partners, Merchant Bankers as *Appendix A* to this document.

Appendix A

REPORT

To: *Arthur Miller, Vice President, International and Members of the Board, Global*

From: *Arbuthnot Partners, Merchant Bankers, Eastland*

Date: *14 May 2002*

Subject: *Our assessment of Eastland supermarkets*

The possible acquisition of supermarket groups A, C and E have been reviewed and rejected. A is too expensive; C is not feasible because of its ownership structure; and E has major problems.

Supermarket group B, the market leader until a few years ago and the present "Number 2", is a very solid business with a good reputation for quality and customer service.

While it was always regarded as impregnable, with the large family holdings and their involvement in management, it is understood, in the strictest confidence, that this is about to change. A suitable cash (not shares) offer could enable the family to unravel various family trusts and complex holdings and move away from the business. They may require supplementary agreements that protect various employees for a period of years. The departure from the board of the family representatives would provide easy scope for introducing new management, which would be essential. Although B's like-for-like sales have recovered in the last two years, it is obvious they are not achieving the sales intensity of A, or the same standard of stock and logistics management. B's home shopping venture is very limited.

There is considerable scope for effective investment in new systems, and B has considerable scope to extend existing stores, having a number of very large sites that are not fully utilised. However, the family has decided that it does not wish to invest any more in the business, and if more investment is needed, this is the time to sell completely.

The only alternative proposition is Supermarket D. It is smaller than B.

You will know the Chief Executive of D – Alfredo Ceniga – he used to work for you. As we understand the matter, some four years ago you restructured, and combined the two posts of Vice President, Marketing, and Vice President, Westland Retail Operations, into the new post of Operations Director, Westland, which he did not succeed in obtaining. He then left your employment. Subsequently he became CEO for two years of a smallish supermarket group in Holland, and apparently increased profits there. In the two years he has been CEO of D, he has certainly made an impact on profits and the share price. He has followed a policy of special promotions successfully, but has never had the finances to modernise the stores.

We have provided below schedules giving our views of future sales and profits of the two groups.

We would recommend that an acquisition premium of 33% above the current market capitalisation be assumed in preliminary calculations, though it may not be as much in practice.

Forecast earnings per share:

	Supermarket B	*Supermarket D*
	€	€
Actual 2001	0·23	0·36
Broker forecast 2002	0·35	0·40
Broker forecast 2003	0·45	0·45
Broker forecast 2004	0·60	0·50

Updated financial data for Eastland Supermarkets B and D for the years ended during 2001

	Supermarket B	*Supermarket D*
Sales	€28.26 billion	€13.36 billion
Profit after taxation	€0.44 billion	€0.37 billion
Shares	1,950 million	1,020 million
Earnings per share	€0·23	€0·36

Information at 30 April 2002

Share price at 30 April 2002	€6·27	€4·92
Price / Earnings ratio	27·3	13·7
Market capitalisation	€12·23 billion	€5·02 billion

Exchange rate: assume €1= $0·86

Exhibit 7

MEMORANDUM

To: *Members of the Board, Global*

From: *Gabriel Eisenstein, Chairman*

Date: *20 May 2002*

Subject: *Financing arrangements*

Without wishing to prejudice the discussion, I have made preliminary enquiries about the acceptability of proposals for additional finance:

- Small-scale Westland acquisitions would be acceptable for loan financing – but at some future point it would be desirable to consolidate arrangements by a rights issue, to maintain a reasonable debt to equity ratio.
- Any possible Eastland acquisition would require wholly equity finance. A rights issue could only be at around a 20% discount to the Global share price at the time of the rights issue.

Institutional investors would certainly require a clear statement on future strategy, and would need confidence that the board and senior management were capable of implementing the strategy.

Exhibit 8

MEMORANDUM

To: *Members of the Board, Global*

From: *John Parker, Chief Executive Officer*

Date: *20 May 2002*

Subject: *Views expressed on future policy by senior management*

I am surprised and disappointed by some of the views expressed by colleagues. They have not shown any previous disagreement with the policies I have followed in recent years, and I thought they were in complete agreement with me.

I do not think we should contemplate selling operations or closing stores. We should be thinking how to make more money from existing operations, maintaining the highest sales volumes possible.

We should borrow more from our bankers, make a large acquisition in Eastland, and only go for a rights issue when it has been completed. I would be against buying group D, because we would not wish to re-employ Signor Ceniga; it has always been against company rules to re-employ anyone who has left the company. We would have no obvious choice of a manager to replace him.

Global's current trading is not encouraging, and the outlook for the year is not as good as it appeared in January. The Finance Director's current forecast is that earnings per share for 2002 will be materially below that for 2001 – possibly as low as $1·25 compared with $1·59. This will not leave any dividend cover.

Exhibit 9

Having seen the memorandum from John Parker, Gabriel Eisenstein despatched a final note:

MEMORANDUM

To: *Members of the Board, Global*

From: *Gabriel Eisenstein, Chairman*

Date: *23 May 2002*

Subject: *The new earnings forecast*

I am most concerned by the memorandum from John Parker, especially the information on current trading. I do not like being surprised by bad news. Better financial systems should enable us to anticipate problems.

When the markets are informed, as they must be, of the new earnings forecast, there will be a sharp fall in the share price and a fall in the price / earnings ratio. To maintain investor confidence, a clear and convincing statement of a plan to improve earnings in the medium term will be essential. A P/E ratio of 20 is the best that can be expected, and this would result in a share price of $25. Maintaining even this share price probably depends, to some extent, on speculation regarding a possible bid for Global from a large foreign group. It is known that some of these have looked at possible acquisitions in Westland.

5.6 Debrief on Global Inc.

5.6.1 Analysing the requirement

The requirement for Global is well structured and it is clear what the candidate is required to do:

Write a confidential report to Gabriel Eisenstein that

- comments on current problems of Global,
- comments on potential developments in Westland,
- assesses the feasibility of buying Eastland Store B or D,
- makes recommendations for future policy.

Expanding this requirement into its elements makes clear what the candidate is expected to do:

Requirement	*Main elements*	*Skills & knowledge to be demonstrated*
Comment on current problems of Global	• recognise implication of 22% fall in EPS • identify likelihood that share price of Global could collapse once profits announced if no recovery plan also announced • recognise that history of underperformance by current management necessitates board room changes and development of retrenchment strategy	• Recognition that having a strategy to deliver better earnings in the short run is essential to survival of Global • SWOT analysis • Awareness of determinants of share price • Ability to integrate analysis of Pre-seen with changed circumstances of Unseen to demonstrate underlying causes • Awareness of managerial and organisational causes of poor financial performance
Comment on potential developments in Westland	• Close down or develop home shopping • Choose whether to develop • home shopping by better systems or by warehouse-based methods • Close down stores • Purchases rationalisation • Westland small acquisitions • Sale of international operations	• Recognise that strategy to continue with home shopping will help support share price but commitments to high capex on systems development should be delayed until share price stabilises • Calculate and demonstrate impact on EPS of proposed store and purchases rationalisations but making clear that they ignore termination costs • Calculate profit impact of acquisitions but emphasise that it depends on a broader strategic context to be suitable • Show that exceptional costs will reduce EPS and so should be avoided. Comment on likely criticism if Global sells-off one overseas operation at a loss whilst trying to argue case for buying another
Assess the feasibility of buying Eastland Store B or D	• calculate the likely acquisition consideration for both stores using data given • demonstrate the impact on Global's earnings per share of acquiring one or other of the stores • consider the attractiveness and potential synergies available if Global purchases either store • consider whether Global's shareholders are likely to	• calculate EPS or combined firms • discuss the risks of international acquisitions • discuss the particular problems of buying family controlled firms with high PE ratios • recognise the difficulties posed to Global by re-employing Signor Ceniga and the implications for the positions of Parker and Miller

Requirement	*Main elements*	*Skills & knowledge to be demonstrated*
	welcome or reject such an acquisition as a way to solve its problems	
Recommendations for future policy	In terms of their ability to support the share price of Global by holding out the prospect of better earnings in the future: ● recommend which options to accept and which to reject ● consider the future position of Parker, the board and other managers ● discuss how to present the poor earnings and the plan to improve them ● describe what next steps management should take to implement the recommendations above	● Show business judgement ● Above all the candidate must actually conclude something and be prepared to recommend something in relation to all the options above.

5.7 The facilitator's answer

STRICTLY CONFIDENTIAL

REPORT

23 May 2002

To: Gabriel Eisenstein, Chairman, Global Inc

From: A Consultant, McCain & Co, Strategy Consultants

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Summary

In view of the latest information on profits, it is urgent that Global should be in a position to make some announcements on proposed changes to improve the situation at the same time as it makes the necessary announcement of the deteriorating situation to the financial markets – the profit warning.

This is essential, as the financial markets have been very nervous in recent months and are liable to over-react to bad news. There are dangers of a very sharp fall in the share price, and some dangers of difficulty in renewing commercial credits and short-term loans.

There will be pressure for considerable change, and this may extend to pressure for a new chairman – unless new and convincing appointments can be made.

The first proposed announcement is clearly the departure of the present Chief Executive Officer. This will need to be followed by more departures; the greater problems are recruiting very good replacements, and formulating new strategies.

The priority is finding a new Chief Executive Officer. Serious consideration should be given to Sr Ceniga. The most likely alternative is an international executive search, which could be difficult and take a significant time.

Profits in Westland must be increased to stabilise the share price, and to enable necessary investment in Westland to be funded by a rights issue.

Key short-term actions to achieve this profit increase are a review of the supply chain, aiming to make savings greater than those envisaged, and a thorough review of administrative expenses.

A new strategy for competing with Market Stores must be devised and a clear marketing approach agreed.

There are many problems with a possible Eastland acquisition, though it may be a sensible route after management problems have been solved in Westland, and credibility and the share price restored. The preliminary view is that Supermarket B would be preferred despite the higher total cost, but there is time for further consideration. No decision can be taken until the board is strengthened and the new CEO is in place. It is clear that some major acquisition, whether in Eastland or Westland, must be considered to change the balance of the business away from purely competing with Market Stores.

A meeting of the non-executive directors is needed as soon as possible, in the next few days, to agree and take necessary action. They must approve the profits warning and any immediate action to be taken and announced at the same time as the profits warning, including all immediate board and management changes.

Analysis of Global's Problems

The latest information provided on Global's sales and profits is a most unwelcome surprise, even though recent trends have not been encouraging.

You were already conducting a necessary strategy review; it was already clear that there were major problems – but the necessary announcement to the markets of the bad news makes it necessary to accelerate the process, and reach at least some conclusions very quickly.

There are a number of issues to address very rapidly:

- the quality of the board, and its usefulness in a situation as difficult as the present;
- the quality of the existing senior management;
- the lack of an apparent clear strategy to compete in a market at present dominated by Market Stores;
- the weak financial situation.

The quality of the board

You, and most of the present non-executive directors, have had long associations with Global. This has helped in understanding the business and its problems, but, with current attitudes to corporate governance, it would be appropriate to have more clearly independent directors, preferably able to bring relevant experience of control of big retail or service industry operations. In the present crisis, it is possible that some shareholders might call for a new chairman with experience in rescuing companies with major problems, but this can be avoided if sufficiently prompt action is taken.

It is suggested that, with their association with your advisors, the present non-executive directors remain on the board, but it is recommended that senior managers should not be on the board, apart from the new CEO to be appointed.

Additional independent non-executive directors are required, but they will take time to recruit.

The quality of the management

This obviously causes considerable concern. Changes are essential to satisfy the markets that action is being taken. The major problem is deciding the timing of all the necessary changes, and recruiting top managers who will be able to lead.

John Parker: CEO

He is clearly limited:

- a career within the company, no outside experience;
- no marketing experience, primarily a career in store operating management and personnel;
- no sign of clear strategic thought, of what he wants to do to lead the company forward. He had the opportunity to contribute ideas to the strategic review – but has not made any proposals.

He is unlikely to change his ways, without continuous pressure.
He should go now.

Jack Louis: Operations Director, Westland

While he has produced some ideas, they are very conventional cost-cutting ideas. His proposals are distinguished most clearly by the lack of any thought of any strategy to bring back lost customers. This demonstrates the lack of any marketing experience.

His ideas for store acquisition do not indicate much commercial sense.

It would be better if he went quite soon, but it may be necessary to retain him for some time until a new CEO has been identified. He should not be left with any illusion that he would be considered for such a post. He may well wish to go now if it is made clear that he has no long-term future with the company, and is not to remain on the board.

David Cohen: Finance Director

He appears inadequate; surprise news on current trading does not suggest awareness of what is happening in the business:

- he has provided very limited financial information, and no forecast data for this strategy review;
- he has not made any future strategy proposal.

It is not at all clear that he could handle the necessary presentations to analysts and to major investors that will be part of the process of raising money through a rights issue to fund changes in Westland, let alone to convince them that the company could manage an Eastland acquisition successfully.

He should be replaced as soon as the main strategy is agreed, and under way. While he will be needed for the time being, it is clear that someone new and credible is needed to explain the numbers underlying the new strategy and indicate forecast earnings. It will be essential that he be replaced before any attempt is made at a rights issue.

Senior managers below board level

These are discussed briefly in *Appendix* 5. The main concern is that Arthur Miller is retained for future development.

To summarise

Some rapid departures are essential; more will follow. The key problem is recruitment. This will be difficult if Global does not offer very good executives scope for future career growth.

The lack of a clear marketing strategy

It is clear that there has been no strategy for competing with Market Stores for some years, and that there has been no significant thought re marketing since the post of Vice President, Marketing was abolished four years ago. It is easy to say this with hindsight, but this problem should have been seen and action taken much earlier.

These problems can be explained in a number of ways:

Porter's generic strategies

Porter defined three generic strategies:

- Overall cost leadership: clearly the strategy adopted by Market Stores, which is almost certainly unchallengeable. It is worth noting that Global, in its early years, had cost leadership, but lost it as Market Stores grew rapidly in out-of-town locations.

- Differentiation: creating something that is perceived industry-wide as unique. The basic problem with this approach is that innovation in retailing is instantly visible to competitors, and easy to copy. This strategy has already been adopted by some regional chains, and upmarket competitors. Clear thought is required on combining differentiation and a national spread of stores.
- Focus: serving a narrow strategic target more effectively than rivals who are competing more broadly. This is not really available to Global, given the scale of the enterprise.

Porter emphasises the problems of being 'stuck in the middle':

- it cannot access the customers who demand low costs, or must reduce margins to attract them;
- it cannot appeal to high margin customers because it is also associated with cheaper offerings and customers – this will detract from its perceived quality;
- it will have a confused corporate culture;
- its management style and control systems will become contradictory.

The 'mid market' is always under attack, and it is not easy to see what to do when a 'universal' offering no longer appeals. Easy examples are *Marks and Spencer* running into trouble after years dominating the High Street, and *Sainsbury* losing to *Tesco*, but apparently making at least a partial recovery.

Competing requires a clear strategy and customer focus; Global does not seem to have got this. It is difficult to provide something 'different' in retail competition; everything is too visible and easily copied – but Global must try. It may be that on-line home shopping is the solution, but this needs further consideration.

Porter's five forces model

The analysis can be in terms of the underlying economic structure of the industry:

- Threat of market entry. While existing firms have significant economies of scale, it is easy for customers to switch to a new supplier. Major overseas companies have the same economies of scale, and could always enter the market.
- Rivalry among existing competitors.
- Pressure from substitute products. The key feature in retailing is the movement away from the High Street to out-of-town stores.
- Bargaining power of suppliers – which is conspicuously limited.
- Bargaining power of buyers. This is a key issue – alternative prices are easily known and there are no switching costs.

Competing against the prime mover

Market Stores clearly had first mover advantage – the first to build out-of-town superstores, the first to build giant stores. It has, in effect, defined the competitive territory. Market Stores has a vision of what will appeal to customers; Global is only responding after change has taken place.

Marketing strategy

It is essential that marketing is restored to its appropriate place in any new structure, and clear thought is given to intended customers and their requirements. The present position

is that Global is attempting to appeal to mid-market and more affluent customers – but is not offering:

- low prices, to compare with Market Stores;
- the best out-of-town giant stores for 'once a week, all in one place shopping' – again to compete with Market Stores;
- a clear upmarket image, placing an emphasis on quality which maintains market share;
- premises that give the right impression with regular refurbishment;
- adequate standards of customer service with very few stock-outs;
- a state-of-the-art, on-line home shopping service.

The weak financial situation

You are aware of the problems, and there is no need to spend too much time on the detail. Further comment is in *Appendix* 6. The consequences have been:

- limited spend on store refurbishment;
- no attempt to keep building new and bigger stores to compete with Market Stores.

The causes are equally obvious:

- not earning high enough margins to fund working capital growth and something towards new capital investment;
- not earning high enough margins to keep a high price/earnings ratio and make new rights issues easy;
- maintaining the dividend at too high a proportion of profit after tax.

If earnings were better, a rights issue would clearly be desirable to fund more stores and more refurbishment – but earnings have to improve. The markets may be convinced by good pro-forma or prospective earnings if they regard new management favourably.

Information systems

It is clear that Global's systems are not adequate, and that the business is suffering as a result of poor systems:

- problems, clearly explained, in developing home shopping with reasonable costs;
- stock-outs have an unquantified, but probably significant effect on in-store sales;
- slow feedback on actual sales can lead to excess stocks, especially of special promotion lines.

Global cannot afford to lose potential sales or carry excess stocks. The problem is not the desirability, or financial justification of new systems – but the relative priority of these systems, compared with other major changes required. New systems require a major investment, significant management time, and a clear vision of the future shape of the business. There will be no short-term payback.

Proposed Changes to Existing Operations, Primarily in Westland

The comment has to be made that the proposals reviewed are mostly limited in their effects, and show only a partial grasp of the extent of the problem. Market Stores are still investing and growing, and competition will only get tougher year by year.

There are some general considerations:

- immediate increases in earnings are sought – not good, but distant payoffs.
- analysts may be happy to ignore write-offs of exceptional restructuring costs in the current year, and concentrate their commentary on pro-forma earnings per share or forecast earnings per share for 2003.
- cash effects of proposals are important; it is not desirable to propose policies with significant immediate costs.

A further consideration, which should not be discussed in any detail at this stage, is that policies may be only partially successful, and that Global may be vulnerable to a bid. In this situation, Global is likely to be valued at least as much with reference to sales volume as to profits. Policies that reduce sales, such as closing marginal stores, should be considered only if the increase in profits is quick and clear.

Proposals by the Vice President, Information Systems

These can be dealt with quite simply:

- There is no point in discussing closing the present home shopping operation at this time. The impact is marginal. It could produce negative reactions, and would make any future home shopping development harder.
- The system improvement 'option' is probably inevitable at some point – but now is not the time to commit funds and start work – it must wait until overall strategy is defined.
- The proposed home shopping development is a marketing option to be considered in the context of an overall strategy.

Charles le Grand's contribution has been helpful and constructive – but his proposals have to be left until other decisions have been taken. More detailed comment is made in *Appendix* 2.

Proposals by the Operations Director, Westland

It was very disappointing that the proposals did not include any suggestions designed to increase sales from existing stores. Generally, a wide range of proposals has been made, but few have been thought through. It was noticeable that no attempt was made to justify the costs of the present store refurbishment programme and the possible benefits of accelerating the programme.

The proposal to close down home shopping has already been discussed, and rejected.

The proposal to close down information systems development is short-sighted. At some point, better systems are needed to reduce stock-outs. Systems to produce better financial information also appear to be needed.

The proposal to review and possibly close unprofitable stores must be followed up, but the real questions are:

- what would the stores in question produce with a better marketing policy?
- what costs could be saved, store by store, taking into account the problems of assigning leases. There is no point in closing a store if the lease for the premises is for say 10–20 years and a new tenant cannot be found who is likely to be able to pay the rent for the whole period of the lease.

Saving significant sums could take some considerable time. The target for head office savings is possibly modest. The regional offices have not been mentioned. These costs must be reviewed, and cut very considerably.

Tough targets for purchasing are essential – but a significant part of the savings will be needed each year to keep pace with Market Stores. More thoughtful targeting is required.

The arithmetic of making small acquisitions makes very limited sense, and should be discarded given present financial constraints. These proposals are discussed further in *Appendix* 3.

Proposal by the Vice President, International, to close most present international operations

These proposals are broadly sensible, but will need detailed examination, and will take a considerable time to negotiate.

Sales of small overseas operations can be very difficult and expensive, and produce much bad publicity – as illustrated by the difficulties encountered by *Marks and Spencer* in closing down in Europe.

Possible Eastland Acquisitions

There is a long-term problem that an Eastland acquisition would address – that even with a clearer marketing strategy, growth in Westland is restricted by the dominant position of Market Stores. Sooner or later an acquisition somewhere of some sort of related business has to be considered.

The acquisition of a very similar business in Eastland would not be regarded as any more risky than the acquisition of a different service industry business in Westland.

General considerations

The first issue is whether there are potential synergies:

- potential global sourcing, leading to further price reductions [assuming that tastes are sufficiently similar in the countries concerned];
- ability to transfer expertise, systems [especially back office, stock control, home shopping].

These must be compared with known problems:

- Retailing is a service industry, employing large numbers of people with low skill levels. Labour management varies considerably from country to country;
- National tastes vary in many products. Similarity may exist only for a few products, such as consumer electronic products.

It is not clear that there are great synergies, or that Global has any great skills to contribute – but there is still scope for arguments that other markets may be more profitable.

The Eastland market may:

- be growing faster;
- be less competitive;
- have greater barriers to entry (for example, difficulty in getting planning permission for new stores);
- offer a better return on capital.

The real issues are whether Global can in any sense add value to whatever the existing management of the target company can do, and whether it is capable of convincing investors in Westland that the acquisition is feasible and sensible.

The specific questions that would need to be answered are:

- is this prospectively two separate businesses under one ownership, or potentially an integrated business?
- how does Global top management add value to what supermarket B or supermarket D does?
- would supermarket B or supermarket D perform better as a stand-alone company?

The question of a fit between the management styles of the operating company and the parent corporate headquarters, and the skills needed for success in the specific business environment must also be addressed:

- headquarters' awareness of critical success factors in the business;
- headquarters' ability to add valuable insight into problems;
- headquarters can recognise whether a business is part of its 'heartland' – within a range where it can be a better parent than any alternative owner.

There is little in what is known of Global at present to suggest possession of the necessary skills. Any move depends on new management, and views of their capability.

General commentary on the cost of the potential acquisitions

Calculations have been produced on two separate bases:

- on the basis of the forecast share price that is expected after the profits warning [see *Appendix 4A*];
- on the basis of the current share price, and previously forecast earnings [see *Appendix 4B*].

Both sets of calculations involve very large assumptions, including:

- your assumption regarding the appropriate discount for a rights issue;
- Arbuthnot Partners' assumption regarding the appropriate acquisition premium;
- the broker forecasts of future earnings for supermarket B and supermarket D.

Relatively small changes in the individual assumptions could lead to significant overall changes.

There are obvious arguments for more detailed evaluation of forecast cash flows for both Global and potential acquisitions, and these will have to be done before any decisions are made. It is worthwhile to make these preliminary calculations, using the available data, with all its obvious problems.

Taking into account pressure to get short-term results, it appears that, on both sets of calculations:

- supermarket D is most attractive in 2003;
- supermarket B is more attractive immediately thereafter as earnings are forecast to grow faster.

Supermarket B is much the larger, and would put Global in the position that a really significant part of overall earnings would be from a different market. It could well make a major difference to the overall rating of Global by the financial markets.

It does not appear that it would be easy to proceed until management problems in Westland have been solved, and earnings at least stabilised, and preferably returned to

former levels. Assuming that all this can be achieved, and Global return to reviewing these possible acquisitions, there are some other considerations that require review:

- The simplifying assumption has been made in the calculations that the whole of the acquisition will be funded by a rights issue. A more appropriate assumption would be that a rights issue would be needed to ensure an appropriate debt : equity ratio after the acquisition. This calculation would also have to allow for any Westland investment programme, which has yet to be defined.
- Any review of the possible acquisitions will have to note the differences in funding working capital between Westland, where this involves a significant investment, and Eastland, where it is all supplier funded. A combined balance sheet will show a very considerable increase in short-term debt. On the other hand, if some Eastland suppliers can be induced to supply products to Westland on the same terms, there is scope for a considerable reduction in the working capital needed in Westland.
- If supermarket group D is eventually preferred, the consolidation of its balance sheet may pose problems with the very high long-term liabilities. There may be some significant restructuring needed. There appear to be surplus assets in the D balance sheet, which is quite different from the balance sheet of the other four Eastland supermarket groups – but much more information is needed.

Supermarket Group B

Supermarket B is obviously trading well and highly rated. It also appears, from the limited data available, to have a broadly similar quality image to Global. It may fit, but is quite expensive.

The potential acquisition of supermarket B does not add immediate value for shareholders based on the forecast 2003 earnings. It would look more attractive on the current 2004 forecast. However, these numbers

- assume stable Global earnings;
- ignore potential synergies.

If there are synergies, the relatively strong market position could make this an attractive proposition. The acquisition is large enough to make a major difference to the whole shape of the company and to have a major favourable impact on earnings per share.

Supermarket Group D

The potential acquisition of supermarket group D looks initially more attractive, but the growth in 2004 appears less. The stores appear smaller, and there is a significant debt problem.

Acquiring the services of the present CEO of D may be attractive, but buying the company is the expensive way to proceed, and is not recommended.

An overall view

The acquisition of B may well be the most sensible long-term aim, but nothing can be done until new management is in place in Global, and can convince the market that earnings can be restored. However, the basic aim of diversifying away from Westland has its attractions. This should influence the choice of a new CEO – it would be very desirable to recruit someone with international experience.

Conclusions and Recommendations

An urgent meeting of the non-executive directors

This must be arranged as soon as possible to agree action. The executive directors and senior management must be available in attendance to be informed of the decisions taken, and their future with the company, or otherwise.

A profit warning cannot be delayed for many days, because there is always a risk of leaks leading to market rumours. The profit warning must be accompanied by an announcement of action to improve the situation.

The board

The board should be restructured to show a clear majority of independent non-executive directors. Announcements will be made of new appointments of additional directors over the next few months. This will demonstrate compliance with current corporate governance requirements, and bring fresh minds and useful service industry experience to the current problems.

The executive management

The present CEO must go immediately. Priority must be given to recruiting a far better replacement, with consideration being given in particular to Sr Ceniga of Eastland supermarket group D. This needs to be followed by further departures, and the recruitment of a strong active Finance Director.

Strategy; marketing strategy

A clear strategy must be enunciated. The markets will expect no less. Ideally, this strategy will be explained by a new CEO.

Financial position

A plan must be agreed to improve earnings in Westland to help finance refurbishment and to justify a rights issue to allow a more extensive refurbishment programme. Ideally, this would allow the building of new stores where present stores are not suitable for refurbishment. It is unlikely that a programme of building stores in new locations or buying existing stores can be justified in the short term.

Cost savings

Action must be taken immediately to make cost savings in head office and the regional offices.

Action must be taken to review the supply chain to ensure greater reliability and to make very large savings.

Eastland

No immediate action should be taken on Eastland. Action awaits:

- finding a new CEO;
- defining a new strategy, and selling it to the financial markets;

- stabilising profits, and being in a position to forecast earnings per share in 2003 at least restored to 2001 levels.

If these can be achieved, it is possible that the markets will welcome the proposed acquisition.

Management

There is a strong case for immediate discussions with Sr Ceniga. His advantages are:

- he understands the problems in Global;
- he has market credibility from the success he has achieved since leaving Global;
- he has a marketing background, and this is the major area of weakness.

However, he is unlikely to be cheap, and is unlikely to wish to re-join Global purely to undertake a short-term rescue job. He will wish to feel that Global has long-term prospects beyond battling for survival in the shadow of Market Stores.

This may match with the possible Eastland acquisitions. He would have an informed view on both the companies and the market.

The only potential internal candidate is Arthur Miller. He is relatively inexperienced, and there would be considerable scope for him to undertake a larger role than his present role, under a new CEO.

International executive search is always possible, but may do no better than the two known candidates.

When the question of the new CEO is resolved, it will be necessary to review the apparent need for a marketing director, in view of the particular strengths of the CEO appointed. More than one new senior appointment is required, but the priorities need to be determined, choosing between:

- a marketing director, to develop a new strategy to compete with Market Stores;
- a chief operating officer to run stores and distribution to maximum efficiency;
- a director of home shopping to develop a separate profitable business;
- a director to evaluate and plan an eventual Eastland acquisition, and ensure that when it is made all synergies are achieved.

Appendix 1: SWOT Analysis – Global

Strengths

- known name in Westland – possibly valuable as a brand;
- still a significant market share in Westland – possibly room in the market for a number of very large groups;
- large estate of stores;
- established network of suppliers.

Weaknesses

- weak competitive position compared with Market Stores; lack of scale;
- weak position compared with newer competitors [upmarket and regional];
- lack of a clear strategic focus;
- lack of clear management strength;
- lack of significant overseas management experience.

Opportunities

- market pressure to perform; markets may accept ambitious growth strategy, but would be sceptical regarding a future of always competing with Market Stores;
- the board is conscious of the need for change, is recognising problems, if not yet finding solutions.

Threats

- difficult to compete against a giant such as Market Stores;
- limited finance. Notable that very little prospective dividend cover. High borrowings, with falling prospective earnings;
- possible takeover bid, if share price weakens further.

Appendix 2: Proposals by the Vice President, Information Systems

1. The present home shopping operation

This has been dealt with clearly.

As pointed out, there is no point in closing this operation. It should be noted that at some stage the systems will have to be written off, and it would be sensible to consider the time over which they are being depreciated.

2. A better accounting and stock control system for the stores

This will be needed to improve the performance of the current stores, especially to reduce the number of 'stock-outs' which annoy shoppers and disrupt the home shopping operation.

There is clearly a significant pay off from this sort of improvement – but this will only appear after the systems have been designed and installed, and purchasing officers can use the information effectively to obtain supplies as required. It may well require some degree of integration of Global's systems and those of key suppliers to be effective. The pay off time is likely to be at least two or three years away.

It will not be possible to start work on such a system until a range of policy and strategic issues is determined, to set system parameters. Among these key issues are:

- the planned marketing policy: whether the current level of special price promotions will be continued;
- the planned marketing policy: whether there will be major changes in the types of goods and services offered in store;
- the planned purchasing policy: whether there will be deliberate moves to single sourcing and reducing the number of suppliers.

3. A new approach to home shopping

This would be a major investment, and would have to compete for funds with a major store refurbishment programme, investment in new stores, or an overseas acquisition.

It has the potential to be extremely profitable – but it is also much more risky than the other investments in existing operations. No-one can tell how home shopping will develop.

Given the financial situation, the decision on this must wait until the main strategic decisions are taken – effectively until after the appointment of the new CEO.

Appendix 3: Proposals by the Operations Director, Westland

Concern must be expressed that there have been no marketing proposals made. There is no suggestion of anything to increase sales from existing stores by attracting more customers or increasing the spend per customer visit. The 'like for like' sales figures are far worse than those for Market Stores – but nothing is done to address the problem.

1. Close down home shopping

This has already been discussed in the commentary on the proposals of Vice President, Information Systems.

2. Close down information systems development

This does not make any long-term sense. Better systems will be needed to improve store performance.

Pending decisions on major system developments, such as the proposals made by the Vice President, Information Systems, the annual spend is relatively small, and much of it is probably effectively unavoidable systems maintenance.

3. Close down unprofitable stores

The proposal to review and possibly close unprofitable stores must be part of any major review of operations.

Stores will have to be reviewed individually, taking into account:

- individual store profitability;
- local competitive situations;
- whether the volume sold is significant to our suppliers, or to making regional distribution centre volumes economic;
- closure costs, including employee obligations, which were increased last year, and lease contractual terms.

The figures quoted need reviewing in detail:

- The proposal is to sell over 400 of over 2,000 stores – some 20%. A loss on book values of $1.7 billion is anticipated. Global's total fixed assets are $7.56 billion – 20% is $1.51 billion. Is Global going to have to pay other companies to take over the leases?
- The 20% of the number of stores appear to produce $2.9 billion of a total sales of $43.9 billion – 6.6%. This would be expected in the smaller, older stores.

- It would have been reasonable to expect working capital to be released in proportion to the reduction in sales – say $0.3 billion.

A detailed review is required.

4. Cost savings

These are essential. The target of $100 million appears modest – certainly it is only 1.7% of the store and administrative costs. However, it should be noted that store and administrative costs have been reduced from 14.38% of turnover in 1999 to 13.42% of turnover in 2001. More detailed review is required. It should be remembered that additional expenditure will be needed at some stage on better information systems, and quite urgently on marketing.

5. Purchasing

Tough targets for purchasing are essential. However, it may be that this sort of saving is needed each year to keep pace with Market Stores. It would not be wise to assume that all these savings would add to operating profit. It would have been helpful to see some more detail of what is envisaged, and how it will be achieved, preferably from the Vice President, Purchasing. A much higher initial target should be set – the present target is not, at 2.9%, a large percentage of the cost of sales.

More focussed targets are required, probably by product group. These should encompass:

- just-in-time delivery and quality standards to achieve customer service standards;
- competitiveness standards: the extent to which prices must match Market Stores, allowing for differences in quality, and aiming at different types of customers;
- gross margin and purchase price targets: Increased gross margins are essential – but after allowing for competitiveness, it is clear that not all purchase price savings will be turned into gross profit.

Some careful thought is needed on what can be done by Global to make it easy for suppliers to supply at lower prices. Single sourcing will enable selected suppliers to increase volumes. Better sales data will enable suppliers to plan better.

The key message to get across to suppliers is that it is in their long-term interest that Global competes successfully and continues to grow, preferably achieving much better like for like sales figures. Global has to accept that efficient suppliers are earning enough to grow at the same rate.

6. Small acquisitions

The proposal only makes very limited sense. The stores likely to be available will be old style High Street stores, rarely new out-of-town stores. It would have to be carefully considered whether more relatively small and probably fairly old stores really fit a proposed new strategy. It is possible that they would, if more emphasis is placed on convenience – but this remains to be determined. It is noticeable that Market Stores do not appear to be buying up stores; they prefer to build new out-of-town stores.

The arithmetic makes little sense, but just might if shares were trading on the sort of price/earning ratio of Market Stores, and additional capital could be raised easily, and Global's management could see ways of making much more substantial improvements in earnings. To summarise the arithmetic:

Year	*Investment*	*Historical after tax earnings*	*Profit before tax and interest*	*Interest*	*Profit before tax*	*Profit before tax: cumulative*
	$ million	*$ million*	*$ million*	*$ million*	*$ million*	*$ million*
1	1,000	$\frac{1,000}{30 \text{ PE ratio}} = 33$ say 35 PAT = 50 PBT	50 × 50% = 25	60	(35)	(35)
2			50 × 150% = 75	60	15	(20)
3			50 × 200% = 100	60	40	20

Appendix 4A: Possible Eastland acquisition calculations

Based on forecast Global share price post-profits warning

Assumed €1 = $0.86: $1 = €1.16

Key Global data [as given]

Global	*Data 31 January 2002*	*Data 23 May 2002*
Earnings per share: $	1:59 [year to 31 December 2001]	1.25 [forecast 2002]
Price/earnings ratio	22	20
Share price: $	34.96	25
Shares issued: millions	900	900
Profits after tax: $000 million	1.43	1.125
Market capitalisation: $000 million	31.46	22.50

Eastland calculations for 2003 and 2004

	Supermarket B	*Supermarket D*
Current market value €000 million	12.23	5.02
Add acquisition premium, say 33%: €000 million	16.26	6.68
$000 million	13.98	5.74
Rights issue at 20% discount:	$\frac{\$13.98}{20}$	$\frac{\$5.74}{20}$
Shares to be issued: millions	699	287
Existing shares issued: millions	900	900
New number of shares: millions	1,599	1,187

	2003	*2004*	*2003*	*2004*
Earnings per share	€0.45	€0.60	€0.45	€0.50
Earnings: Acquisition [2003] $ million	$0.39eps × 1.950m = 761	$0.52 × 1.950m = 1,014	$0.39 × 1.020m = 398	$0.43 × 1.020m = 439
Existing Global:	1,125	1,125	1,125	1,125
	$1,886	$2,139	$1,523	$1,564
New earnings per share	1,886 / 1,599		1,523 / 1,187	
	$1.18	$1.34	$1.28	$1.32
c/fwd Global alone (current forecast)	$1.25	$1.25	$1.25	$1.25

The calculation shows that D looks more attractive in the short term, but that both possible acquisitions lead to increased earnings per share in 2004.

Appendix 4B: Possible Eastland acquisition calculations

Calculations based on Global's pre profits warning share price – no longer relevant – unless strong management action can restore Westland earnings and share price
Assume €1 = $0.86: $1 = €1.16

Key Global data [as given]

Global	*Data 31 January 2002*
Earnings per share: $	1.59 [year to 31 December 2001]
Price/earnings ratio	22
Share price: $	34.96
Shares issued: millions	900
Profits after tax: $000 million	1.43
Market capitalisation: $000 million	31.64

Eastland calculations for 2003 and 2004

	Supermarket B	*Supermarket D*
Current market value €000 million	12.23	5.02
Add acquisition premium, say 33%: €000 million	16.26	6.68
$000 million	13.98	5.74
Rights issue at 20% discount:	$13.98 / 27.97	$5.74 / 27.97
Shares to be issued: millions	500	205
Existing shares issued: millions	900	900
New number of shares: millions	1,400	1.105

	2003	*2004*	*2003*	*2004*
Earnings per share	€0.45	€0.60	€0.45	€0.50
Earnings: Acquisition [2003] $ million	$0.39eps × 1.950m = 761	$0.52 × 1.950m = 1,014	$0.39 × 1.020m = 398	$0.43 × 1.020m = 439
Existing Global:	1,430	1,430	1,430	1,430
	$2,191	$2,444	$1.828	$1,869
New earnings per share	2,191 / 1,400		1,828 / 1,105	
	$1.57	$1.75	$1.65	$1.69
c/fwd Global alone (current forecast)	$1.59	$1.59	$1.59	$1.59

At this sort of Global share price, the acquisition of Eastland supermarket group B would be very attractive after 2003.

Appendix 5: Senior managers below board level

These brief notes indicate the advice to be given to these managers, who are bound to query whether they have a future with the company with a change of CEO.

James Stuart: Vice President, Purchasing

There is too little really known to express a firm view. He may be able to achieve more if firmly managed and given clear targets. As achieving supply chain savings rapidly is essential, he should be retained.

Charles le Grand: Vice President, Information Systems

He appears competent. It would be sensible to retain his services, assuming that almost any sensible strategy will involve better systems at some stage.

However, if in present difficulties, any investment in systems has to be postponed, it is unlikely that he will wish to stay, or that there is any point in encouraging him to stay.

Arthur Miller: Vice President, International

I was impressed by his willingness to contemplate change. He may be a future CEO – but has limited experience. Strategic decisions have to be taken first, but there is probably a greater role for him somewhere in the company in the future. Effort to retain him is fully justified.

Susan Hageman: Vice President, Human Resources

Given that any strategic options will include cost cutting, and that this is easiest carried out at working levels if there are also conspicuous cuts at executive levels, she is a prime candidate for rapid departure.

Appendix 6: Global's financial situation

Comparison of Global and Market Stores

Profit after tax margins for 2001 are:

Global	3.26%
Market Stores	3.36%

The Global margin can be analysed, separating out the overseas 12% of sales contributing 2% of profit. The home sales margin then is $\frac{1,401}{38,632} = 3.7\%$.

It is realistic to assume that Market Stores buy at lower prices than Global. Global then takes a higher margin – and so has to be charging higher prices than Market Stores. The relative sales performance is not surprising.

Analysis of three-year trend data

	2001	*2000*	*1999*	
Sales value increase %	5.8	8.1	n/a	
Gross profit %	21.18	21.59	22.40	A steady downward trend
Store and admin cost %	13.42	13.59	14.38	Control of costs, but possible effect on service levels
Profit before tax %	4.87	4.99	5.00	
Profit after tax %	3.26	3.35	3.36	
ROCE %	20.70	20.83	20.02	PBIT/Total assets less current liabilities
Return on equity %	19.14	19.39	18.80	PAT/shareholders equity
	2001	*2000*	*1999*	
Current ratio	1.97	2.01	2.21	
Gearing %	37.90	38.03	40.03	Long-term liabilities/Total assets less current liabilities
Dividend paid $000 million	1.13	1.08		Calculated from change in shareholders' equity
Dividend payout %	79.02	77.70		

The latest forecast

The forecast EPS of 1.25 is a fall of 21% from the previous year. The implied profit after tax of $1,125 million would be wholly taken up by the current level of dividend of $1,130 million. Prudent financial management would suggest a cut in the dividend – but this could lead to further shareholder reaction.

No explanation is provided of the revised forecast earnings per share of $1.25 compared with $1.59, other than that it is 'current trading' – that is, it is not any accounting adjustment for pension liabilities or other restatements. The obvious areas for review are sales, whether there is actually a fall in like-for-like sales, compared with previous very modest increases, and gross margins, which have been under pressure and been falling slightly. If there has been a fall in sales, there may well be an increase in stocks, which will lead to acute pressure on short-term funding.

5.8 Sparkle pre-seen material (May 2003)

Now that you have worked through one past case, we will now analyse the May 2003 case on Sparkle, set in the competitive sports club marketplace. Below is the pre-seen material which we will analyse in Sections 5.9–5.12. The case writer's answer on Sparkle is included in Section 5.13.

After you have read the pre-seen material, start to analyse the pre-seen material as we did for the Global case above, BEFORE you look at what has been prepared for you. Remember this is **your turn** to practice and hone those analysis skills!

Sparkle

The sports club marketplace

In every major European city there are large numbers of private sports clubs, offering their members a range of sports and relaxation facilities. In some capital cities there are in excess of 100 different clubs competing for members, all offering similar facilities.

Membership of a sports club, offering a well-equipped gym, some personal training and usually a swimming pool, is becoming increasingly in demand by many young people and families, who want better facilities than the "pay as you use" facilities offered by local government in various European countries. The monthly cost of membership at a sports club is still out of reach for many, but the market is rapidly growing and is highly competitive.

Leisure time and enjoyment of sports facilities are seen as important parts of the lifestyle of many people. Many sports clubs offer a high standard of facilities and service. Membership of a sports club may be regarded as a status symbol and many people aspire to join a particular chain of sports club, which attracts famous personalities, even if no notable personalities ever attend their local club. Sports clubs cost their members around €1,000 per annum, before additional coaching or personal training costs. Members also spend money in the bar and restaurant at the clubs.

There are a few very prestigious clubs in most of the European capitals that do attract famous sports personalities and show-business stars, but the prohibitively high joining fees and monthly membership fees are unaffordable to all but the very wealthy. However, the companies that own these prestigious clubs use them to promote their own brand of sports clubs to prospective new members. Branding also helps to retain existing members. Marketing promotes the "exclusivity" and high standards that such clubs offer.

There are a number of major companies in the sport and leisure industry which all report very healthy profits and whose share prices have grown strongly in the last few years. Inevitably, there is also a small number of companies who have not been able to deliver the level of growth in profitability that their shareholders expected; some companies' share prices have dropped and some have been acquired by other, more successful, sports club companies. In most towns and cities across Europe, clubs are opening up each month or existing sports clubs are being taken over by another company and re-branded.

Background to the start of Sparkle

James Lellee had been a successful athlete who achieved an Olympic gold for his 1,500-metre run when he was 21 years old. After retiring from competitive sport in his early 20s, he made a comfortable income from being a "sports personality", making speeches, attending promotional events and television sports presenting. However, commenting on sport bored him and he had always wanted to become more involved in a sports-related business.

One day in early 1986, while working out in the gym at the sports club he used regularly, an idea came to him and he wondered why he had not thought of it earlier. Every time he went to the

sports club that he had joined years ago, there was always either a piece of gym equipment that was out of order or something minor that went wrong which spoiled his experience at the club. He was paying a substantial membership fee to an exclusive club and he felt that he was not being well looked after. He joked to his friends that he could run the club better. His friends at the club agreed that he probably could, and that set him thinking. After much consideration, he decided that he would like to operate the best ever sports club in the city.

James Lellee then set about researching which of the five clubs in the city he should try to buy and also how and where he could raise the necessary finance to acquire a sports club. He mixed in a social circuit where he had many very wealthy friends, including Charles Juan, a self-made multi-millionaire. After initial discussions, Charles Juan agreed that it would be a fun investment and agreed that he would take a share in the equity of the club that James Lellee planned to operate.

Charles Juan agreed to risk investing the equivalent of €10 million without requiring any security, if James Lellee were to give him a substantial share of the company. He agreed that Charles Juan could have a 40% stake in the company that they set up together. They called this company Sparkle.

They held initial informal discussions with the owners of two of the sports clubs in their home city, who were both sceptical as to whether a successful sportsman could actually have the business knowledge to run a sports club. Both sports club owners were reluctant to sell at the price James Lellee considered the clubs to be worth. He then decided that he would not acquire any of the existing clubs in his home city but would instead build his own sports club.

The first Sparkle club

James Lellee and his fellow director, Charles Juan, located a good accessible site in a respectable district of the city. They were both involved with the design of the club building and interior and exterior layout, and they agreed on the facilities to be offered. Within 18 months, the first Sparkle club was opened in 1988 and it was accompanied by much press coverage due to James Lellee's Olympic achievement some eight years earlier.

James Lellee had recruited a good team, and the service and the excellent facilities offered at the Sparkle club attracted a high number of members in a very short time. The new Sparkle club was recommended by members to their friends, and by the end of the first year membership was over 3,000, and the club was nearing break-even.

The growth of Sparkle clubs across Europe

On the basis of the very successful first year of the first Sparkle club, and the excellent reputation it had achieved in the very short period since it had been open, James Lellee decided that he would like to build other clubs in a number of European cities. An expansion programme was established and designs for a number of new Sparkle clubs in other cities were planned.

However, the company did not have sufficient funds to finance the expansion. James Lellee sought funding from Sparkle's bankers, using his personal property, as well as the first Sparkle club, as collateral for a substantial loan. This enabled him and Charles Juan to retain their original 60/40 share of the company.

James Lellee wanted to raise over €80 million to build Sparkle clubs in other cities, but was successful in raising only €60 million from Sparkle's bankers, who felt that the company should not expand too quickly. The bank insisted on holding the title deeds of the properties being acquired as security for the loan. The loan would be repayable in 15 years and was fixed at 12% interest per annum for the term of the loan. Loan interest is eligible for tax relief at 30%.

However, James Lellee wanted to press ahead with his plans and he had already located suitable sites for five of the planned new clubs. Furthermore, he did not want to build fewer new clubs, nor cut back on their specifications. Again, his fellow director Charles Juan came to the rescue and agreed to put together a loan, obtained from four of his wealthy friends. The terms of the loan required a fixed rate 3% higher than that of the bank loan. The full amount of this new loan of €20 million would be repayable in 15 years. As James Lellee wanted to expand rapidly, he accepted these terms on behalf of the company.

Within two years, the company was operating six Sparkle clubs. All were as successful as the first and membership was growing rapidly. All Sparkle clubs had a wide range of facilities including a large, well-equipped and properly-staffed gym, indoor and outdoor swimming pools, sauna and steam rooms, and a crèche facility. Some clubs had squash and badminton courts as well as indoor and outdoor tennis courts, and two of the clubs that were built on edge-of-town sites even had compact 9-hole golf courses and a golf driving range.

Sparkle clubs were recognised as being among the best of the sports clubs, but James Lellee did not want to have the membership costs set too high. Instead, he decided that the success of Sparkle clubs should not be based solely on profitability, but should also measure the growth in membership. If Sparkle clubs could attract and maintain a large enough membership base, he believed that profitability would take care of itself.

Sparkle's policy of allowing free access to promising sportspeople had also attracted a certain amount of funding from various sports organisations. These organisations paid for the facilities used by some promising juniors, and also helped fill off-peak use of some of the tennis courts and this helped to achieve better utilisation of facilities.

Many of the members of the Sparkle clubs had been members of other clubs in their respective cities and had switched to Sparkle clubs as the new facilities were better maintained and more competitively priced than other local sports clubs.

By the time that the sixth Sparkle club opened in 1990, James Lellee had recruited a good team of senior managers. He held the role of Chairman and Chief Executive and was actively involved in all areas of the business, especially the development of new clubs.

Charles Juan did not want to take on a full-time role with the company, but he held the role of Deputy Chairman. He helped James Lellee in the early years of the company's development by providing advice. James Lellee valued his judgement and often used him as a "sounding board" to discuss the company's future. Brief career histories of Sparkle's senior management team in 1990, who have since become directors, follow.

Charlotte Fine – Human Resources Director

Charlotte Fine, then aged 30, was previously HR manager at a leading international hotel chain, which had seen profitability rise significantly due to several factors, including the introduction of new working practices and increased staff loyalty due to an improved Employee Share scheme. Charlotte Fine was recruited into Sparkle when there were only 6 clubs, but she saw the HR Director role, her first directorship, as a great opportunity to enhance her career.

Adam Shah – Finance Director

Adam Shah had qualified as an accountant in his mid twenties while working for a software development company. Since qualifying, he has had three career moves in ten years. Before joining Sparkle, he had spent four years as Chief Accountant for a company that operated a chain of 30 restaurants across Europe. Adam Shah was a member of a Sparkle club in the city where he lived. When he was approached about the role of Finance Director for Sparkle, he seized the opportunity to move into a company while it was still developing. Although he was very commercially minded, he lacked some financial planning skills and had no personal contacts with many of the key financial institutions.

Trevor Smith – Development Director

Trevor Smith, then aged 45, had worked in the construction industry in his twenties. He had then transferred into property management, working for a chain of high street shops, where he was responsible for site selection and development. He then progressed to become Acquisitions Manager for a Europe-wide chain of retail outlets. He saw his move to Sparkle as a very exciting step, where he could help this newly-formed company grow rapidly. He was responsible for identifying suitable sites for expansion or other clubs in cities that Sparkle wished to expand to, which could possibly be acquired. He quickly formed a strong friendship with James Lellee and they worked well together in bringing the latter's ideas to life.

Ashley Wilkins – Marketing Director

Ashley Wilkins, then aged 33, had previously worked for a leading international advertising agency, followed by five years working as Marketing Manager for a smaller group of health clubs (Company D in competitor analysis shown in *Appendix 4*). He saw the opportunity at Sparkle as personally challenging and very exciting as the company had much potential. His remit was to promote the strong brand name that Sparkle had already created to boost membership numbers for all Sparkle clubs.

Stock market flotation in 1999

In 1993, after five years of operation and with 30 successful clubs across Europe, his management colleagues advised James Lellee that the company should consider flotation in a few years' time in order to raise additional finance to fund expansion. Initially, James Lellee was against the idea; with time, and discussions with Charles Juan, he agreed that it would be a logical way to grow the company.

By 1998, James Lellee recognised the need for a substantial injection of equity funds in order to reduce the burden of debt. The high levels of interest payments continued to cause cash flow problems as most of the expansion had been debt financed, and Sparkle had taken on a number of further loans from different financial institutions, since the original €80 million worth of loans. Indeed, on two occasions, interest payments had been rescheduled.

James Lellee and Charles Juan agreed to a flotation, and market analysts seemed to favour Sparkle as it had grown so rapidly since its formation only eleven years earlier. At the end of 1998, Sparkle had 42 operational clubs.

At the time of flotation in 1999, the company's stated ambitions were to have over 100 clubs in Europe by 2004, with expansion plans to operate over 200 clubs within 10 years. Sparkle publicised that it aimed to generate a return on capital employed of 20% and that it planned to reward its shareholders with both significant growth in share values and also annual dividends.

James Lellee wanted to retain a significant holding in the company, but Charles Juan, who already had personal wealth, agreed to reduce his shareholding down to 10%. Charlotte Fine proposed that a significant number of shares should be authorised for the use of staff performance-related purposes and that the six directors should also have share options.

The flotation of Sparkle was a public offer and Sparkle's advisers recommended an issue of 315 million shares of €1 nominal value, at a share premium of €0·26 per share because of Sparkle's good press coverage and the then buoyant state of the Stock Market. The issue was popular and was fully subscribed, although not as over-subscribed as analysts had expected. The shares initially traded at €1·41.

At the time of flotation in 1999, of the 400 million authorised shares, 315 million shares were issued and the main shareholdings were as follows:

	Number of shares 000s	*% shareholding*
James Lellee	100,800	32·00%
Charles Juan	31,500	10·00%
Sparkle's other four Directors	160	0·05%
Individual investors	40,950	13·00%
Institutional investors	135,290	42·95%
Employee shares *	6,300	2·00%
Total number of shares issued	315,000	100·00%

* *Note:* The employee shares were purchased by Sparkle and given to employees free of charge.

Of the shares held by institutional investors, 20% of Sparkle is held by Wye Ltd, a private equity group, which considers Sparkle to be a fast growth company. Wye Ltd wants high returns for its substantial stake in the company.

With the new injection of equity capital, Sparkle was able to repay all of its high-interest loans in full. It also negotiated a new loan of €200 million, which would be used to assist in the financing of further planned new clubs in the next five years. This new bank loan was repayable in ten years at a rate of interest of 9% per annum.

At the time Sparkle was listed in 1999, the company had six directors. An Executive Share Option Scheme was established in order to reward these directors if the planned expansion produced the forecast results, which would lead to growth in the share price. The share option scheme allowed all six directors to purchase up to 1,000,000 shares each at any time up to 31 December 2009 at a price of €2·00 per share.

Sparkle in 2002

By the end of 2002, the group owned and operated 81 clubs around Europe. There were also 12 more that were in the pipeline to be built and opened in the next 18 months. By the end of 2002, most Sparkle clubs were continuing to be very successful and profitable, but growth in membership numbers was starting to slow down. The Sparkle management team had identified that some of the first Sparkle clubs opened had membership levels remaining static and in some clubs membership levels were even falling. This was partly due to these clubs not being equipped with "state of the art" gym equipment. This was particularly noticeable in certain cities where a competing chain of sports clubs had recently opened several clubs which were marketed at the same top level as Sparkle. Sparkle's response was to increase marketing spend to promote the corporate brand name and to run a series of promotional events at certain clubs.

At the end of 2002, Sparkle's membership numbers had reached 325,000 paying members. Many new Sparkle clubs were still establishing themselves in the marketplace and in these newer clubs, membership had not reached target numbers. The brand name of Sparkle was now widely recognised in the sports club marketplace as a premier brand. This had been achieved in two ways. First, the style and facilities of Sparkle clubs had been built to a very high standard and the clubs are exceptionally well maintained. Secondly, Sparkle clubs actually do value their members.

Many companies state that "the customer is king" but few companies in reality treat their customers well and take note of what they need and desire. Sparkle has a good track record of actively looking after its customers and reacting to their needs and wishes. James Lellee is especially pleased about this as this was his intention from the start.

James Lellee knows that most of his members come to Sparkle clubs to get away from the stress and hassle of life. They expect above average facilities that are in full working order and assistance to be available without having to go looking. Sparkle has set its staffing levels at a level whereby it is able to overcome any problems that occur. As with any business, sports centres have their problems such as faulty machines and staff sickness. Sparkle attempts to overcome these everyday problems with either no disruption to members, or with little noticeable inconvenience to members. Each club manager has full, delegated authority to take the necessary action to rectify the everyday problems that occur.

Accounting information and performance measures

Sparkle operates sports clubs in a number of European countries. Sparkle has separate operating companies for each country, which are wholly owned by the Sparkle group. In each country in which Sparkle operates, it has a small regional office, with administrative staff, managed by a regional manager (see Sparkle human resources, page 11).

The regional offices are responsible for all finance, administrative and human resource issues for that country, including the payment of all suppliers in that country. The regional offices are also responsible for the production of management information for Head Office, which they prepare with the help of individual club managers.

James Lellee had always been keen to look at non-financial performance measures. He felt strongly that high achievement in the areas covered by the non-financial performance measures would reflect positively in the financial data. Some of the key non-financial measures that the Sparkle management team reviews on a regular basis are:

- *membership statistics*. These include the number of new members, the number of members leaving and the overall growth, or reduction, in membership for each club;
- *utilisation of facilities*. The weekly statistics that are produced by each club include measures such as the number of people using the gym at certain times, the number of people attending exercise classes, and tennis, squash and badminton court usage at different time periods (including the hours when courts are not used);
- *the number of staff employed*. Staff numbers are expressed in full-time equivalents, as all clubs employ large numbers of part-time staff. For example, an employee who works half of the hours of a full-time employee is half a full-time equivalent;
- *ratio of staff numbers to membership numbers of each club*. James Lellee has always wanted sufficient members of staff to be around to help members and to actively encourage them to use the facilities more effectively;
- *average length of service for staff*. Charlotte Fine's objective was to build a good, high-quality team and she encouraged active participation in running and making improvements to each club. She felt that this helped to maintain good staff relations, so that each employee felt a part of the team and would not want to leave.

The key financial performance measures that Sparkle uses to monitor each club are growth in sales, profitability and return on capital employed (defined as operating profit for the club before interest and tax divided by net operating assets for the club).

Adam Shah is responsible for the company's IT strategy, but due to other demands on his time and demands on Sparkle's finances, the company does not use very sophisticated IT solutions. Sparkle operates some of its administrative systems centrally, such as the membership database, which all clubs are able to interrogate remotely. Each club's management has been left to develop its own forecasting and budgeting systems.

Each regional office operates a nominal ledger for the clubs in its own country, which can be accessed on a "read only" basis by both Head Office finance staff and individual club managers (for their club only). Therefore club management, and Head Office, can interrogate appropriate and relevant accounting information in the nominal ledgers, or membership details from the membership database, on demand. They can generate reports that analyse income and costs by club and cost code, as well as reports analysing the membership from the membership database.

During 2002, Adam Shah introduced an updated monthly financial report that management at each club, together with its regional manager, are responsible for completing and submitting to Head Office electronically. The report includes a profitability statement for the current month and financial year to date, a rolling 12-months' cash flow forecast and key financial performance indicators. These performance indicators include:

- average turnover per member;
- turnover per full-time equivalent employee;
- profit per full-time equivalent employee;
- return on capital employed;
- profitability per club.

Unfortunately, club management, regional offices and head office have problems producing and interpreting the monthly reports, due to errors with the basic data in the nominal ledgers. For instance, where employees have moved between clubs, there is often a timing problem with obtaining correct payroll details per club. Additionally, there are always large numbers of invoices that are not yet included in the nominal ledger system, as they have been incorrectly sent directly to the clubs by suppliers, instead of to the regional office accounts department. Furthermore, many of the utility bills (for heating and lighting) are invoiced quarterly. The accruals and prepayments, which need to be prepared to ensure that correct charges are incorporated into the monthly accounts, are not always done.

While the managers at each club play an important role in the preparation of accounting information for their respective clubs, there is a general feeling at club management level of a "lack of ownership" of the figures produced for club profitability. Furthermore, some club managers simply do not recognise many of the costs that appear in the nominal ledger for their club and produce alternative management information, which does not always reconcile with the company's nominal ledger. There is a lack of communication and co-ordination between club management, regional office administration staff and the Head Office finance team. The accounting problems are further exacerbated by the fact that many club managers are not very financially astute, despite financial awareness training that is regularly offered to them.

Adam Shah feels that the company needs to invest in improving, and thoroughly overhauling, its management reporting systems, as well as its marketing and membership databases, which are proving inadequate to support current membership numbers. A recent internal audit of one under-performing club demonstrated that not all of the existing databases held consistent records. For example, when a member resigns from a Sparkle club, the individual should be removed from the marketing database, as well as the membership and billing database. Another problem had also manifested itself: a very small number of members appeared correctly on the membership and marketing databases, but did not appear on the billing database and had never been billed.

Profitability analysis

In 2002, Sparkle clubs produced a net profit before interest and tax of €40·6 million, a return on turnover of 14·3% (2001 was 17·7%). However, net operating profit after interest and tax fell by €4·9 million to €21·3 million in 2002. This was mainly as a result of cash reserves falling, resulting in far lower interest receivable in 2002.

The company had capital employed of €686·7 million at the end of 2002 (average for 2002 was €681 million), which resulted in a return on capital employed of 6·0%. (Sparkle's total return on capital employed is defined as net profit before interest and tax divided by the average total assets less current liabilities for the year.)

The profit and loss account and balance sheet for Sparkle for the last two financial years are shown in *Appendices 1* and *2* (see pages 13 and 14).

New Sparkle clubs usually turn profitable by the end of their second year of operation. In the first year of operation, after opening, the average ROCE is around 20% negative, and the second year averages a small negative ROCE. Therefore, within two years of building a new club, that club should have attracted sufficient membership to produce an operating profit. After that, each new club should increase its profitability as its membership grows and the management of each club improves.

The company was looking to achieve a far higher return on capital employed than it was currently achieving. However, the number of newer clubs, which had not yet turned profitable, distorted this statistic. A few of Sparkle's popular city-centre clubs were producing a ROCE of over 30% in 2002, whereas most of the new clubs were either still making losses or producing a ROCE of around only 4%. Additionally, there were eight clubs that had been operational for more than two years that were under-performing and were still showing an average ROCE of 10% negative each year. These clubs had an average capital employed of €9·9 million each.

The turnover of sports clubs mainly comprises fees paid by members either monthly or annually in advance of using club facilities. There is usually an element of prepaid income, which is shown as a current liability in the balance sheet, and there are none of the usual business problems associated with debtors and bad debts. The remainder of the company's turnover is additional fees paid for coaching or income generated in the clubs' restaurants and bars, and rental income generated from space let out to retailers of sports equipment and clothing.

Sparkle analyses its operating costs into five main cost categories. The breakdown of operating costs for the last two years is shown below:

Breakdown of Sparkle's operating costs	*2002 € million*	*2001 € million*
Staff costs	82·1	63·7
Utilities costs	46·8	39·6
Depreciation	30·2	23·6
Marketing costs	27·1	20·0
Other operating costs	21·3	16·1
Total	207·5	163·0

Sparkle's depreciation policy is as follows:

- land and buildings (freehold and long leasehold) are depreciated over 50 years;
- equipment is depreciated over 10 years;
- furniture and fittings are depreciated over 10 years;
- there are no cars, as all vehicles are leased.

It is not possible, from information published by Sparkle's competitors, to fully determine their cost profile. However, as many of Sparkle's competitors provide a lower quality of service that is less manpower intensive, their staff costs are likely to be much lower. Some competitors simply offer a sports club that provides gym and swimming facilities only, with a very low staff force. They do not offer the many facilities and training that Sparkle clubs offer.

Sparkle is currently in negotiation with a small competitor, Company Z, which it is planning to acquire. Company Z has 12 clubs, which are operating profitably in a European country in which Sparkle has little presence. The owner of these clubs has given Sparkle's management access to some of the internal management accounts. These give a breakdown of their operating costs, as follows:

Breakdown of Company Z's operating costs	*Company Z 2002 %*
Staff costs	28·7%
Utilities costs	21·1%
Depreciation	18·2%
Marketing costs	23·6%
Other operating costs	8·4%
Total	100·0%

Capital expenditure

History to date

The cost of building a Sparkle club varies widely, although every Sparkle club is built to the same high specifications. Each club offers different facilities, depending on its location. Some sites are edge-of-town or city suburb sites, whereas others are prestigious city-centre clubs.

Sparkle's policy is to build new clubs on carefully selected sites and to construct purpose-built clubs to its own high specifications. However, on many occasions, a suitable site in a city that Sparkle had targeted had not been available. Where a sports club or a chain of clubs belonging to a competitor had suitable facilities, Sparkle has been able to acquire either an individual club, or a small number of clubs. In order to expand the number of clubs over the next five years, Sparkle plans to build around 60% from new, with the remainder through acquisitions. It has not yet been decided whether the acquisitions will be small numbers of clubs in different European countries or possibly a major acquisition of one of Sparkle's competitors.

The capital cost of building new clubs varies. A large club with tennis, fitness, swimming and golf facilities costs considerably more than the average site, depending on the location of the site itself and the cost of land, which varies depending on the city. Over the last few years, the average cost of newly-built Sparkle clubs has been around €11·5 million each. This average cost has been based on a smaller club costing around €10 million and larger clubs (which offer a greater range of facilities) costing around €15 million.

As a general measure, Sparkle has paid an average of €9 million for clubs acquired from competing companies, which have generally been smaller city-centre clubs with limited facilities, such as only fitness and swimming. Clubs that are acquired are re-branded after acquisition and require a significant amount of capital expenditure, averaging over €2 million per club, to bring facilities in line with Sparkle's corporate guidelines, and to maintain standards across the company.

An exception to these average costs is one club that Sparkle acquired in a major European city centre. This club was previously owned and operated by a competitor, which operates a very small number of high-profile, elite sports clubs, which are frequented by some very famous personalities and also minor members of royalty. For this prestigious club, Sparkle paid a high premium, as it was purchasing a high-profile club with luxury facilities and fittings in an excellent city-centre location. This club already had a large number of wealthy members who were largely insensitive to the country's economic conditions.

Sparkle paid in excess of €50 million for this prestigious club, which is now the "flagship" of the Sparkle clubs. This club generated a turnover of around €10 million in 2002. The elite membership of this club added to the prestige of the Sparkle brand and was marketed to promote membership of other Sparkle clubs across Europe. Ashley Wilkins was very enthusiastic about this acquisition as he felt that it would enhance Sparkle's standing and help boost membership at other Sparkle clubs. At the time of the acquisition, Adam Shah argued vehemently that the company was paying too much. However, James Lellee saw this as an opportunity to acquire the club and, after much negotiation, agreed to this price. The club was profitable and the previous owner was selling it to fund other activities.

Capital expenditure has been running at around €100 million per year for the preceding three years, with a record amount of capital expenditure in 2002 of over €160 million.

Future plans

The company's current five-year plan, prepared in January 2003, shows that the number of Sparkle clubs is planned to grow from 81 clubs at the end of 2002 to 200 clubs by the end of 2007. To achieve this growth in the number of clubs, Sparkle plans to build some new clubs itself, and its management is also looking to acquire existing sports clubs, and to re-brand them. The planned capital expenditure for the next five years is forecast to be around €1,500 million if Sparkle is to grow at the rate that James Lellee and Trevor Smith would like. Details of the five-year capital expenditure plan are shown in *Appendix 3* (on page 15).

Trevor Smith has been examining several small chains of clubs that are operational in cities across Europe where Sparkle has currently little, or no, presence. These could provide Sparkle with a fast entry into those cities, particularly where prime sites are not frequently available.

It is planned that nearly half of all new Sparkle clubs in the next five years will be acquired from a number of competitors around Europe, such as Company Z. Acquiring clubs from competitors has many advantages and also many disadvantages; the key is getting the right sized club in the right location, at an acceptable price. It also speeds up the process of clubs achieving profitability sooner, as clubs acquired already have large numbers of existing members. While the plan is to acquire a small number of clubs each year from competitors, Sparkle has not ruled out one or more major acquisitions (of large numbers of clubs) if the locations and the acquisition price are acceptable.

Since flotation of the company, Adam Shah has become increasingly worried about the continued fast rollout of new clubs. The loan of €200 million taken out in 1999 has almost entirely been exhausted, and existing clubs are not yet generating sufficient cash from operations to finance the continued capital expansion programme.

Trevor Smith feels that Sparkle ought to diversify into a complementary sphere, and consider acquiring a chain of restaurants. He is pleased that the restaurants that Sparkle currently operates within each club are profitable and he feels that this is an area that Sparkle should expand into. He has brought to the attention of James Lellee a chain of restaurants that has recently been offered for sale by an international company that wants to concentrate on its core business activities. The next Sparkle Board meeting will discuss this proposed acquisition.

Sparkle human resources

Charlotte Fine has been responsible for recruiting and training a large workforce in the past 10 years, which is employed in such diverse fields as fitness training and coaching, catering, sports club management, finance and administration, and marketing. The company's ethos is to deliver a high quality of service to members and each member of staff has been carefully recruited and trained and works as part of a team.

The staff structure of the company is that each club has a manager who is responsible for all staff and activities in that club. As the number of Sparkle clubs grew, covering a number of European countries, it was necessary for James Lellee to introduce a new layer of management between individual club managers and Sparkle's directors. In early 1996, Sparkle appointed its first regional manager, and by the end of 2002 Sparkle had six regional managers. Each regional manager is responsible for managing between 10 to 15 clubs, and reports directly to James Lellee, with a dotted line relationship to the other Sparkle directors. The regional managers are responsible for managing a small finance and administrative staff, and they manage all payroll and human resource issues for their region.

The regional managers oversee the running of clubs and particularly assist with all new clubs. Regional managers assist with staff recruitment and staff training needs and also help to monitor each club's growth in membership and financial results. They are responsible for identifying under-performing areas within a club. Furthermore, if a club fails to become profitable within two years of launch, the regional manager will assist the club manager with implementing remedial action.

James Lellee always wanted every area of his clubs to offer excellent service and he felt that the only way the club could deliver this was to recruit high-quality staff in the first place. The company then trains and rewards its staff, in order to foster good company relations and to enjoy the benefits of low staff turnover and good team morale. The company also offers its staff the ability to move internally within the company, either to a different role within the same Sparkle club or to transfer to other Sparkle clubs around the country or within Europe. This policy has been very popular with many of the staff.

In many areas, Charlotte Fine has recruited graduates and offered them a fast track to management. The recruitment of young, keen graduates followed by training in the goals and ambitions of Sparkle, enabled individuals to quickly learn the business and progress rapidly in terms of salary and responsibility. Growing its own management in this way is regarded by Charlotte Fine as cost effective, compared to the slow recruitment of managers from competitors or the recruitment of managers with little understanding of the sports club marketplace. The resultant Sparkle management team is young and responsive to the needs of members.

By the end of 2002, Sparkle employed nearly 5,700 staff, of which 3,800 were full-time employees, with the remainder of the employees working part time (averaging 16 hours per week). The number of full-time equivalent employees at the end of 2002 was 4,610.

Since flotation in 1999, the company has adopted a policy of rewarding staff with free shares. The shares that are given to staff free of charge are purchased by Sparkle on the open market. An employee is entitled to free shares from the "Employee Share Scheme" each year in accordance with the following criteria:

- all staff receive a standard fixed allocation each year dependent on the overall profitability of the company;
- staff from each club can be nominated for additional free shares by club managers, based on their personal performance during the year;
- all staff at a club receive an allocation if that club's membership numbers and turnover targets are achieved.

In 2002, staff received a total of 4,300,000 shares. At the end of 2002, Sparkle employees held 18,900,000 shares, which represents 6% of the shares in issue. The total number of shares in issue remains at 315 million.

Competitor analysis

Sports clubs exist in a very crowded marketplace, in which there are many large companies operating chains of sports clubs similar to Sparkle's. There are also individual clubs in most cities that are successful as they differentiate their facilities and service to their members.

The type of customer that is attracted to sports clubs is looking to choose a club that meets several criteria. Some are simply looking for good value for money and will select a club with basic facilities at the cheaper end of the scale. Other, more discerning, customers want more extensive facilities. Location and convenience, as well as good service, remain important features, which is why Sparkle has chosen its sites so carefully.

Sparkle has consistently marketed itself as having the best facilities with excellent service and sports instructors. It is recognised as being at the top end of the private sports club market. Some other sports companies operate large numbers of clubs that provide a fairly basic gym and few other facilities, and have a substantially cheaper membership cost. They are also more profitable than Sparkle as their staff and running costs are lower.

A comparison of Sparkle with six of the many companies in the sports club market place is shown in *Appendix 4* (on page 16).

Appendix 1

Sparkle

	2002	*2001*
Number of clubs – end year	81	67
Number of clubs – average for year	74	63
Profit and loss account	*€ million*	*€ million*
Turnover	284·2	231·0
Operating costs	207·5	163·0
Gross profit	**76·7**	**68·0**
Administration expenses	36·1	27·2
Net profit before interest and tax	**40·6**	**40·8**
Net interest payable	(11·6)	(5·9)
Taxation on ordinary activities	(7·7)	(8·7)
Net operating profit after interest and tax	**21·3**	**26·2**
Dividends paid and proposed	9·9	9·5
Retained profit for the financial year	**11·4**	**16·7**

Appendix 2

Sparkle

Balance sheet	*End 2002*	*End 2001*
	€ million	*€ million*
Tangible assets		
Gross book value	845·2	683·1
Depreciation	108·5	87·9
Net book value	**736·7**	**595·2**
Current assets		
Stock	2·8	2·0
Debtors	10·4	9·1
Cash and short-term investments	26·8	132·3
Total current assets	**40·0**	**143·4**
Current liabilities		
Amounts due within 1 year:		
Trade creditors	13·7	6·8
Corporation tax	7·1	8·0
Other tax creditors	2·8	2·2
Deferred income *	61·4	41·6
Proposed dividends	5·0	4·7
Total current liabilities	**90·0**	**63·3**
Net current assets / (liabilities)	**(50·0)**	**80·1**
Creditors falling due after 1 year:		
Bank loan	200·0	200·0
Net assets	**486·7**	**475·3**
Financed by:		
Called up share capital	315·0	315·0
Share premium reserve	81·9	81·9
Profit and loss reserve	89·8	78·4
Total equity shareholders' funds	**486·7**	**475·3**

* *Note:* Deferred income represents membership fees paid in advance

Appendix 3

Sparkle – five-year plan

Analysis of number of clubs and capital expenditure

	2003	*2004*	*2005*	*2006*	*2007*
Number of clubs					
Number of clubs at start of year	81	95	115	139	168
Additions in the year:					
New build	9	10	12	17	20
Acquisitions	5	10	12	12	12
Number of clubs at end of year	95	115	139	168	200
Cost per club	*€ million*	*€ million*	*€ million*	*€ million*	*€ million*
New build	11·5	11·5	11·5	11·5	11·5
Acquisition	9·0	9·0	9·0	9·0	9·0
Re-branding per acquisition	2·0	2·0	2·0	2·0	2·0
Total forecast capital spend	*€ million*	*€ million*	*€ million*	*€ million*	*€ million*
New builds	103·5	115·0	138·0	195·5	230·0
Cost of acquisitions	45·0	90·0	108·0	108·0	108·0
Re-branding	10·0	20·0	24·0	24·0	24·0
Improvements	5·0	10·0	10·0	10·0	10·0
Major repairs	5·0	10·0	15·0	25·0	40·0
Total capital expenditure	168·5	245·0	295·0	362·5	412·0
Cumulative gross book value of tangible assets	1,013·7	1,258·7	1,553·7	1,916·2	2,328·2

Appendix 4

Comparison of Sparkle to six competitors in the sports club market place

	Sparkle	*A*	*B*	*C*	*D*	*E*	*F*
Number of clubs in Europe [end of latest year]	81	49	148	45	20	18	62
Turnover (€ million) [latest year]	284	181	370	171	44	74	171
Annual % growth in turnover [latest two years]	23%	6%	18%	19%	5%	4%	22%
Share price:							
End December 2002	€1·60	€2·48	€2·09	€0·76	€0·90	€1·34	€4·43
Highest in 2002	€1·88	€3·19	€4·23	€1·18	€0·94	€3·42	€6·98
Lowest in 2002	€1·27	€2·04	€1·98	€0·45	€0·67	€1·29	€3·60
Earnings (€ million) [latest year]	21·3	13·4	32·9	11·8	3·7	8·9	15·3
Earnings per share	€0·0676	€0·1578	€0·0941	€0·0347	€0·1069	€0·1595	€0·1784
P/E ratio * [December 2002]	23·7	15·7	22·2	21·9	8·4	8·4	24·8
Gross book value of clubs' tangible assets (€ million)	845·2	480·2	710·4	418·5	262·0	181·8	316·2
Return on capital employed **	6·0%	8·2%	15·6%	7·9%	5·4%	13·1%	13·0%
Gearing ***	29%	35%	45%	28%	42%	30%	28%
Number of full-time equivalent employees	4,610	2,550	6,070	2,600	560	1,040	2,240

Notes:

* The industry average P/E ratio is 18·4.

** Return on capital employed is defined as net profit before interest and tax divided by the average total assets less current liabilities for the year.

*** Gearing is defined as loans and borrowings as a percentage of total equity shareholders' funds plus loans and borrowings.

5.9 Analysis of Sparkle pre-seen material

5.9.1 Précis of main points of each page

Work methodically through the pre-seen and make a précis of the main information and points.

Page	*Main information*	*Significance*
2	• Case involves the leisure & fitness industry • Industry has premium pricing for quality	• Clear indication of differentiation v. cost leadership

Page	*Main Information*	*Significance*
	• Financial performance of clubs has been mixed and take-overs and rebranding common • James Lellee, a sportsman, set up his first sports club due to dissatisfaction with existing provision	issues in industry • High volatility of industry will make it hard to develop strategy • Some concern over business experience and motivation of Lellee
3	• Initial finance of €10m for first club provided by personal friend Charles Juan • Doubts expressed over Lellee's ability as businessman • First club opened 1988 and was successful • Break even membership 3,000 • Lellee keen to grow rapidly and internationally • Initial growth funded by debt secured on Lellee's assets but banks prepared to lend only €60m not full €80m @ 12% • Balance €20m borrowed informally @ 15% • All loans repayable in 15 years (1988 + 15 = 2003!)	• Clearly a business built on passion • More doubts about Lellee's business skills • Break even revenue €3m pa (3,000 × average spend of €1000) • High gearing and penal interest rates suggest high risk • Note, Juan not prepared to invest more • Lellee blinded to risks by his enthusiasm and vision • Will loans fall due for repayment in May 2003 exam?
4	• Six clubs by 1990 with premium reputation • Lellee thinks success not only profitability • Lellee CEO & Chairman • Building of a management team by 1990 • Charlotte Fine seems good recruit as HR Director • Adam Shah lacks planning and investor relations skills needed in a Financial Director • Trevor Smith seems well-qualified as Development Director	• Lellee has total power but is not strictly commercial in outlook • Sparkle shifted from entrepreneurial to functional structure by 1990 • Weak financial controls not good in a geared company
5	• Ashley Wilkins is Marketing Director and worked for smaller rival D • Debt caused by growth forced flotation in 1999 • 42 operational clubs by end of 1998 • Key goals at flotation = 100 clubs by 2004 and 200 by 2009 + 20% ROCE + significant dividend growth • Sparkle shares were issued at €1.26 in 1999 and raised €397m but were issued 11% below market value • Lellee and institutions were main shareholders in 1999 (74%)	• Demonstrates that growth leads to cash burn as clubs rose from 6 to 42 in 8 years • Goal of rapid expansion whilst raising dividends is unrealistic given past record of cash burn. Suggests Shah not good forecaster • Sparkle given poor corporate finance advice or stock market hard to forecast?
6	• Wye Ltd. private equity holds 20% of Sparkle & wants high returns • New loan €200m @ 9% repayable in 2009 • Share options scheme for Directors €2 per share before 2010 • 81 clubs and 325,000 members by 2002 • Problems in new clubs not reaching target numbers despite good reputation. Older clubs run down • Lellee customer orientated • High degree of delegation to club managers and country managers	• Venture capitalists will have conflicting motivations from Lellee • Average membership/club = 4012 which is above earlier breakeven of 3,000 • Suggestions of saturation of market • Need for additional capex to maintain membership will strain cash flows if expansion continues
7	• Balanced scorecard in place • Indications that IT/IS is not good • Club managers responsible for forecasts and Budgets • Systems improved during 2002	• How well does balanced scorecard measures track and deliver the financial results shareholders want? • Suggestion of weak financial control over clubs

Page	*Main Information*	*Significance*
8	• New system not working due to data problems and 'lack of ownership' of budgets • Low financial awareness at club level • Profitability falling and cash flow problems emerging in 2002 • New clubs struggling to become profitable within 2 years forecast (e.g. 8 have 10% negative ROCE after 2 years)	• Further evidence of weak financial control over clubs • Expansion strategy in trouble and dragging down profits and cash flows • Issue seems to be that Sparkle is running out of locations or is running into stiffer competition
9	• Data on Company Z's costs compared to Sparkle's	• Comparison between Sparkle and Z will show potential for improvement to Sparkle's financial results
10	• Sparkle has choice on whether to build Greenfield new clubs or acquire existing clubs and re-brand them. Current plan is expansion 60%/40% in favour of Greenfield development. • Sparkle bought prestigious 'flagship' club for €50 m which generates €10 m pa. Purchase resisted by Shah (FD) • Commitment to €1.5b capex over 5 years	• Expect to be asked whether financial problems can be resolved by using acquisitions more because they're cheaper and repay quicker. Consider other pros and cons of external versus organic growth • Flagship club generates 20% turnover to assets compared to 58% for Sparkle as a whole indicates Shah was right. What does this say about the commercial judgement of Lellee and his 'strong friend' Wilkins? • Capex looks unaffordable from current diminishing cash flows. Sparkle is in danger of overtrading.
11	• More details on external growth and mentioning that clubs will 'be like' Company Z • 1999 loan exhausted indicates that Sparkle needs a capital injection soon • Trevor Smith (Development Director) wants to diversify into restaurants. This will be discussed at next board meeting • Some repetition on organisational structure and Lellee's vision and commitment	• Consider whether applying Sparkle's cost and revenue ratios to Z would increase or reduce the value of clubs acquired • The viability of the expansion plan is a key issue in this case • Expect to be asked to evaluate a restaurant diversification in the exam
12	• Details of staff incentive and remuneration scheme • Repeat detail on market emphasising its competitiveness	• Does Sparkle need to be so generous with its staff and what does it get in return? • How will staff be affected if Sparkle's share price falls or rises?
13–16	• Detailed financial information to be evaluated separately • Shows falling profits • Shows comparisons between Sparkle and other clubs	• Expect to be asked about acquiring one of these other clubs or, perhaps, receiving an approach to merge or be taken over by one, in the exam

5.10 Applying technical knowledge to Sparkle

Working through the techniques covered in Chapter 4 the following additional insights

can be gained:

Technique	*Section*
The four elements of strategy (competitive, financial, investment and risk)	5.10.1
Using ratios to conduct a financial analysis of a company's position	5.10.2
Assessing a business portfolio	5.10.3
Industry analysis	5.10.4
Position audit	5.10.5
Conducting a managerial and organisational audit	5.10.6
Critical success factors	5.10.7
Assessing information systems strategy	5.10.8
Assessing corporate risk	5.10.9
Assessing the cost of capital	5.10.10
Conducting a corporate appraisal (SWOT analysis)	5.10.11
Business valuations	5.10.12
Generating strategic options	5.10.13
Evaluating strategic options	5.10.14

5.10.1 Four elements of strategy

Sparkle is pursuing a competitive strategy of differentiation in the European leisure club industry. It is seeking to grow rapidly to catch up with the much larger, and still growing, competitor B. Its financial strategy has been to use principally equity (71%) raised at flotation and to promise high current returns and promising growth. The finance has been used to build a chain of 81 clubs between 1988 and 2002 and to expand these to 168 by 2007 via a 60/40 mix of new development and acquisition. However this fast growth rate and poor cash flows from recent clubs means it must raise more capital if it is to meet its goals. Its ROCE of 6%, share price growth of 13% in 3 years (€1.60/€1.41) and annual dividend growth of 4.2% (9.9/9.5) means it has not met the promises it made to investors at flotation. Aside from specific operational risks, such as health and safety issues at clubs, the main risks Sparkle runs relates to financial risks as its growth strategy is reducing earnings and straining cash flows (its cash balances have declined by 80% between 2000 and 2001).

5.10.2 Financial analysis

Using the data on pp. 13 and 14 the following information can be extracted:

Ratio	*2002*	*2001*	*Comments*
ROCE (PBIT/TA-CL)	6%	6.04%	Slight reduction due to new clubs having negative ROCE
EPS	€0.0676	€0.0831	19% fall in EPS. This will affect the share price
Gross margin %	27%	29%	Slight fall reflecting poor returns from new clubs unable to gain critical mass of membership
Net margin PAT/Sales	7.5%	11.3%	Serious fall of 3.8% that needs investigation
Admin expenses/sales	12.7%	11.8%	Extra 1% of gross margin absorbed by increased admin costs

Net interest costs/sales	4.1%	2.6%	Extra 1.5% of gross margin absorbed by interest. This will increase if expansion continues
Asset/Turnover Turnover/TA-CL	0.41 times	0.37 times	Apparent improvement mainly due to using up of €105.5m of cash reserves from loan raised in 1999 to open 14 new clubs
Gearing loans + borrowings/equity + loans + borrowings	29%	29%	No material change and remains moderate. Some room for increased gearing.
Current ratio	0.44	2.27	Sharp fall appears worrying. However this is principally due to fall in cash reserves and rise in deferred income. Unless the firm stops trading there is no reason to expect that Sparkle will be called on to repay these advance fees.
Interest cover	3.5 times	6.9 times	Deterioration underlines the increased risk run by Sparkle as it builds more loss making clubs using cash that previously earned it interest.
Dividend cover	2.15 times	2.76 times	Slight deterioration reflecting negative cash flow implications of Sparkle's growth.

Sparkle seems to be heading into cash flow problems and lower profitability and hence lower EPS.

There also seems to be a falling share price which, according to Appendix 4 in sparkle case, has slipped from €1.88 to €1.60 during 2002. In 2001 Sparkle paid a €0.0302 dividend (9.5/315) so assuming the higher price was the cum div price inflated by this amount, and that the price at the end of 2002 contained no anticipated dividend, it still suggests a fall from €1.85 to €1.60, a fall of 13.5% precipitated by the 19% fall in EPS. The fall in the earnings is due to the rapid building programme of clubs that create more costs than revenues for the first 2 years of their existence. However, assuming that markets are efficient this should not affect the share price if the clubs generate a present value of future earnings in excess of the current costs of development and the present value of initial losses. The falling share price suggests that investors are beginning to doubt that Sparkle will generate the profits anticipated.

However this observation should be treated with caution. Because the majority of shares in Sparkle are held by directors and Wye Ltd. at most only 38% its shares can potentially change hands on the stock market. Share price volatility is likely to be greater in a thinly traded share like this and so perhaps the share price does not properly anticipate the future earnings of Sparkle in the way assumed by the efficient markets hypothesis (EMH).

The following additional financial analysis is useful:

	Sparkle	*A*	*B*	*C*	*D*	*E*	*F*
ROCE %	6.0	8.2	15.6	7.9	5.4	13.1	13.0
Net margin %	7.5	7.4	8.9	6.9	8.4	12.0	8.9
Asset T/O	0.34	0.38	0.52	0.41	0.17	0.41	0.54

Turnover per club €m	3.5	3.7	2.5	3.8	2.2	4.11	2.76
Assets per club €m	10.4	9.8	4.8	9.3	13.1	10.1	5.1
Turnover per employee	€61,605	€70,980	€60,955	€65,769	€78,571	€71,154	€76,339
Employees per club	57	52	41	58	28	58	36

Competitor A shows the benefits of better asset utilisation due to lower growth rate. It has marginally less equipment and staff per club than Sparkle (perhaps marginally smaller clubs?) but better utilisation of assets (staff and fixed assets). Perhaps once Sparkle stops growing it can perform similarly.

Competitor B is the most successful club given its high ROCE (15.6%) resulting in part from a high net margin but mainly from high asset turnover due to low asset investment per club. Its clubs seem to be smaller than Sparkle's (lower assets per club and employees per club) which suggests it is focusing on fitness equipment rather than the more resource intensive activities such as pools and courts.

Competitor C also has better asset utilisation than Sparkle, which gives it a better ROCE despite also having a rapid growth rate.

Competitor D seems in trouble. It has seemingly elected for a capital intensive approach with very few staff and very high asset investment. It forecasts little growth and enjoys the poorest ROCE.

Competitor E has similar levels of staffing and equipment to Sparkle but is able to generate a better ROCE due to greater utilisation or perhaps greater spend per customer as reflected in its better net margin and asset turnover. However with only 18 clubs it is possible that E is focused on a premium segment that is not large enough to accommodate the number of clubs that Sparkle operates. Clearly E does not anticipate much growth.

Competitor F seems to be a cost leader with very low staff and asset investments in the club, which, despite low turnover per club, does generate a good ROCE. Like B is probably focused on simply fitness and avoids the high cost assets of a full leisure club.

Another piece of comparative analysis inferred by the case is to compare Sparkle with Company Z:

	Z 2002	*Sparkle 2002*	*Sparkle 2001*	*Comments*
Staff costs	28.7	39.6	39.0	Reflects Sparkles commitment to higher staffing
Utilities	21.1	22.6	24.3	Improving but perhaps due to other costs rising faster!
Depreciation	18.2	14.6	14.5	Surprising given Sparkles high investment in assets. Could suggest inadequate provision for depreciation in accounts and therefore in budgets?
Marketing	23.6	13.1	12.3	Significantly lower but this could be due to Z being smaller
Other	8.4	10.3	9.9	

5.10.3 Business portfolio

Sparkle's portfolio is simple. There are presently 81 clubs of varying sizes in which the new ones were forecast to be negative return for 2 years but in practice seem to be remaining as Problem Children for longer. Earlier clubs yield an ROCE of 30%, which, if compared to the negative 10% ROCE of the recent clubs and the group ROCE of 6%, seem to be cash cows.

However the positive cash flows from these earlier clubs are not sufficient to finance the growth of Sparkle and so cash balances have declined.

The unusual part of Sparkle's portfolio is the 'flagship club' bought for €50m but returning only €10m turnover: asset turnover of 0.2 compared with group asset turnover of 0.34. Although supposed to add additional respectability to Sparkle's brand by association with its exclusive clientele its hard to see how this will work. The name of Sparkle is unchanged since 1988 and the clientele at the flagship club will presumably not welcome its renaming as Sparkle.

It is worth noting that, according to p. 16, Sparkle has a relative size of 0.76 by turnover and 0.55 by clubs compared to competitor B (its not possible to assess relative market share as the BCG matrix requires because we are not told the size of the entire market not whether the clubs are evenly spread across Europe). However it is noticeable that B also has the highest ROCE, which does suggest competitive strength.

5.10.4 Industry analysis

Industry life cycle stage seems to be growth for leisure clubs. This is reflected in the high P/Es for the clubs on p. 16 that are intending to grow. Given that some of the others are struggling it suggests that some growth will be accomplished by acquiring these.

However, the fact that Sparkle is finding that more recently opened clubs are not returning profits so quickly could suggest that the market is reaching a shakeout phase due to slowing demand growth whilst provision continues to grow.

Competitive position of Sparkle is broad market differentiation whilst it seems Competitors B and F are cost leaders. Competitor E seems to pursue differentiation focus.

This leaves A or C as potential acquisition targets is Sparkle wants to grow. They both have similar operational characteristics to Sparkle and with a lower PE ratio than Sparkle could permit an increase in shareholder value if acquired.

PEST factors are not discussed in the Pre-seen material and would need researching. Factors to consider would include:

Political/Legal:

- government policy on encouraging healthy lifestyle through subsidies to government run leisure and sports centers;
- changes in health and safety legislation affecting the staffing and costs of clubs;
- taxation changes on employment, for example, the treatment of self-employed coaches used by Sparkle.

Economic:

- The disposable and discretionary incomes of Sparkle's clientele (Leisure clubs may be luxury that will be cancelled in a recession.);
- Interest rates given that Sparkle may soon be borrowing capital to expand;
- The attitude of the stock market to investments in such intangible businesses as leisure centers.

Social:
- attitudes to fitness and health. Generally we assume people are becoming more conscious of their physical appearance (This will help Sparkle.);
- demographic changes affecting the age of new members.

Technology:
- new fitness equipment (e.g. smart card activated) that will hasten the obsolescence of Sparkles equipment and force additional investment;
- new fitness regimes which may necessitate re-training of staff.

5.10.5 Position audit

Using the M's model we note the following:

- *Manpower*: Staffing is high compared to Z and most other clubs and costs of average €17,809 per employee (€82.1m/4,610). However they are a source of our differentiation. Effectiveness of employee share scheme to motivate and retain staff will decline if share price continues to fall.
- *Management*: We have doubts about the motivation and commercial acumen of Lellee (and of Wilkins) and also the competence of Shah. There is also a problem of lack of financial know-how at club level, which seems to harm financial control in Sparkle. The shares owned by directors since Sparkle's flotation are falling in value and this may precipitate some action. How long will shareholders put up with the current financial performance before Directors' are put under pressure by shareholders to deliver better financial results.
- *Money*: Financial performance has not met the promises at flotation in relation to ROCE (20% promised but only 6% achieved), share price growth (its value has risen slightly but is now heading downward) or dividend growth. Sparkle's growth will force it to raise additional capital soon.
- *Makeup*: Basically a functional structure with large degree of autonomy given to club managers and regional managers. Tier of regional managers seems unnecessary given use of balanced scorecard to evaluate and control club management.
- *Machinery*: Some suggestions that equipment is run down in older clubs, which may be consequence of inadequate depreciation rate. Quality equipment is one of Sparkle's differentiating features.
- *Methods*: No specific points here.
- *Markets*: Second largest club in Europe with wide network and good reputation.
- *Materials*: Nothing specific mentioned.
- *Management information*: Forecasting has been poor and new accounting information systems and balanced scorecard need to be implemented properly.

5.10.6 Organisational and managerial audit

- All key functions except IT/IS have appropriate management.
- Some reservations over Adam Shah (FD) due to lack of financial planning skills and investor contacts. However this statement was made regarding his experience in 1999 and things may have improved since.

- James Lellee seems to lack the clear profit motivation than several significant shareholders will expect.
- Clear weaknesses at club level affecting financial control and management information.

5.10.7 Critical success factors

Revenues in this industry are the key to success because costs are mainly fixed. That is, if a facility is open then health and safety will demand a minimum level of staff cover. Other staff costs, such as coaching, are entirely variable with volume and a profit is built into the mark-up on their fees to clients. Therefore profits increase rapidly once breakeven is passed, as the case indicates clearly in relation to the first club on p. 3 and again in discussing new clubs on p. 8 (both pages refer to the pre-seen material for Sparkle case).

Revenues will be driven by:

- number of members,
- spend per member (e.g. fees, coaching, sports clothing and accessories, refreshments, etc.).

The Pre-seen also makes reference to loading of clubs during the day. This opens the opportunity for price discrimination to boost income, say by having lower fees during the day for non-working members but premium rates in evenings and weekends for working members. If costs are fixed then Sparkle should aim to maximise revenues in this way.

In terms of growth of the club the critical variable would be location of the club. The early clubs were in city centres but it seems likely that with 81 operating clubs that Sparkle will be exploring secondary locations. Moreover facilities like golf courses, pools and courts will not be viable in city centres due to the high costs of space.

5.10.8 Information systems strategy

This seems to be a weakness at Sparkle. We are told that Adam Shah does not have the time to improve it. It is also interesting that it is controlled by the FD. This suggests that it is mainly an operational accounting system and may lack the customer facing attributes of a CRM system.

Using Earl's grid it should be reassessed to see if it can yield:

- better financial information (say on fees and refunds);
- better customer information (e.g. spend per visit);
- better customer support (e.g. bookings, access to fitness records, programming of gym equipment).

5.10.9 Risk

The case does not give examples of particular risks. The issue of cash flow and overtrading has already been discussed.

5.10.10 Cost of capital

A rough cost of equity can be derived from the dividend growth model as follows.

Therefore using 2000/01 as the basis

$$K_e - g = \frac{D_0 (1 + g)}{P_0}$$

$$K_e - g = \frac{9.9 (1 + 0.042)}{504.81}$$

$$K_e = 6.2\%$$

P_0 is arrived at using data from page 16 being $P/E \times$ Earnings, that is, 23.7 × 21.3 = 504.81

Dividend growth rate is per page 13 9.9/9.5 = 0.042

Page 6 states that interest is 9% and p. 3 states loan interest qualifies for 30% relief (both pages refer to the pre-seen material for Sparkle case).

Therefore a rough WACC is given by:

$$\frac{(200 \times 0.063) + (486.7 \times 0.062)}{200 + 486.7} = 6.23\%$$

This is higher than Sparkle's 2002 ROCE of 6% which suggests destruction of shareholder value equal to €1.46m in 2002 (6.23% − 6% × total shareholder's funds of €486.7m). However as has been stated, the profits of Sparkle are depressed by the investment in new clubs and the losses in 8 of the recent clubs.

5.10.11 Corporate appraisal – SWOT analysis

Strengths:

- respected brand,
- second in market,
- profitable.

Weaknesses:

- uncommercial CEO/Chairman,
- deteriorating cash position,
- recent clubs loss making,
- loss of financial control at club level,
- high relative staff and equipment costs,
- falling share price,
- failure to live up to promises at flotation.

Opportunities:

- acquisition of struggling clubs,
- fitness lifestyle growing,
- expanding market.

Threats:

- signs of market saturation,
- intervention by Wye Ltd. if growth not delivered,
- expansion may lead to overtrading,
- potential takeover from another club as industry consolidates,
- price competitive market.

5.10.12 Value of Sparkle

Market capitalisation stands at €504.81 which is slightly (3.7%) above its net assets value of €486.7. If share price falls further it would become a break up target.

For example, if valued on P/E of B or C its market capitalisation would be below its net assets value.

Highest value, using Competitor F's P/E = (€21.3 × 24.8) = €528.24 m

5.10.13 Strategic options

This case contains clear guidance on the strategic options being considered by Sparkle's board. These are:

- to grow according to the 5 year plan to 2007,
- within the above, to choose whether to grow by acquisition of by greenfield development,
- whether to diversify into restaurants.

You should expect to be asked to evaluate these both financially and with reference to the issues confronting organic versus external growth.

5.10.14 Evaluating strategic options

These can be evaluated using the three criteria suggested by Johnson & Scholes:

Option	*Suitability*	*Acceptability*	*Feasibility*	*Preliminary verdict*
Grow according to 5 year plan	• Sparkle needs to overtake market leader B if it believes there may be a benefit in being able to offer a complete Europe-wide coverage of clubs • Will severely strain finances and lead to further decline in earnings • Market may be saturated	• Unlikely to be accepted by Wye Ltd who will be looking for strong capital growth in shares to make a return. This can only be achieved if investment stops • Lellee will wish to continue with growth despite poor financial return	• Doubts over whether Sparkle can afford this growth • Need to improve management control before committing to more clubs	Unless bargain club becomes available do not implement at the moment
Organic versus external growth	• Organic growth causes negative cash flows and costs more • External growth gives more immediate cash return and reduces competition	• No indication that anti-trust authorities will restrict growth • More likely to increase EPS in short run	• Depends on clubs becoming available at the right price and with right clientele to convert to Sparkle clubs	External growth better is possible.
Diversify into restaurants	• unnecessary distraction from main line of business • hard to see any synergies	• Preferred option of Ashley Wilkins and of James Lellee	• Will strain cash flow too far and will further disappoint investors	Not a good use of management and finance at a difficult time for Sparkle

5.11 Sparkle requirement and unseen material

Sparkle – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 18 – 22.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are the consultant appointed by the Board of Sparkle to assist the new interim Finance Director, Roger White.

Prepare a confidential internal report for the Sparkle Board that

- briefly discusses the take-over proposal from the perspective of the different stakeholder groups;
- recommends strategies which would enable Sparkle to deliver a sustainable improvement in financial performance and growth in its share price. Evaluate your proposed strategies to demonstrate how Sparkle's share price and return on capital employed could be improved. State clearly the assumptions you have made.

Note: Assume, for simplicity, tax is payable at 30%.

Sparkle – Unseen material provided on examination day

Read this information before you answer the question

Sparkle clubs since flotation

By May 2003, Sparkle had been a listed company for over three and a half years. In 1999, the company's stated ambitions were to have over 100 clubs in Europe within the next five years, growing to over 200 clubs within 10 years, and to be generating a return on capital employed of 20%. Sparkle planned to reward its shareholders with both significant growth in share values and growth in annual dividends.

The prospectus forecast for the 1999 flotation included high levels of membership growth and an ambitious capital expenditure programme to build, or to acquire, new clubs in cities across Europe. However, apart from acquiring small groups of five or fewer clubs, Sparkle has, to date, made no major acquisitions of clubs from competitors. It has continued to open new Sparkle clubs at the rate of eight each year over the last few years, except in 2002 when it opened fourteen new clubs. At the end of 2002, Sparkle operated 81 clubs.

Membership growth has not been as strong as anticipated. This is due to two main reasons. First, there has been a large increase in the number of competitors in the sports club

marketplace, with many of them offering cheaper membership and more basic facilities. Second, at the top end of this market, there has been a significant amount of "churn", with strong growth in new members, but a decline in existing membership as members are attracted to join other, newer clubs.

Shareholders' expectations

For a long time, Adam Shah has argued with James Lellee that growth in operating profit and growth in membership numbers were insufficient to satisfy shareholders. Adam Shah had to keep reminding James Lellee that shareholders want to see a growth in their investment, and James Lellee was finding it difficult to continually defend the way he wanted to run Sparkle. He still saw the company as *his* company and his dominance of the Board irritated a number of his fellow directors.

Adam Shah was worried that James Lellee would continue to dictate the way he wanted the company managed. Sparkle was not producing the desired growth in share price that shareholders expected. Unless he could convince James Lellee to bring in new management to improve profitability in some clubs, he was worried that the company could fall into decline, despite being profitable at present. He also continued to worry about the ambitious expansion plan and how this could be financed and managed, as experienced management were already barely coping with their current responsibilities.

Adam Shah had introduced a number of new financial reporting performance measures, including growth in EPS and growth in share price, and was also focussed on Sparkle's return on capital employed ratios. The return on capital employed ratios were being studied by Sparkle's management on a country-by-country basis, as well as for each individual club, to identify areas of under-performance.

Market analysts and the financial press had been critical of Sparkle's financial performance for over 12 months, and the company's share price had fallen from its 2002 high of 1·88 to its current level of 1·51. James Lellee has assured the market analysts that Sparkle's profitability and its share price will improve significantly when many of the newer clubs establish themselves and membership grows.

Appendix 5 (on page 22) shows current share prices for Sparkle and for six of its competitors, as well as share prices during 2002 (that had been given previously in the pre-seen material). The share prices for all companies in this sector have dropped over the last 12 months. Senior management in Sparkle are particularly concerned at its share price, given the increase in the number of clubs operational and the profits being generated.

Cashflow projections

For many months, Adam Shah had been increasingly concerned over the cashflow projections, due to the high capital spend on the building of new clubs and the acquisitions made. Many of the new clubs being built were coming in over budget, as James Lellee would not have anything but the best built. James Lellee did not want to reduce the high specifications of the new clubs, which could damage the corporate image.

At the end of the last financial year in December 2002, Sparkle had cash and short-term investments of just under 27 million, but this had been used to finance the rapid capital expenditure programme. All of the cash generated to date by business operations had also been used to finance the expansion of new clubs, leaving Sparkle short of cash again.

The next quarterly interest payment on the 200 million loan, which had been taken out in 1999 to finance the building of new clubs, is due at the end of June 2003 and Adam Shah is increasingly worried that the company simply will not be able to pay it.

A similar situation had recently happened to another sports club company and its share price had seen a dramatic drop as the market lost confidence in its ability to generate cash returns. Adam Shah feared that this could happen to Sparkle and has tried to warn James Lellee and

the Board. His warnings have gone unheeded. James Lellee made comments at a recent Board meeting that "Sparkle has come through worse cash shortages before, and the company is strong with a large asset base, so there is no need to worry".

Adam Shah was starting to consider whether to discuss rescheduling interest payments with the key banks involved, which had been done previously. However, since the flotation in 1999 the company has been in the public eye, and any rescheduling of interest payments would reflect badly on Sparkle's management. Instead, he sought Board approval in April 2003 for Sparkle to take out an additional loan. The Sparkle Board approved that negotiations should be commenced for a further loan of 100 million, but to date this new loan has not been finalised.

Adam Shah resigns

Following much media criticism of the Sparkle management and the company's falling share price, Adam Shah felt that it would be in the company's interests if he resigned.

He resigned on 2 May 2003. Despite James Lellee requesting him to stay on until a successor could be found, or at least completing his one-month notice period, Adam Shah asked to leave straight away, as he was concerned that the financial situation at Sparkle could get much worse. He wanted to sever his ties with the company. James Lellee reluctantly agreed to release Adam Shah from his contractual notice period.

His departure left a gap in the management structure, and there were no suitable candidates internally in Sparkle for the Finance Director role. The Board agreed to the external recruitment of a senior interim manager to act as Finance Director while the company started the process of recruiting a permanent Finance Director. The recruitment consultants identified a few suitable candidates for this temporary role, and the interim manager who was subsequently selected by the Sparkle Board was Roger White, who could start immediately.

Roger White was well respected in the financial community and had created much media attention in the past by being able to turn around companies that market analysts feared would decline into bankruptcy. His arrival at Sparkle was welcomed by most of the Sparkle Board, except that James Lellee feared that he would interfere too much in the way he was running the company. However, he agreed that Sparkle needed much tighter financial controls to ensure that it overcame its current cash flow problems and that it did not have repeated cash flow problems in the future.

James Lellee was finally starting to be concerned about the market analysts' reactions to Sparkle's results and the depressed share price. He also realised that the company now needed a senior and experienced Finance Director.

James Lellee falls ill

James Lellee continued to travel to visit Sparkle clubs throughout Europe, and it was on one of these trips that he felt unwell, but continued with his hectic schedule. On the way to one of the clubs, James Lellee suddenly collapsed, having suffered a major heart attack. Doctors advised that he would not be able to return to work for at least six months.

The Sparkle Board was notified and immediately one of the regional managers, Martin Hawkins, was appointed temporary Chief Executive. Charles Juan was appointed temporary Chairman during James Lellee's absence.

Martin Hawkins, aged 40, was the most experienced of the six regional managers, and his appointment was supported by Charles Juan. He was one of the few senior managers who had agreed with Adam Shah that Sparkle needed time to resolve problems with some of the existing clubs; he felt that the company was expanding too fast. Unlike many of his colleagues, he had spoken up against James Lellee on several occasions when they disagreed over particular issues or ways to tackle certain problems. He was an experienced, hands-on manager who had the ability to make tough decisions.

Proposed take-over by Company F

One of Sparkle's competitors, Company F, owns and operates 62 sports clubs in Europe. It has always stated that it wanted to expand rapidly and that by building its own clubs on new sites, expansion was not fast enough. *(Note: Company F is competitor F in Appendix 4 of the pre-seen material.)*

Company F offers its members lower standard fitness clubs with none of the extras, such as the extensive leisure facilities, offered at Sparkle clubs. Market analysts have, for a long time, been concerned that unless Company F "goes upmarket" there will not be enough growth at the bottom end of the private sports market to sustain Company F's current growth plans. The Chief Executive of Company F agreed with the analysts, and this has led the company to make a bid to acquire Sparkle.

Company F has access to sufficient cash resources to make an outright cash bid for Sparkle. Company F's Chief Executive, Derek Wright, stated that "we want to expand and we see the acquisition of Sparkle clubs as the right way to grow in today's buoyant market. Since we cannot grow fast enough by organic growth, we have decided that the time is right for us to acquire one of our competitors which is still struggling to succeed".

Coincidentally, the take-over bid for Sparkle was announced on the morning that James Lellee had been taken ill, which was 16 May 2003. Derek Wright had called a press conference to announce a cash offer of 1·90 per share, conditional on being assured of obtaining more than 51% of Sparkle's shares.

The rest of Sparkle's Board, led by its new temporary Chief Executive, Martin Hawkins, and its corporate advisers convened a hurried meeting to decide a course of action and to make a press statement. They announced to the financial press that, in their view, the bid should be rejected and that long-term growth prospects would be better if Sparkle were to remain independent.

The Board, including James Lellee's long-term friend and temporary Chairman, Charles Juan, was furious at the bid from Company F. Charles Juan was also angry that Derek Wright had stated that "Sparkle is struggling". Charles Juan considered that Company F's clubs were very basic bottom-of-the-range sports clubs that appeal to a very different sector of the market from the one in which Sparkle operates.

Charles Juan stated to his fellow Sparkle directors that James Lellee (who was still in hospital) would not want Sparkle to be taken over at all, least of all by Company F. However, he admitted that since its membership numbers were high (at over 350,000) and since it offered sports clubs with only basic facilities, its return on capital employed ratio was far better than Sparkle's.

The news of the proposed take-over and of James Lellee's sudden absence had mixed reactions in the financial press, but Sparkle's share price rose from 1·51 (where it had hovered for the past few months) to 1·72, mainly due to news of the bid. Also, the market analysts viewed that James Lellee's absence would force the company to make some difficult decisions. The market analysts considered that James Lellee might not be prepared to agree to some of the actions that may become necessary if he were still running the company.

The new interim Finance Director, Roger White, who was trying to grapple with Sparkle's expansion plans and cash flow problems, was now thrown into the sudden turmoil of preparing to help the Sparkle Board to defend the company from the proposed acquisition.

The Sparkle Board appointed a leading firm of corporate advisers to assist Roger White in defending itself against the proposed take-over. After several briefing meetings with the corporate advisers, Martin Hawkins and Roger White agreed on a series of short-term responses to all of the stakeholders to the proposed take-over bid.

James Lellee, Charles Juan and some of the employees are known to be supportive of the incumbent management and they would not sell their shares to Company F.

Martin Hawkins, Roger White and a representative from the firm of corporate advisers held meetings with some of the institutional investors. At these meetings, it was established that most institutional investors intended to stay loyal to Sparkle, but that the institutional investors were looking for reassurance from Sparkle's management that the company's growth in both dividends and share price would be substantial within the next two years.

The institutional investors requested that they be kept closely informed of the strategies that would be put in place by Sparkle to achieve this growth. Furthermore, they also stated that they could not give Sparkle's management any commitment of their loyalty should another higher bid occur or if Sparkle did not put in place convincing and deliverable strategies to increase growth in dividends and share price.

The Sparkle Board also appointed a consultant to assist the new interim Finance Director, Roger White. Together with Martin Hawkins, they are working to establish the strategies that are required in order to deliver a sustainable growth in share price that will enable Sparkle to defend itself from this, and any further, take-over bids.

Appendix 5

Share prices for Sparkle and six competitors

	Sparkle	*A*	*B*	*C*	*D*	*E*	*F*
Share price: 15 May 2003 (pre take-over bid)	1·51	2·41	2·05	0·73	0·86	1·31	4·34
End December 2002	1·60	2·48	2·09	0·76	0·90	1·34	4·43
Highest in 2002	1·88	3·19	4·23	1·18	0·94	3·42	6·98
Lowest in 2002	1·27	2·04	1·98	0·45	0·67	1·29	3·60

Note: Share price data for 2002 is the same material that was given as part of Appendix 4 in the pre-seen material.

Present Value Table

Present value of €1, that is $(1 + r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Periods	Interest rates (r)									
(n)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	0.683	0.672	0.661	0.650	0.640	0.630	0.620	0.610	0.601	0.592
3	0.564	0.551	0.537	0.524	0.512	0.500	0.488	0.477	0.466	0.455
4	0.467	0.451	0.437	0.423	0.410	0.397	0.384	0.373	0.361	0.350
5	0.386	0.370	0.355	0.341	0.328	0.315	0.303	0.291	0.280	0.269
6	0.319	0.303	0.289	0.275	0.262	0.250	0.238	0.227	0.217	0.207
7	0.263	0.249	0.235	0.222	0.210	0.198	0.188	0.178	0.168	0.159
8	0.218	0.204	0.191	0.179	0.168	0.157	0.148	0.139	0.130	0.123
9	0.180	0.167	0.155	0.144	0.134	0.125	0.116	0.108	0.101	0.094
10	0.149	0.137	0.126	0.116	0.107	0.099	0.092	0.085	0.078	0.073
11	0.123	0.112	0.103	0.094	0.086	0.079	0.072	0.066	0.061	0.056
12	0.102	0.092	0.083	0.076	0.069	0.062	0.057	0.052	–	–
13	0.084	0.075	0.068	0.061	0.055	–	–	–	–	–
14	0.069	0.062	0.055	–	–	–	–	–	–	–
15	0.057	0.051	–	–	–	–	–	–	–	–

Cumulative Present Value of €1 per annum. Receivable or Payable at the end of each year for n years $\frac{1 - (1 + r)^{-n}}{r}$

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods (n)	Interest rates (r) 11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Periods (n)	Interest rates (r) 21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	1.509	1.492	1.474	1.457	1.440	1.424	1.407	1.392	1.376	1.361
3	2.074	2.042	2.011	1.981	1.952	1.923	1.896	1.868	1.842	1.816
4	2.540	2.494	2.448	2.404	2.362	2.320	2.280	2.241	2.203	2.166
5	2.926	2.864	2.803	2.745	2.689	2.635	2.583	2.532	2.483	2.436
6	3.245	3.167	3.092	3.020	2.951	2.885	2.821	2.759	2.700	2.643
7	3.508	3.416	3.327	3.242	3.161	3.083	3.009	2.937	2.868	2.802
8	3.726	3.619	3.518	3.421	3.329	3.241	3.156	3.076	2.999	2.925
9	3.905	3.786	3.673	3.566	3.463	3.366	3.273	3.184	3.100	3.019
10	4.054	3.923	3.799	3.682	3.571	3.465	3.364	3.269	3.178	3.092
11	4.177	4.035	3.902	3.776	3.656	3.544	3.437	3.335	3.239	3.147
12	4.278	4.127	3.985	3.851	3.725	3.606	3.493	3.387	3.286	3.190
13	4.362	4.203	4.053	3.912	3.780	3.656	3.538	3.427	3.322	3.223
14	4.432	4.265	4.108	3.962	3.824	3.695	3.573	3.459	3.351	3.249
15	4.489	4.315	4.153	4.001	3.859	3.726	3.601	3.483	3.373	3.268
16	4.536	4.357	4.189	4.033	3.887	3.751	3.623	3.503	3.390	3.283
17	4.576	4.391	4.219	4.059	3.910	3.771	3.640	3.518	3.403	3.295
18	4.608	4.419	4.243	4.080	3.928	3.786	3.654	3.529	3.413	3.304
19	4.635	4.442	4.263	4.097	3.942	3.799	3.664	3.539	3.421	3.311
20	4.657	4.460	4.279	4.110	3.954	3.808	3.673	3.546	3.427	3.316

5.12 Debrief on Sparkle

5.12.1 Analysing the requirement

The requirement for Sparkle has surprising content, a takeover proposal and an open-ended invitation to recommend suitable strategies. Instead of the expected choice of possible acquisitions, which many candidates expected, they were faced with the hostile take-over

bid by Competitor F. Many candidates failed to appreciate the seriousness of the take-over bid and simply wrote much of their pre-prepared answers, which resulted in low marks. Your answer **MUST** relate to the requirement of the question and must incorporate the data given in the Unseen material.

The requirement for this case caught many students and tutors by surprise. The candidates who had prepared well and applied their knowledge of the case to the actual requirement generally did well and passed. However, far too many students talked about long term plans and changes to Sparkles strategies, with little or no consideration of the hostile take-over. Sparkle would not have a long-term future if is taken over by Company F. Candidates who failed to understand this key point and did not answer the requirement set, generally earned lower marks and failed.

The golden rule with all cases, is ANSWER THE REQUIREMENT THAT HAS BEEN SET – not the requirement that you expected!

Expanding this requirement into its elements makes clear what the candidate is expected to do:

Requirement	*Main elements*	*Skills & knowledge to be demonstrated*
Briefly discuss the takeover from the perspective of different stakeholder groups	• evaluation of reasonableness of F's offer of €1.90 per share compared to forecast earnings for Sparkle • consider impact of F on quality of clubs and so on members • consider impact of takeover on management of Sparkle (i.e. potential gain on shares versus redundancy) • consider impact of bid on employees (e.g. value of shares but also F's lower staff/turnover ratio suggest redundancies) • consider impact of bid on interests of secured and unsecured creditors • recognition that higher offer is likely from F	• business valuation • recognition that bid will fail if institutional investors, Lellee & Juan remain loyal • recognition that turnaround needed to retain institutions may alienate Lellee (& Juan?) if it impacts on quality of clubs • recognition of need for management of Sparkle to move to reassure these stakeholders to avoid a rush for the door amongst staff and shareholders if bid is rejected
Recommend strategies that will enable Sparkle to deliver sustainable improvement in its financial performance and its share price	• discussion of need to identify and dispose of under-performing clubs • suggestion of techniques to increase memberships and also spend per customer • recommend improvements to management controls, particularly over financial performance	• recognition that plausible strategy for Sparkle's recovery will be essential to its survival as independent firm • recognition of depth of financial problems of Sparkle • business awareness on what other clubs in real world offer and do to increase earnings • recognition of impact of efficiency drive on Lellee and other stakeholders • avoid recommending takeovers of other clubs by Sparkle which would be unrealistic in present circumstances
Evaluate your proposal and demonstrate how Sparkle's share price and ROCE could be improved.	• evaluate potential profits if expansion plan is halted • evaluate effect if efficiencies made to bring costs in line with Company Z	• financial calculations showing potential profits at different level of operating costs • financial calculation to show improvement to ROCE if 8 under-performing clubs are liquidated (elimination of loss and capital employed)

5.13 The facilitator's answer

Case Writer's Answer for Management Accounting – Case Study

REPORT

22 May 2003

To: Members of the Sparkle Board From: Consultant

Report on the proposed take-over bid by Company F from the perspective of the different stakeholder groups and the strategies available to Sparkle to secure a sustainable improvement in its financial performance and growth in its share price

Report contents:

1.0 Introduction
2.0 Terms of reference
3.0 The take-over proposal from the perspective of the different stakeholder groups
4.0 Strategies available to Sparkle to secure a sustainable improvement in its financial performance and growth in its share price
5.0 Recommendations

Appendix 1 Market capitalisation values
Appendix 2 Strengths, weaknesses, opportunities and threats analysis for Sparkle
Appendix 3 Evaluation of proposed strategies and their effect on Sparkle's profitability, ROCE and share price

1.0 Introduction

Sparkle has been a listed company for over three years but has not seen significant growth in its share price. It is operating profitably but continues to have cash flow problems due to its capital expenditure programme. Its Chairman and Chief Executive, James Lellee, is currently absent from the company, recovering from illness. The company is temporarily being managed by Martin Hawkins, who previously was one of Sparkle's regional managers. The Finance Director, Adam Shah, resigned from Sparkle in May, and the post is currently being held by an interim manager, Roger White.

Company F has made a hostile take-over bid for Sparkle and has offered a cash price of €1.90 per share, which values Sparkle at €598.5 million.

2.0 Terms of reference

I have been appointed as a consultant, who works for a firm of corporate advisers, to prepare a report that discusses the take-over proposal from the perspective of the different stakeholder groups. The report also recommends strategies that would enable Sparkle to deliver a sustainable improvement in financial performance and growth in its share price.

Attached, as Appendix 3 is an evaluation of the effects on pre-tax profits and capital employed of each of the proposed strategies. This also demonstrates how Sparkle's share price and return on capital employed could be substantially improved.

3.0 The take-over proposal from the perspective of the different stakeholder groups

3.1 Value of the take-over bid and the main shareholders

In the short term, shareholders would see an increase in the value of their shares if they accepted the proposed take-over by Company F. As shown in Appendix 1, the market

capitalisation of Sparkle has increased from a pre-bid value of almost €476 million to almost €542 million, but the bid values Sparkle at almost €600 million. The offer price of €1.90 per share in cash would be very tempting for some groups of shareholders. However, if Sparkle can demonstrate to its shareholders that the company can achieve share price growth of at least this magnitude (which it has failed to do in the past), it may be successful in defending itself against the take-over.

The proposed take-over values Sparkle at €598.5 million, which is €122.9 million higher than the pre-bid share price. Presumably, Company F feels that it can achieve synergies of at least this amount to justify this premium. The premium over the pre-bid share price is 25.8%, which is about usual for a hostile take-over of this nature.

Due to market reaction following the bid, Sparkle's share price has risen by 13.9% to €1.72, thereby reducing the premium by €66.2 million. However, the gap between the bid price and the post-bid price is €56.7 million.

While Charles Juan has stated that he considers that James Lellee would not want Sparkle taken over by Company F, perhaps with James Lellee recovering from a major heart attack, a payment of €192 million for his shares may seem attractive after all. Charles Juan is already stated to be a multi-millionaire, so a payment of €60 million for his stake may not be a significant inducement to sell; he would want to support his fellow director James Lellee.

The key influencing factor as to whether the bid will succeed or not will be the main institutional investor, Wye Ltd, and its reaction to the bid.

The main question that needs to be addressed is whether the proposed take-over by Company F is in the long-term interests of Sparkle's shareholders.

The take-over proposal needs to be evaluated from the perspective of the different stakeholder groups, which include:

1. shareholders
2. directors
3. employees
4. Sparkle's club members (that is, customers)
5. creditors
6. Sparkle's bankers
7. government

(1) Shareholders

The most important stakeholder in a company is its shareholders. Of Sparkle's shareholders, James Lellee owns the largest block of shares with a 32% holding and his fellow director and close personal friend, Charles Juan, owns 10%. Together they own 42% and can exert a lot of influence.

The three main shareholders will want to exert their personal preferences as to whether the bid should be rejected. The three main shareholders and the value of the bid to them are shown in the table below:

Shareholder	*Number of shares (000)*	*% shareholding*	*Value of the bid at €1.90/share (€ million)*
James Lellee	100,800	32.0%	192
Charles Juan	31,500	10.0%	60
Wye Ltd (institutional investor)	63,000	20.0%	120
Other shareholders	119,700	38.0%	227
Totals	315,000	100.0%	599

The institutional shareholders own around 40%, with one large shareholder, Wye Ltd, holding 20% of shares. The success of the bid may well depend on whether Wye Ltd feels that the long-term future of Sparkle will be better managed and produce better results under Company F's control, or not.

Additionally, the other institutional shareholders, which own almost 23% of Sparkle's shares, may be persuaded to accept what is on the table. A cash offer now, may be better than an empty promise for the future, particularly with the shake up of Sparkle's senior management. However, market analysts may consider the management changes favourably.

In the unseen material, it was stated that Martin Hawkins, Roger White and a representative from the corporate advisers had held meetings with some of the institutional investors. It would be expected that one of these meetings would have been with the single largest institutional investor, Wye Ltd. The unseen material states that it intends to stay loyal to Sparkle's management, but that it was looking for reassurance that Sparkle could produce substantial growth in profits and its share price within the next two years. It would be up to Sparkle's management to convince Wye Ltd in particular that they could achieve the growth that Wye Ltd is looking for.

However, if Wye Ltd were to decide that it would accept the terms of the take-over, then it would do its best to influence other shareholders also.

It would be expected that if the bid were successful, then Company F would continue to operate the majority of Sparkle clubs, as well as its own clubs, but some Sparkle clubs that are in a close proximity in the same city, would no doubt be sold or closed. Additionally, Company F may wish to close clubs that were not producing an acceptable return on capital employed. If clubs are closed, staff will be made redundant, but as all sites have a valuable city resale value, it is likely that the site would be sold easily.

If Sparkle's management can persuade shareholders not to sell their shares to Company F, by demonstrating clear and achievable strategies to generate increased profits over the next two years, then the premium may look less attractive. However, if the bid lapses, shareholders may see the Sparkle share price fall to below its post-bid level before the management's new strategies take effect.

A further problem is that Company F might increase its offer, or another competitor may make a higher bid for Sparkle.

Sparkle's earnings per share in 2002 were €0.0676 per share on earnings of €21.3 million. Sparkle paid dividends of €9.9 million in 2002 (€9.5 million in 2001), an increase of 4.2% in 2002, equating to a dividend per share of €0.0314 per share. Almost half of Sparkle's post tax earnings were paid out in dividends, in line with Sparkle's stated ambition to reward its shareholders with growing returns.

Details are not given on Company F's dividend policy or its latest accounts. The only figures available are earnings per share (which were €0.1784) and post-tax profit of €15.3 million. Therefore Company F has approximately 86 million shares in issue and a market capitalisation value of around €373 million. Even though Sparkle has a higher market capitalisation value, Company F feels that it can manage a take-over in the same market sector of this magnitude.

Post-tax profitability per club is similar for Company F and for Sparkle, despite the significantly higher capital cost of Sparkle clubs. Company F's profitability is €0.25 million per club (€15.3 divided by 62 clubs) whereas Sparkle's is €0.26 million per club (€21.3 million divided by 81 clubs). This results in Company F achieving a much higher ROCE than Sparkle (13.0% versus 6.0%).

In this industry, several companies have been the target of take-over bids over the last 18 months. In 2001, Cannons Sports clubs was the first to accept private finance to fund

expansion. During 2002, Cannons Sports made a bid to acquire Holmes Place clubs for over £200 million. However, this bid was not successful. At the time of going to print, Holmes Place remains in discussion with an interested party, which may lead to an offer to acquire it. The share price of Holmes Place has fluctuated greatly during this period, and in February 2003, the share price fell by over 40% on the announcement of a delay in the publication of its 2002 full year results and a warning of reduced profits for 2003. The share prices for other companies in this sector were also adversely affected by this news. It is expected that some rationalisation in the industry is due, and that some acquisitions and club closures will occur within the next few years.

The Cannons proposed take-over of Holmes Place, which was unsuccessful, was similar to the situation in this case, where a smaller 'down market' company was attempting to take over a larger 'up market' company.

(2) Directors

The directors of Sparkle should put the interests of the company before their own personal interests, but they will have concerns over the possible (and highly probable) loss of a job if the take-over is successful, and also the loss of their share options. They would also probably wish to be loyal to James Lellee, and want the company not to be taken over.

It is in the directors' interests to defend against the proposed take-over and ensure growth in share price, so that they could exercise their share options.

If Sparkle were to successfully defend the take-over and it was able to increase its share price, then the directors would be eligible to exercise their share options, and could make a substantial profit personally. If the Sparkle share price could be increased to €2.68 (as evaluated in Appendix 3 and discussed below) then each of Sparkle's directors could exercise his/her options and make a profit of €680,000.

Share options are exercisable at €2.00 for 1,000,000 shares for 5 of the 6 directors (not Adam Shah as he has resigned). Therefore, each of the directors could purchase up to 1,000,000 shares at a discount. For each 1,000,000 shares purchased, a director could make a profit of €680,000. Additionally, if the share price were to rise more in future years, up to December 2009, their options would be worth considerably more.

If Sparkle's share price failed to grow to this level, it would have two effects. Firstly the directors would not exercise their share options, and secondly it would be likely that Sparkle would be taken over by another company, or even by Company F having another attempt.

(3) Employees

All Sparkle employees would naturally be very concerned at the take-over bid. They would also be feeling unsettled by the two senior management changes that had occurred in May 2003. These were Adam Shah resigning and the crucial Finance Director role being filled by an interim manager while a permanent replacement is recruited. The other major personnel change was James Lellee falling ill. Many of the staff would know and respect James Lellee as he regularly visited all clubs.

Sparkle has been good to its staff with free shares and a flexible working environment (ability of staff to move between clubs and also a high number of staff working part time). At the end of 2002, Sparkle employees held 18,900,000 shares, which represents 6% of the shares in issue. While some staff may be tempted to sell their shares for the cash bid of €1.90, most employees would be expected to stay loyal to Sparkle.

Staff would fear that if the take-over were to be successful, there would be some club closures and redundancy, or general cut backs in staffing across all clubs to improve profitability.

Company F has a much lower staffing level at its clubs (2,240 full-time equivalent employees for 62 clubs equals only 36 per club, whereas Sparkle has 4,610 full-time equivalent employees at 81 clubs which equals 57 per club).

Sparkle offers a different service to its members, at higher fees, so these average employee levels cannot be directly compared, but it would seem that there is scope for staff reductions at Sparkle, by either Company F, if it was successful in the take-over, or by Sparkle's own management, to improve profitability.

Some key members of staff fearing redundancy may decide to leave of their own choice. If experienced club managers, or regional managers, were to leave, Sparkle would be even more exposed to a successful take-over, as staff are a valuable part of this service industry.

Charlotte Fine, the HR Director, should reassure staff by internal communications means, as well as meeting with senior staff members, so that staff morale is not adversely affected. Indeed, it may be possible for all club managers and regional managers to see this as an opportunity to defeat the take-over bid, by looking closer and harder at areas for improvement.

It is likely that some staff redundancies may be necessary and these will have to be dealt with fairly and carefully, so as to avoid a drop in staff morale around the company. While staff will be disappointed that redundancies may occur, they may realise that redundancies could be more widespread if Company F were to be successful in acquiring Sparkle. They, therefore, may be willing to all 'pull together' to ensure that Sparkle is not acquired.

(4) Sparkle's club members

It is likely that it would create a feeling of uncertainty with many members who may choose not to renew their membership. Furthermore, it would be difficult for Sparkle to actively market itself to attract new members with the take-over bid going on. It would receive a lot of press coverage, with much of it being negative towards Sparkle because of the lack of the expected growth in share price and its low ROCE.

Sparkle should write to all members reassuring them of Sparkle's commitment to put their needs first and that it was defending against the proposed take-over bid by Company F. It should also market the message to members, in a number of different mediums, that 'business continues as normal'.

(5) Creditors

Trade creditors may be in favour of the take-over if they felt that they would have greater security over payments and possibly an increase in business from the enlarged Company F. However, Company F may already have preferred suppliers who Sparkle does not currently do business with, which would leave Sparkle's creditors choosing to remain loyal to Sparkle for fear of losing future business.

All creditors will be looking for reassurance of payments and should continue to be paid promptly, so that any possible press speculation of a cash crisis is minimised.

(6) Sparkle's bankers

Sparkle's bankers, who have loaned €200 million, would want reassurance from Sparkle that quarterly interest payments will be made as usual. Unfortunately, due to the cash flow problem, Sparkle may have difficulty making the next quarterly interest payment of €4.5 million due at the end of June 2003.

Sparkle would also be unable to finalise negotiations for a new loan, which was approved by the Sparkle Board, whilst the take-over bid was being defended. This would put Sparkle in an

immediate cash flow crisis. It is suggested that all capital expenditure that could be delayed is done so immediately, so that all surplus cash is channeled towards the next interest payment.

Furthermore, while there is a lot to be said with being open and honest with its bankers, word would quickly travel through the financial media that Sparkle was in trouble, which could adversely affect its share price. If this happened, then the cash offer of €1.90 would look increasingly attractive to Sparkle shareholders.

This is a difficult situation, which would need extremely careful handling. Perhaps a short-term solution would be for Charles Juan to make a short-term loan to Sparkle, to help the company through this difficult period. Alternatively, James Lellee, or lawyers acting on his behalf, might be prepared to make a loan to the company. Both of these individuals have personal wealth (Charles Juan was described as a multi-millionaire and James Lellee would have funds from when the company was listed in 1999).

(7) Government

Sparkle paid corporation tax of €7.7 million in 2002, as well as other staff related costs, such as national insurance contributions. If Sparkle were to continue to expand and operate profitably, then taxation payments to European governments would increase. However, if Sparkle were to be taken over by Company F, profitability, and taxes to be paid on these larger profits, may increase to a greater extent.

Furthermore, while sports clubs operate in a competitive marketplace, it would not be in the interests of competition if there were a small number of sports club chains. However, this market sector is not closely monitored by governments and it is unlikely that the take-over would meet with any disapproval from the government in any of the European countries in which Sparkle operates.

4.0 Strategies available to Sparkle to secure a sustainable improvement in its financial performance and growth in its share price

4.1 Overview

Sparkle has expanded rapidly and has been managed by a strong Chairman and Chief Executive, James Lellee. His approach was perhaps suitable when the company was developing, but is inappropriate now that Sparkle has a diverse group of shareholders to whom it is responsible.

Sparkle needs to put the following strategies in place to ensure that the company can grow strongly in terms of shareholder value, by achieving a sustainable improvement in financial performance and growth in its share price.

A SWOT analysis showing the strengths, weaknesses, opportunities and threats facing Sparkle is shown in Appendix 2.

Sparkle should use the Porter's Five Forces model to demonstrate to its shareholders and its members how it is able to differentiate itself from its competitors. Company F has been relatively successful by being a low cost sports club and has delivered a competitively priced service to its members. Sparkle has, however, charged a premium price to its members and has been able to differentiate its clubs by offering a superior service. Sparkle's management needs to ensure that its members will continue to pay for this superior service if staffing levels are reduced. Furthermore, Sparkle's relative ability to charge premium prices may reduce, as more clubs are available in the market and price competition becomes more widespread.

In the sports club industry, there have been a number of take-overs during the last year and more rationalisation will take place, so that prospective customers can make a clearer choice when evaluating the merits and the costs of staying at particular clubs. However, the majority of members choose to remain at the club they have joined, as there is a social aspect to their decisions, which are not simply based on cost.

Sparkle needs to continue to market itself as a market leader by differentiating its clubs from its competitors, which are mainly focused by low costs and low (relatively) charges to members.

The company needs to undergo a period of stabilisation in order to put the correct IT solutions in place and to review its strategies. This is what Sparkle's Finance Director Adam Shah had been proposing for some time, but had continually been over-ruled by James Lellee.

Furthermore, Sparkle also needs to underpin its expansion plans with a well planned financing programme, which may necessitate further investment from shareholders, via a rights issue, as well as more debt finance. However, the company would not be able to raise funds via a rights issue until it could demonstrate that it could achieve a sustained improvement in its share price.

Sparkle also needs to address the human resource issues and perhaps have a major management reorganisation. James Lellee is absent, on sick leave for six months, and the company is without a permanent Finance Director. This latter post would have to remain filled by the interim manager, Roger White, until the take-over bid has been defeated, as it would be impossible for recruitment of this key role to take place whilst the company was defending the hostile bid.

Sparkle should review its policy of 'growing its own management' which may be cost effective, but the club and regional managers are perhaps not very commercially astute and are too inexperienced to manage their roles. There is also some indication of overstaffing at clubs, compared with competitors, and staffing levels throughout Sparkle should be reviewed.

The company's IT systems need reviewing and improving so that all information available for all levels of Sparkle's management is accurate and robust. Perhaps an Internet-based database solution that can be accessed by all clubs, regional offices and head office would provide the IT solution. Improved financial planning is urgently required, which should monitor actual results with plans.

4.2 Proposed strategies to secure a sustainable improvement in Sparkle's financial performance

If Sparkle is to be successful in defending against the proposed acquisition, and any further bids from other predators, it needs to demonstrate to its shareholders that it can boost its share price in the short and long term.

The share price could be increased in a number of ways. Firstly, by taking some clear strategic moves, which it had not done in the past. This would signal to the market that action is being taken to improve profitability in the future. Sparkle would need to have a clear plan in place with measurable targets so that it could demonstrate to shareholders and market analysts that it is achieving its plan.

Secondly, it needs to manage the process of delivering improved profitability and demonstrate improved return on capital employed ratios. However, even after communicating these plans, Sparkle may still be unable to defeat the proposed take-over.

A good example of another relevant take-over that occurred in this industry was when Duke Street, a venture capital group, made a successful, but hostile, take-over of the Esporta group of clubs in September 2002. Over the six-month period that the take-over took,

Esporta tried to improve its profitability to boost its share price, by selling a number of clubs that were under-performing. Despite being able to boost its share price to higher than the initial bid of 80 p per share, it was not successful in retaining its independence when Duke Street increased its bid to 87.5 p per share. The venture capital group bought almost 57% of Esporta shares for a total of £145 million. Its first actions were to remove most of the Esporta directors, including the original founders.

Sparkle's management needs to investigate the following areas and develop proposed strategies that will help it to deliver a sustainable improvement in the company's share price:

1. Improvement in its ROCE by selling or closing under-performing clubs
2. Increased membership fees at selected clubs
3. Reduction in operating costs, particularly staff costs
4. Long-term financing plan to be put in place for future expansion
5. Human resources policy

An evaluation of these proposed strategies is shown in Appendix 3.

This appendix shows that the overall effect of these proposed strategies could boost pre-tax profitability to **€71.9 million**, which is an increase of €31.3 million in a full year. If this level of profitability was delivered it could result in a much improved ROCE of **14.2%**.

This is much higher than Sparkle's current 6% ROCE but is still below Sparkle's ambitious 20% ROCE. It is, however, above the ROCE that many of its competitors are able to achieve (as shown in Appendix 4 of the pre-seen material).

However, these forecasts have been based on the actual results for 2002 with estimates for the effects of the above strategies. A detailed forecast for 2003 and 2004 should be prepared and actual results and key business statistics should be very closely monitored. Additionally, the evaluation of the proposed strategies shown in Appendix 3 does not include any one off costs, such as closure costs and redundancy costs.

If Sparkle could achieve the level of profitability shown in Appendix 3, then it could result in a possible share price of €2.68, which is far beyond the bid price by Company F of €1.90. No doubt some of the proposed strategies are among those that Company F would adopt if it were able to acquire Sparkle.

Sparkle would need to prepare and publish to shareholders and market analysts these proposed strategies and the effects that they could have on the company's long-term financial performance, in order to defend itself against the proposed take-over. If it could demonstrate to its key shareholders that it has strategies in place to deliver such a large increase in the company's profitability, ROCE and share price, many investors would be willing to give Sparkle's management a chance to prove that they can deliver the forecast results.

The directors would also need to lobby the key investors (particularly Wye Ltd) to convince them that their long-term interests are better met by Sparkle staying independent, rather than being taken over by Company F.

However, if the forecast results failed to materialise, then the institutional investors would lose confidence in Sparkle's management and the company could be faced with a further take-over bid.

4.3 Improving Sparkle's return on capital employed

Return on capital employed is very important. Overall, Sparkle is achieving only 6.0% (among the lowest of all of the competitors). If some of Sparkle's clubs are producing high returns, then a significant number of Sparkle clubs must therefore be producing low ROCE. The under-performing clubs must individually be identified and a decision taken on each of them.

Sparkle stated that it wanted to achieve a ROCE of 20%. Of the 81 clubs that are operational at the end of 2002, how many are achieving this return? The pre-seen material stated that a few clubs were producing a ROCE of over 30%, which must mean many are producing a very low ROCE.

Eight clubs were producing an ROCE of 10% negative each year and these eight clubs had an average capital employed of €9.9 million each (as stated in the pre-seen material). This means that these eight clubs are producing losses of almost €1.0 million each per year. They should be sold or closed immediately.

This action would have the effect of removing eight loss-making clubs and would boost profitability and the company's ROCE as follows:

- Sparkle's capital employed would fall by €79.2 million (the capital employed for these eight clubs) from €687 million to around €608 million.
- The effect on Sparkle's net profit before interest and tax would be to remove the losses of almost €1 million per club, which would boost profits from €40.6 million to €48.5 million. The effect of this one strategic initiative of actually closing loss-making clubs would improve Sparkle's ROCE by two whole percentage points to 8%.

The evaluation of this proposed strategy is summarised in Appendix 3. It should be noted that closure costs and redundancy costs have not been included, as the forecast is intended to reflect ongoing operations and their underlying profitability, rather than the results for the current financial year.

In respect of other possible under-performing clubs, they should be identified rapidly and management needs to investigate all aspects of the clubs (membership profile, competitors in the area, cost controls etc). After its investigations, a prompt decision should be made (perhaps within weeks), which would decide whether they could be improved quickly, or whether they should be sold. It could be that all the clubs in one European country, together with the regional office staff, are divested.

If clubs are to be sold, Sparkle needs to consider whether they would be sold as a going concern to a competitor or the club closed and the site sold. If the location was valuable, the site could be sold for alternative use, such as a retail outlet. The equipment at clubs that were closed could be either scrapped or used in other clubs if possible.

Sparkle's management also needs to look at the clubs which are achieving a high ROCE, and examine what they are doing right and replicate it in other clubs.

A further proposed strategy is to close clubs that are achieving low levels of profitability and low ROCE. It is possible that a number of clubs should be divested, possibly a further 10 clubs, which are achieving low profitability. If they were closed, this would reduce capital employed by a further around €100 million (€10 million average × 10 clubs). This move would have a positive effect on Sparkle's overall ROCE, as the capital employed would fall, but profitability would not be too significantly affected.

It is estimated that these clubs were producing a ROCE of around only 2%, which is a reduction in profits of around €2 million for all 10 clubs. This proposed strategy is included in Appendix 3.

Additionally, as the 14 clubs that were opened in 2002 increase their membership, their ROCE improves. New clubs achieve a 20% negative ROCE in their first year, which reduces to a small negative ROCE in the second year of operation (as stated in the pre-seen material). The average cost of clubs that opened in 2002 was €11.5 million each, which is €161 million for 14 clubs. Assuming the clubs opened evenly throughout the year, the average capital employed for these new clubs was €80 million in 2002 (€161 million divided by 2).

If the ROCE on these 14 clubs falls from 20% negative to, say, 2% negative in their second year of operation, the reduction in losses is as follows:

- Estimated first year losses = 20% negative × €80 million = €16 million
- Estimated second year losses = 2% negative × €161 million = €3 million

This amounts to a reduction in losses for these 14 clubs of approximately €13 million in a full year. This is included in Appendix 3.

4.4 Proposed increases in membership fees

Turnover, in the form of joining fees and membership fees, needs to be examined to see how more revenue can be generated. This can be achieved in two ways: reducing fees to attract more members (how price sensitive are fees?) or by possibly increasing fees to existing members at certain clubs (how sensitive are members at some, or all, clubs to fees? Would Sparkle lose more than 10% of members if fees were increased by 10%?).

It is proposed that Sparkle should increase membership fees at 50% of clubs (40 clubs) by 5% above inflation from the start of the next membership year. Sparkle's turnover comprises mainly membership fees but also includes income from its restaurants, coaching fees and rental income from sports shops within most clubs. However, a split of revenue has not been given, and most of the revenue generated is driven by membership numbers. For simplicity, the proposed increases in membership fees have been based on total turnover.

Estimated turnover per club is just under €4 million per club (based on 2002 turnover of €284 million divided by an average of 74 clubs). This would generate an estimated increase in turnover of €8 million (40 × 5% × €4 million). If this price increase adversely affected membership numbers, say by 1%, then this could reduce turnover by almost €2 million, resulting in a net increase of €6 million. This is included in Appendix 3.

Sparkle needs to be very careful with altering its pricing structure, because if prices were to be reduced to boost membership, it is very difficult to put them back up to previous levels and would be resisted and could cause bad press.

An audit needs to be undertaken to ensure that all members are being accurately billed, as the pre-seen material indicated that some clubs had identified a small number of members that are not being billed as Sparkle's IT systems appear not to link together.

The flagship club that was purchased for over €50 million should also be specifically reviewed to ensure that it is generating the target return of 20%. If this particular club were under-performing, then this would have a large effect on Sparkle's overall returns, since there is a large amount of capital employed associated with this club. If it is not producing the required ROCE, then Sparkle should examine ways in which this could be increased, including raising membership fees. This particular club was depicted in the pre-seen material as having 'a large wealthy membership' who may be less prone to change clubs if the membership fees were to be increased, as there is a certain amount of status associated with such a club. If the ROCE for this prestigious club is below the target 20%, a decision needs to be taken to either improve the ROCE or even sell the club.

It is proposed that membership fees at this flagship club are increased by 10% above inflation at the start of the new membership year. It is estimated that this would not affect membership numbers at the club and would generate around €1 million additional revenue. This is included in Appendix 3.

Additionally, marketing spend needs to be carefully targeted to maximise Sparkle's ability to grow its membership.

4.5 Analysis of operating costs

Operating costs need to be thoroughly examined to reduce any non-added value costs. The breakdown of costs in the pre-seen material is compared to Company Z's cost breakdown as follows:

Analysis of operating costs	*Sparkle 2002 € millions*	*Sparkle 2002 %*	*Company Z 2002 %*	*Difference 2002 %*
Staff costs	82.1	39.6%	28.7%	+10.9%
Utilities costs	46.8	22.5%	21.1%	+1.4%
Depreciation	30.2	14.5%	18.2%	−3.7%
Marketing costs	27.1	13.1%	23.6%	−10.5%
Other operating costs	21.3	10.3%	8.4%	+1.9%
Total	207.5	100.0%	100.0%	–

While it should be noted that Sparkle's costs are based on 81 clubs and Company Z has only 12 clubs, there are some striking similarities and also some striking differences. The main difference is on staff costs where Sparkle spends more than 10% more of its operating costs on staff, whereas Company Z spends 10% more on its marketing costs.

If Sparkle were able to reduce staff costs by 10%, to roughly Company Z's level, then this could save €20 million, quite a considerable sum. However, to reduce staff costs to 30% of operating costs would mean cutting headcount by 25%, which seems very drastic.

The conclusion is that Sparkle appears to be spending too much on staff costs. This is due to two possible reasons: Sparkle has more staff at each club (overstaffing) and Sparkle appears to be generous in paying its staff (salary and cost of free shares).

It is stated throughout the pre-seen that James Lellee wants a high staff-to-member ratio so that members always have access to helpful and available staff. Sparkle can no longer afford to do this. Each club needs to prepare a plan of what staffing it can manage its club well with, but without the excessive staff levels that it currently has, and also to assess what effect this may have on members.

Sparkle has an average of 57 full-time equivalent employees for each club (4,610 divided by 81 clubs as shown in Appendix 4 to the pre-seen material), which compares to 36 for Company F. Other competitors have between 28 and 58 per club, with the average among the seven companies given in Appendix 4 of the pre-seen material of 46 full-time equivalent employees.

It is proposed that staffing levels are cut by 10%, which would result in an annual saving of €8.2 million. It is estimated that this reduced level of service to members could reduce membership numbers by 1%, which would result in a fall in turnover of €2.8 million. The net effect of this proposed strategy to reduce staff costs is estimated to be €5.4 million increase in pre-tax profitability. This is included in Appendix 3.

Most of the utilities costs could not be reduced in the short term, as they are rates, heating lighting etc, and apart from the normal drive to manage these costs, no major cost savings could be made here.

Depreciation charges, which are a non-cash cost, but do affect profitability, will be affected by only two factors, which are the value of the assets employed and the depreciation policies adopted for different categories of assets. The depreciation charges will reduce as a result of the proposed club closures, as the value of assets in service will reduce. However, depreciation charges will remain the same proportion of operating costs, as other operating costs will also reduce as a result of the proposed club closures. The only way that depreciation charges could be reduced would be to change depreciation policy to lengthen the lives of assets. However, it should be noted that already the lives of fixtures and fittings and also equipment are all 10 years, which is rather long, particularly for state-of-the-art gym equipment, which

should perhaps be depreciated over 3 or 4 years. However, since reducing the asset lives would adversely affect profitability, in the short term this is not recommended, but is something that Sparkle should review in perhaps one year's time.

Therefore, these two cost categories, which make up 37% of the operating costs, cannot really be significantly changed. This leaves only staff costs, marketing spend and 'other' costs.

In respect of marketing spend, it would be very short-sighted for Sparkle to reduce marketing spend when the key to profitability is the increased utilisation of facilities, that is, more members. What is required here is an examination of the way the marketing budget is spent and who has control of the way in which it is spent. Marketing spend needs to be focussed on what will be effective, so as to achieve the objective of maintaining existing members and recruiting new members. During the period that the take-over bid is occurring, Sparkle should continue to promote its clubs and counter any adverse press about the company, so that membership is not adversely affected.

'Other' costs need to be examined by Roger White's staff and discussions with club managers should be held to control or eliminate costs in this rather misleading cost category. Over €21 million is spent by Sparkle on 'other' costs and this needs to be closely monitored and properly controlled. More meaningful cost classifications should be made.

4.6 Sparkle Board approval of the proposed strategies

After investigation and evaluation of the proposed strategies, the Sparkle Board needs to approve the strategies. The evaluation of these proposed strategies should be communicated to key shareholders and market analysts to attempt to gain their confidence, and to prove that the Sparkle Board has plans in place to boost Sparkle's share price beyond the €1.90 that Company F is offering. The company needs to ensure that it can deter shareholders from selling their shares to Company F within the time period that the bid is open for.

When the strategies and the financial forecast have been agreed and communicated to shareholders, Sparkle's management needs to prepare the operational plans that will deliver the forecast improvements. Sparkle's management also needs to carefully monitor actual results to ensure that the proposed targets are met.

Marketing budgets need to be carefully examined to ensure that marketing spend is effective. The marketing budget, handled in the past by individual club managers, needs to either be managed centrally by Ashley Wilkins (Marketing Director) or his team needs to actively get involved at club level prior to market spend being committed. Perhaps a big marketing drive would boost membership numbers and increased spending, in a proven effective manner, needs to be approved by Roger White.

4.7 New financing for expansion

Sparkle has a low gearing ratio of 29% at the end of 2002, and is profitable enough to afford increased interest payments. The company could negotiate additional loan financing to fund more, but carefully planned expansion after the take-overbid has been defeated.

Many of Sparkle's past cashflow problems appear to have originated by poor cashflow management, and poor planning. Sparkle's head office finance team, led by Roger White, needs to improve its cash control for the Sparkle group and to ensure that all club managers and regional managers understand the importance of forecasts, and the need to meet cashflow targets. In the past, much emphasis was given to profitability and not cash flow.

More careful market research of sites and cities to expand to is necessary to ensure new clubs are opened only where demand is forecast to be present and that there are not too many competing clubs already in that city.

Until the outcome of the take-over proposal is established, Sparkle must put all of its expansion plans on hold, as contracts for acquisitions and major building works could not be undertaken with the take-over bid in progress.

By effectively stopping the expansion plan, due to the take-over bid, this will have a favourable effect on the company's profitability and ROCE as there will be fewer new loss-making clubs and it will enable the newer clubs to become established and become profitable. There will be fewer clubs that produce negative ROCE and this will enable Sparkle to improve its overall level of ROCE.

All new club acquisitions or purchases of land for new clubs could not be progressed and no new contracts could be signed. Clubs that are currently under construction should be finished, but improved management control is needed to ensure that costs are contained to their original agreed budgeted capital expenditure limits.

Only when Sparkle is successful in defending against the take-over bid, should the company thoroughly review its expansion plans. Before any new commitments are agreed for purchase of sites for new clubs, or acquisitions agreed, the marketing manager should be more closely involved to ensure that the site and the city are acceptable and meet the necessary criteria for expansion and that there are not too many competitors already present there, which may necessitate undertaking further market research.

When Sparkle is successful in defending against the proposed take-over bid, a detailed financing plan should be established that could explore how funding for future expansion should be made. It is proposed that a mixture of increased equity, through a rights issue, and new debt should be used to finance a carefully planned expansion programme.

4.8 Human resources policy

Sparkle has adopted a policy of 'growing' its own management at club level. Whilst this may reduce recruitment costs, and encourage staff loyalty, staff actually managing each Sparkle club lack external experience and focus. Furthermore, many club managers are depicted as not very financially aware. This must change, and financial control at club level needs to be improved.

James Lellee has managed the company in a strong visionary manner, which is inappropriate for a listed company. Corporate governance in the company is weak and this could be improved by appointing independent non-executive directors. It is also recommended that the Chairman and Chief Executive roles are split. The company lacks external focus, which is demonstrated by the lack of share price growth.

There is a need to improve the financial controls of the company. Since the departure of Adam Shah, who had not managed the finances of a growing company well, Roger White needs to quickly put systems and procedures in place to manage Sparkle's cash flow. This would mean increasing the accuracy of profit and cashflow forecasting, which could only be done by having experienced finance staff involved at club level.

In the very short term, it would be impossible to recruit staff into these positions whilst the takeover is hanging over Sparkle. Therefore, current head office finance staff, or independent consultants, should be brought in to work with local club managers and area managers to identify exactly what is going on at the 'grass roots'.

Sparkle management needs to identify what added value regional managers contribute and whether this would be best managed by having a small head office roving team that works with club managers, rather than by country or region. As most of the regional managers are themselves ex-club managers (who ran successful clubs), they also lack the external market experience, particularly if they have only worked for Sparkle. They are also possibly not very financially aware.

Redundancies will be necessary, if the 10% cut in staffing levels is agreed. This would need to be handled carefully so that staff morale is not too adversely affected. Perhaps some staff could be given the option of moving to newer clubs that have not yet been fully resourced.

There is evidence of overstaffing throughout Sparkle clubs, and possibly in Sparkle's regional offices. A thorough review of staffing levels throughout the company is required, together with an audit of managerial experience at club level. This should ensure that key staff members are retained. Furthermore, club managers (and other Sparkle managers) who have not proven their ability to meet agreed targets, should be either given better training to improve their managerial skills or made redundant. Perhaps some regional offices should be closed.

It is also recommended that staff contracts should be reviewed, and key personnel should have a longer notice period than the one month that Adam Shah had. A three-month notice is recommended for senior management.

5.0 Recommendations

It is recommended that Sparkle defends against the proposed take-over bid by Company F by proving to its shareholders that effective steps, taken by the new management team, can be put in place to boost profitability and Sparkle's share price.

The company should close the eight loss-making clubs and possibly a further 10 clubs that are not producing an acceptable return on capital employed. Membership fees at selected clubs should be increased at above inflation rates to boost turnover, but careful monitoring of the effect on membership numbers at these clubs is necessary.

The expansion plans need to be put on hold until the bid is defeated and then a clear financing plan needs to be prepared before new clubs are built or acquired. More emphasis needs to be put on cash flow and profitability rather than on growth.

A financial forecast needs to be prepared and communicated to key investors and market analysts. This needs to clearly demonstrate that the offer of €1.90 is far too low, and that shareholders long-term interests are better served by Sparkle remaining independent.

The company needs to develop and put in place new strategies for staffing, financing and actions to improve its profitability as outlined above. This should help Sparkle to achieve its objective of a sustainable improvement in financial performance and growth in its share price.

An evaluation of these proposed changes is shown as Appendix 3, which demonstrates that Sparkle's share price could increase to €2.68 if profitability could be significantly improved. This should deter other hostile bids if the share price could be maintained and improved in the future.

Appendix 1

Market capitalisation values

	Pre-bid price	*Proposed take-over*	*Post initial bid price*
Share price	€1.51	€1.90	€1.72
Number of shares	315 million	315 million	315 million
Market capitalisation	**€475.6 million**	**€598.5 million**	**€541.8**
Change since pre-bid		+€122.9 million	+€66.2 million
Gap from bid price			**−€56.7 million**

Note: Company F has a market capitalisation of around €373 million (based on its pre-bid share price of €4.34 multiplied by 86 million shares).

Appendix 2

SWOT analysis for Sparkle

Strengths:

- Sparkle has 81 clubs, with the majority of them profitable
- It has some clubs achieving a high ROCE (over 30%)
- It has established a good brand image and is well established at the top end of the market
- It has high membership numbers overall
- Sparkle has successfully grown from nothing to being a major player in a large and growing market
- It has institutional investors who have indicated that they would stay loyal to the incumbent management
- Regional management in place and the company can cope with expansion in the number of clubs

Weaknesses:

- The share price has been disappointing since flotation and shareholders had been expecting better financial performance
- Significant short term cash flow problems
- May need to spend significant sums to keep existing club's facilities up to the required standard
- Despite the good brand image, there are signs that some clubs are no longer up to standard required by discriminating customers
- Accounting systems weak and improvements needed in budgeting and cost control
- Internal audit systems needs to be improved to cope with more clubs
- Some of Sparkle's members may leave if service levels fall due to staffing and cost cutting measures
- Management of Sparkle lacks external focus
- Some Sparkle clubs may be over-valued and Sparkle may have paid too much for some acquisitions

Opportunities:

- The market is still growing and there is room for expansion
- There may be scope for Sparkle to acquire a major competitor if its share price improves, and to take the lead in market consolidation
- Sparkle's gearing is relatively low and there is scope to borrow more, with good asset backing
- Sparkle can make some strategic changes that could significantly improve its long term financial performance
- The proposed strategic changes should increase Sparkle's share price beyond the current bid price of €1.90
- The proposed strategic changes could improve Sparkle's ROCE to over 14%
- Sparkle's management team could improve its cost control
- Sparkle new managers (Martin Hawkins and Roger White) are more externally focussed than James Lellee
- Roger White's reputation for turning companies around and improving its share price

Threats:

- Company F may increase its bid price
- Other competitors may try to acquire Sparkle even if Company F's bid is unsuccessful
- Other major players in the market may be better placed to expand and have stronger financial backing (possibly from parent company)
- Some of Sparkle's institutional investors decide not to stay loyal to Sparkle's management
- The economic outlook is not encouraging, which could adversely affect clubs at the top end of the market
- Staff morale may fall
- Roger White may decide not to stay with Sparkle during the bid process and to assist sparkle in turning the company around
- If Sparkle fails to recruit an able Finance Director for the longer term
- James Lellee may decide not to, or may be unable to, return to Sparkle

Appendix 3

Evaluation of proposed strategies and their effect on Sparkle's profitability, ROCE and share price

	Effect on net profit before interest and tax *€ million*	*Effect on capital employed* *€ million*
Sparkle 2002 financial results	**40.6**	**686.7**
Proposed strategies:		
Closure of 8 loss-making clubs	+7.9	(79.2)
Closure of 10 low-profitability clubs	(2.0)	(100.0)
Full year effect of reduction in losses for 14 new clubs	13.0	–
Increase in membership fees of 5% above inflation at 40 clubs (net of 1% fall in membership numbers)	+6.0	–
Increase in membership fees of 10% above inflation at the flagship club	+1.0	–
Reduction of 10% in number of employees, offset by a 1% reduction in turnover	+5.4	–
Forecast full year effect on pre-tax profits of proposed strategies	**71.9**	**507.5**

Forecast full year ROCE = 14.2%

Effect on Sparkle's share price:	*€ million*
Forecast pre-tax profit	**71.9**
Interest payable on €200 million loan	(18.0)
Tax at 30%	(16.2)
Forecast operating profit after interest and tax	**37.7**

Forecast EPS: $\frac{\text{€37.7 million}}{\text{315 million shares}}$ = €0.120 per share

Forecast share price *(using Sparkle's P/E ratio of 22.3) =* ***€2.68 per share***

Note 1 *Sparkle's P/E ratio at December 2002, of 23.7, could be used by candidates to calculate a revised share price.*

Note 2 *The financial effects of the proposed strategies shown in this Appendix do not include any costs associated with the disposal of loss-making clubs, nor any accounting adjustments where their sale values differ from their book values.*

Note 3 *There is scope for candidates to prepare different calculations on different strategies to those shown above, which would be acceptable. However, it is expected that candidate's calculations should show the effects of their proposed strategies on the company's profit and loss, its capital employed and on its share price.*

Note 4 *Sparkle's P/E ratio of 22.3 is based on its pre-bid share price of €1.51 and its 2002 earnings per share of € 0.0676.*

Researching the Industry for Background Knowledge

6.1 Introduction

The solutions to the cases in Chapter 5 demonstrate that an understanding of the real world context of the industry will gain you marks in TOPCIMA (Figure 6.1) by:

- providing examples of actions and strategies that companies operating in the real world would follow which could be used by the company in the case study material;
- demonstrating to the reader of your TOPCIMA report (the CIMA examiner), that you understand the industry and its opportunities and challenges, and therefore your advice is reliable and realistic;
- helping your report to look professional by avoiding suggestions of unrealistic ideas that could make your report look ridiculous and cast doubt on your competence as a management accountant.

This chapter briefly suggests ways to get industry knowledge and then applies this with reference to a further case from the FLCS exam of November 2002 – Constro (Pty) Ltd.

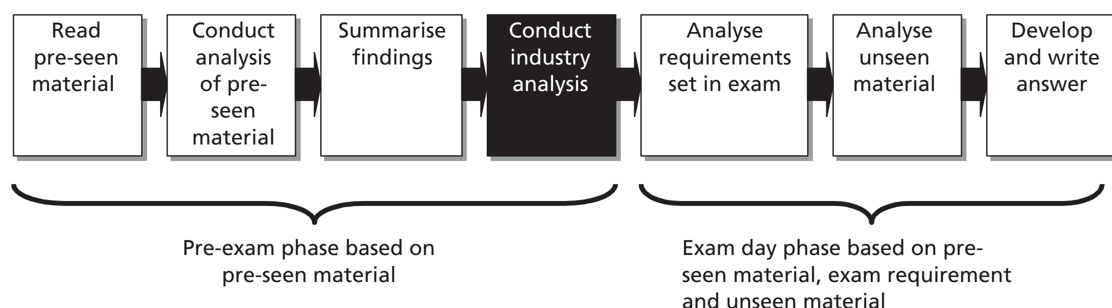

Figure 6.1 Diagram of TOPCIMA process

6.2 What to look for in conducting industry research

The pre-seen material usually contains a good summary of relevant information about the industry. This can be relied on as accurate at the time it is published.

You are unlikely to gain many marks from being able to demonstrate a grasp of the minutiae of the industry. It is likely that the recipient of your report will know this anyway and will not thank you for being told again.

Instead you must put the information into an analytical framework and use it to forecast the issues facing the organisation and, from that, justify your recommendations.

Therefore many of the factors you should look for can be summarised using the Industry Analysis section of the Technical Toolkit in Chapter 4:

1. identify industry lifecycle stage and the factors driving it;
2. identify whether any of the five forces are strong or strengthening and the forces causing this;
3. consider the competitive strategies being followed by companies operating in the real world and how they are achieved (e.g. special technologies, use of brands) and whether they could be adopted by the company in the pre-seen;
4. identify real-world issues against the PEST framework (This may involve some basic research into the laws and technologies of the industry.);
5. consider the impact of globalisation on the future of the industry and on the firm in the pre-seen.
6. Consider the problems and challenges facing companies in the real world and to be aware of topical news stories on the issues facing them and how they deal with them.

An additional factor to consider is the state of the investment markets, which will affect costs of capital and share prices.

6.3 Sources of industry information

The four sources of industry information are:

- personal networks,
- visits to similar real-world companies,
- trade media and news media,
- Internet searching.

6.3.1 Personal networks

Some candidates have been lucky enough to find themselves facing a set of pre-seen material describing the industry they work in. In this situation, they have plenty of colleagues they can talk to about.

Alternatively, and depending on the industry in the *Case Study*, it is possible that you know someone in the business from whom you can get information.

Likely contacts include:

- other people in your college class who work in the industry or who have worked in it;
- family members or their friends;
- contacts at work who have dealings with the industry in the case.

Discussing the case and your analysis of the situation of the business with an expert will help you to test out your understanding of what is important.

6.3.2 Visiting similar firms

Again, this depends on the accessibility of the industry. For example, the case studies on Global and Sparkle reviewed in Chapter 5 gave ample opportunity for candidates, at least in the UK, to visit various supermarkets and leisure clubs to see first-hand the product ranges and methods of competing they used.

However in observing competitive strategy and product range, or in talking to managers (if they will spare you the time) about the industry you should always remember that you are trying to draw conclusions about the future for the industry.

6.3.3 Trade media and news media

A journalist is a paid professional who searches out and presents information about an industry. If you can find a trade journal for the industry in the case it will save you a lot of searching for yourself. It is also easier than a web page or conversation to cite as a source in your final report.

Trade journals can be located in four ways:

- *Visit a good newsagent*. The difficulty here is that only very large industries such as accounting, financial advising, computing, music and building provide enough customers for a newsagent to consider stocking the magazine.
- *Visit a business library*. Most universities and better colleges will permit you a reader's ticket to consult their journals on a read-only basis. It is a good idea to take along your CIMA membership details to demonstrate that you're a serious student. However such libraries will not let you borrow journals and may place restrictions on photocopying them. Good librarians will be able to locate relevant journals for you too.
- Ask someone who works in the industry for the name of the journals for the industry.
- *Use the Internet*. Many trade journals now have websites and, in many cases, can be downloaded as PDFs. Naturally there will be restrictions on logging in if you have not paid but there is a surprising amount of free media available. The best approach is to go to a search engine (see below) and type in a search inquiry such as: 'trade magazine for <name of industry> industry' or 'articles on <name of industry or real world firm>'.

News media is more general although some quality business newspapers may carry special supplements on particular industries from time to time.

It is also very important to spend time reading the financial pages of any good newspaper, not necessarily the *Financial Times*. It is relevant to understand what is happening in the real world with acquisitions, mergers, down sizing, boardroom conflicts etc. The more widely that you read the financial press, the more it will help you to understand and fully appreciate all of the many complex factors that affect companies and the selection and implementation of their strategies.

Obviously news media is available in hard copy from shops but also most good newspapers have websites that give you the day's stories and also have searchable archives on past stories about the industry or specific firms within it.

www.ft.com	Website of UK *Financial Times* with searchable articles archive	Useful for • articles on particular firms • articles and surveys on industries • surveys on countries • articles on technologies and management techniques
www.nytimes.com	Website of US *New York Times* with searchable articles archive	As FT above but with greater emphasis on US firms
www.theeconomist.com	Website of *Economist* magazine with searchable articles archive	Useful for • surveys of large industries • economic surveys of countries • economic forecasts
www.bloomberg.com	Financial information website	Useful for • investor information on particular firms (including history of share price) • surveys of prospects for particular industrial sectors

6.3.4 Using the Internet

This is the most convenient and commonly used method of researching the industry.

Generally you will be looking for the following sorts of information:

- Websites of firms similar to the one(s) in the TOPCIMA pre-seen material. This can help you learn about the sorts of products and competitive strategies they follow and may also yield financial information that can be compared with the data in the pre-seen material.
- Trade journals of the industry in the pre-seen. This will provide information on real-world environmental issues facing the business.
- Articles on the industry in journals and newspapers. These will keep you up-to-date on developments.
- Stock market information on the real firms.

Internet searching requires the use of a search engine. There are two sorts:

(1) *Proprietary search engines*: These are for subscribers only and will give access to journal articles. It is not worth subscribing to one of these in order to pass TOPCIMA. However, if your employer, or library, already subscribes to one, then it is a valuable resource.

(2) *Public search engines*: These are much less focused on business information but they are free to use (providing you do not mind all the pop-ups and banner advertising you will receive too). Some examples of search engines are given below:

www.allsearchengines.co.uk/business_list.htm	Powerful meta-search engine for business sites
www.searchengineguide.com/pages/Business/	International site giving links to industry specific search engines
www.bizweb.com	Directory of US business websites broken down by industry
www.google.com (or www.google.co.uk) www.yahoo.com (or www.yahoo.co.uk) www.copernic.com www.ask.com(or www.ask.co.uk)	These are familiar public search engines which can access public documents and other search engines

To search on the Internet, it is important to have keywords that will identify the articles and sites you are interested in.

To avoid information overload we suggest you follow these rules:

- Start your search as narrowly as possible. For example, suppose you were researching the food retailing industry as part of your preparation for the May 2002 case study on Global Inc. reviewed in Chapter 5. The keyword 'retail' is too broad and it is better to use the keywords 'retail, food, UK'.
- Where you have the option, instruct the search engine to 'search for all words', that is to look for items that contain all the words, rather than 'search for any words' which, in the example above, would list all sites with the word 'UK' in it.
- Another way to ensure that only items corresponding to all the keywords are selected is to input the keywords with '+' between them, for example, 'retail+food+UK'.
- Set yourself a time limit for your search; we suggest 30 min, after which you read through what you have found to make sure it is relevant to questions posed in Section 6.2.2. It is very easy to spend a lot of time following irrelevant lines of enquiry in cyberspace.

By using merely one of these public search engines, you may generate around 20 Email 'alerts' each day! It is recommended that you read these news alerts on a regular basis and that you properly manage this vast flow of information. Do not get bogged down by information overload – be decisive. If the news alert contains information that is relevant to your research for the case, then retain it for future reference. However, most of the email alerts may not be strictly relevant, so you should delete them after you have read them. If you do not manage this information process as it arrives, you will find a huge mass of data that becomes difficult to manage and absorb. Information overload can be worse than no information. Use your common sense to sort the relevant from the irrelevant.

6.3.5 Using information from company websites

If companies can be identified that are in the same or similar industries to the industry in the *Case Study*, and these are relatively simple companies, not conglomerates, it is possible to gain much information from these websites. It is not helpful, as some candidates and tutors have done, to believe that you have found the company on which the case-writer has modeled their material. No past case has ever been based exclusively on a real-world company and hence data will have been changed significantly.

Company websites of public companies in similar industries can provide the annual report and accounts, any press releases, publicity material and product descriptions, and detailed documentation on such matters as rights issues and share option schemes. Often they contain specially commissioned pieces of market research that you can download. However its worth remembering that this research is there to encourage investors to anticipate higher returns in the future and will tend to put an optimistic gloss on events.

Some US company sites provide exceptional levels of information including all legal document filings, such as company returns. However remember this is only background: don't spend too long on gathering this information.

You should review the accounts and establish:

- typical industry working capital ratios;
- typical ratios of fixed assets to sales;
- margins;
- growth rates.

You should then compare the accounts with the current share price and compare the market capitalisation with the asset value, and review all the normal investment ratios.

You may provide yourself with some 'normal' industry figures as a basis for any comparisons you may wish to make of the unseen material in due course.

You should also review all the non-financial information provided, looking in particular for:

- new technological developments, new products;
- the competitive situation.

You should also regularly read the business pages of a quality newspaper (at least once a week) to learn what is happening in the business world. It is almost impossible not to find at least one article in any newspaper that is relevant to your research for the TOPCIMA exam, and sometimes there are several, depending on the industry that you are researching.

For example, when the pre-seen material for Sparkle was available, there was a spate of both friendly and hostile take-over bids, and also a floatation of one company, in the private sports club industry. Therefore, well-read candidates were able to relate to these companies and quote real life examples in their exam answer, which enhanced the credibility of the rest of their answer.

6.4 November 2002 Case Study pre-seen

Now that you understand the ways in which industry data may be collected and researched, we will look at the November 2002 FLCS Case Study on Constro. Shown below is the pre-seen material for Constro and in Sections 6.5–6.7 we will analyse this pre-seen material.

Constro (Pty) Ltd

Background to telecommunications in Africa

Africa is some way behind the rest of the world in terms of communications and even landlines are few and notoriously unreliable. Because of government bureaucracy in some countries, waiting lists for landlines are long, and high tariffs have contributed to the fact that all but wealthy individuals and multinational businesses have no access to basic communication services.

Africa has experienced many problems throughout the last century, including political instability in many countries and natural disasters. For these reasons alone, few companies have been enthusiastic to invest large amounts in infrastructure since the level of returns is so uncertain.

Some countries in Africa are now undergoing a period of change, and investment in the vital infrastructure is at last happening, although many African countries remain underdeveloped. Historically, most of the fixed (landline) telecommunications infrastructure has been dominated by government-run telephone networks, and in many countries the telephone systems in place are ageing and regularly have major maintenance problems, partly caused by climatic extremes.

The Africa Telecom 1998 Conference

The Africa Telecom 1998 conference was opened by the (then) South African President Nelson Mandela in May 1998. The event attracted nearly 20,000 telecommunications (telecoms) specialists. It was hailed as a triumph by many of Africa's leaders, who wanted to see the latest technology being exhibited. Over 400 companies had exhibitions of their products and services and the exhibition covered telecoms, information technology and audio-visual entertainment fields.

The conference was attended by over 500 VIPs including heads of state, ambassadors and government ministers of many of Africa's 55 countries. Attendees included industry leaders at the highest level, as well as many industry analysts and commentators.

Among the many important industrialists who attended this conference was a delegation from Constro (Pty) Limited, a leading construction company in the country of Afri. The Chairman and Chief Executive, Malan Beka, had always been frustrated that his home continent was so far behind the rest of the world in telecoms and was interested to hear what the leading telecoms companies from around the world would be saying and how they saw the future of telecoms in Africa.

Demographic data for the country of Afri for the year 2000

The key statistics for this country are as follows:

Area	0·9 million sq km
Political system	Democratic republic
Number of major towns	9 (including the capital city)
Number of ports	2
Population	42 million
Population growth rate	2·0% each year
Urban population (as a % of total population)	45%
GDP	US$ 50,400 million
GDP growth rate	1·2% per annum
Exports	Oil, textiles, fruit, leather, olive oil, clothing.

Constro

Constro (Pty) Ltd (Constro) is a large construction company that has been operating for over 40 years in the North African country of Afri. Constro's shares are not listed on a stock exchange but the majority of the shares are held by four of Afri's former industrialists. No market value is easily available for Constro.

The principal four shareholders of the company are all now retired, and no family members are actively involved with, or employed by, Constro. The families of the four main shareholders all have their own business interests. The owners required dividends of $20 million in 2001 in total, and the remaining cash generated from operations is held in the form of short- and medium-term investments, which have a variety of risk profiles. The founders have no family succession plan and the appointed Constro Board of Directors has full authority for the company's actions.

Constro's four shareholders have had a number of approaches from leading African companies and other multinational companies over the last ten years, all of which have been declined as the owners have stated that Constro is not for sale. The prices offered for Constro have varied between $250 million and $450 million, all of which have been refused.

Constro is one of the Afri government's preferred builders and has been involved in a number of large, high-risk construction projects including the construction of a large hydroelectric dam. Its main areas of construction have included road-building projects, building of airports and other construction projects involving public service buildings, such as administration offices and hospitals within Afri.

The company has two wholly-owned subsidiaries, one of which is involved in the construction of residential houses and apartments. The other is involved in the import and sale of domestic electrical appliances. The company has grown rapidly in the past by expansion in new areas, such as the import and sale of domestic electrical products, and is in need of a new opportunity to invest some of its available cash reserves.

The Board of Directors of Constro is made up mainly of Afri nationals, many of whom had worked outside of Africa in a variety of jobs before returning to their home country. Brief career histories of some of Constro's senior management follow.

Malan Beka –Chairman and Chief Executive

Malan Beka is 51 years old. He had been educated in Europe and had graduated from a leading university with a degree in electrical engineering. After working for several large construction companies in the UK and Europe for over 10 years, he returned to his native country of Afri in his early thirties.

He joined Constro as Director of Road-building, and worked in this division for almost 10 years. He was then transferred to Constro's Special Construction Projects team, where he managed a large contract, which was finished almost on time and to the satisfaction of the government. This project had brought him closer to many influential government ministers and he has maintained and built upon these links, which have assisted Constro in being awarded many more contracts over the years.

Five years ago, the founder of the company, Mani Freel, retired. He appointed Malan Beka as Chairman and Chief Executive, with a remit to expand the company and to take it into the 21st century. The company has built up large cash reserves from positive cash flows for the last quarter century, and has been awaiting a suitable investment opportunity. With the exception of dividends, the owners of Constro and their families have no desire at present to remove funds from the company.

Malan Beka does not see how the company can expand, or indeed maintain its current turnover and profitability, unless it generates business in new areas. The country of Afri has been transformed over a 50-year period and now has a good road infrastructure in place. While there are new building projects that Constro could bid for, the scope for expansion is becoming limited.

In order for Constro to continue to grow, Malan Beka knows that Constro will have to embrace some of the many new business opportunities that are manifesting themselves in the fast-changing African continent. No longer could the company operate only within its own country or almost entirely within its current sphere of construction. Malan Beka, with his electrical engineering background, has always been interested in and knowledgeable about telecoms.

Andani Noon – Operations Director

Andani Noon, aged 48, has worked on large road and other building projects for Constro for over 20 years. He is an excellent manager and is well respected by the large workforce. He feels that Constro is good at building projects and should expand by bidding for construction contracts in neighbouring countries and elsewhere within Africa.

He is a little narrow-minded and, while happy to see changes introduced in working practice, he is not a very forward thinking director. Constro appointed him as Operations Director as he has the management skills to deliver the projects that he oversees, meeting quality and safety standards and deadlines.

Ben Knowle – Finance Director

Ben Knowle, aged 52, has been Finance Director of Constro for 18 years and has worked for the company for over 25 years, having started his career with one of the other large construction companies in Afri. He is IT-literate and is responsible for the IT requirements of the company and its subsidiaries.

He has seen the company grow and expand over the last ten years and he has introduced some very popular management tools, including sophisticated forecasting systems and an executive information system that all the senior managers actively use.

While he is forward thinking, he is very cautious by nature, and has always been reluctant to support Malan Beka's keenness to see the company expand into telecoms. He feels that the company is managing to grow, both in turnover and profitability, and does not see the need to put the company at risk by diversifying into telecoms.

Sol Endi – Marketing Director

Sol Endi joined Constro five years ago, having worked for a number of large companies in different African countries over the last 15 years. At the age of 40, he has acquired a wide

range of marketing experience, though none in the telecoms industry. He feels confident that he can contribute to Constro's growth by continuing to increase the market awareness of its projects and available products. He has a small team of marketing managers, mainly dealing with the sales of residential accommodation and household appliances. His marketing team does very little work in regard to the large government-financed projects.

Sol Endi sees the growth of mobile telecoms in Africa as a huge opportunity for Constro. The company could also become involved in the import and sale of mobile handsets both within Afri and in other countries in Africa. He feels confident that Constro has the necessary purchasing and stock control systems in place to purchase in bulk from manufacturers and to sell to end users in Afri and in several neighbouring African countries.

AfriTel (Pty) Ltd (AfriTel)

The senior managers from Constro who attended the *Africa Telecom 1998 Conference* were encouraged by all that they had seen and heard at the conference. Many of the senior management team had been educated in Europe and had lived and worked abroad (outside of Africa) before returning to Africa. They were continually frustrated that Africa had failed to move with the rest of the world. Africa simply did not have access to the technology or the required infrastructure to improve and revolutionise companies' business practices and to improve the lifestyle of individuals.

In 1998, many African countries had either cellular mobile networks operating or were preparing to launch cellular networks, but the Afri government had been slow to react to the potential demand for mobile telephony.

Immediately following the conference, Malan Beka prepared a detailed paper for the next monthly Board meeting. In it he proposed that a subsidiary company should be set up to explore ways in which Constro could enter the fast-growing telecoms business in Afri.

Malan Beka felt strongly that Constro had the expertise and the necessary standing in the business community to finance the venture into telecoms and he badly wanted Constro to benefit from the large profits that telecoms companies elsewhere around the world were generating.

During the meeting, the Board agreed to set up a subsidiary company, wholly owned by Constro, called AfriTel, to explore this possible new market.

New staff recruited for AfriTel

Malan Beka appointed a global high-technology recruitment agency to identify some key individuals who had the necessary technical and managerial skills that Constro would need. Using this agency, Malan Beka recruited Tanda Lew in 1999 to be the Telecommunications Director for Constro, who would also hold the role of Chief Executive of AfriTel.

Tanda Lew's remit was to develop a strategy for how Constro could enter the growing telecoms market in Afri. This appointment was controversial at the time, and was opposed by many other senior managers in Constro who were concerned that Constro was entering an unfamiliar business sphere.

Tanda Lew is 43 years old and has had extensive experience in a variety of roles in cellular mobile telephony. He had worked for two different global telecoms companies. He had also been educated in Europe and had worked for over 12 years installing cellular networks in Europe for a leading telecoms company with global interests. He was then headhunted to design and implement a cellular network in an Eastern European country by a different global telecoms company, where he worked for four years prior to joining Constro.

He is an experienced telecoms engineer, who is well respected in the industry. He has a proven track record of managing the selection and implementation of mobile telecommunication technologies to meet the chosen objectives of the companies he has worked for.

When Malan Beka approached him for the role in Constro, he was initially a little reluctant. He was unsure whether the country of Afri would ever embrace the challenges of the technologies

available, and did not want to find himself in a role in which it would take many years to bring a project to fruition. However, he accepted the challenge and was given a free rein to recruit a small team and to develop a business plan.

By the end of 2000, Tanda Lew had put together a small team of commercially-aware engineers and managers who investigated how the available mobile technology (known as GSM) could be introduced to Afri. He recruited an Operations Manager, Peter Bradley, who would be responsible for customer registration, customer service and billing.

Peter Bradley, aged 35, had previously worked as Customer Service Manager for a mobile telecoms network operator in another African country. He saw Constro's interest in running a network in Afri as a personal challenge. There would be an opportunity for him to be involved right from the beginning and to gain a senior management position in what he hoped could become a leading mobile telecoms operator within five years.

Peter Bradley had investigated the possible purchase of "off the shelf" mobile customer registration and billing packages with a number of leading international software companies. Ben Knowle, who is responsible for IT in Constro, was concerned that Peter Bradley was inexperienced and should not be responsible for the selection of such vital software without considerable input from him and his finance department.

Furthermore, the hardware requirements for AfriTel were considerable. Ben Knowle was concerned that new expertise would need to be brought into Constro to ensure that the systems installed were future-proof. The systems would need to be capable of being added to or upgraded to cope with the necessary large volumes of data that would be handled in the future with a rapidly expanding customer base. If Constro were to be successful in running a mobile telecoms network in Afri, and its customer base were to grow to over several million subscribers within five years, one of the key issues would be the selection of hardware and software, and an understanding of the demands which would be placed on these. In Ben Knowle's view, neither Peter Bradley nor Tanda Lew had appropriate experience in these areas.

The International Telecommunication Union's Telecom Africa 2001 Conference

At the *International Telecommunication Union's Telecom Africa 2001 Conference*, a report was released stating that the mobile telecoms marketplace in the whole of Africa could reach 100 million subscribers by 2005. By the end of 2001, many African countries had introduced cellular technology, and these new mobile telephone networks have provided telecoms to many people. The cellular markets have experienced a boom in many countries and it was forecast that the number of mobile subscribers would exceed the number of fixed (landline) connections during 2002.

Tanda Lew and his team, together with some of Constro's Directors, attended this conference. All of the representatives from Constro were reassured to see the long-awaited change in communications coming to Africa at last. However, some Directors were apprehensive as to whether Constro should enter this new market and also concerned about when the Afri government would announce that cellular networks would be licensed in Afri.

Market opportunities

By the beginning of 2002, many countries in Africa had opened up their telecoms markets (or were in the process of liberating them), in anticipation of encouraging private investment in telecoms infrastructure.

The growth in telecoms in many African countries is expected to bring with it many economic benefits and will demonstrate to the world the growth potential locked up inside many African economies.

South Africa launched its cellular mobile networks with two licensed operators as early as 1994, and in 2001 a third cellular operator was approved. Since 1994, there have been more than 70 new mobile telecoms networks licensed within the whole of Africa, in countries such as Egypt, Morocco, Cameroon, Nigeria, Kenya and Uganda. These markets have seen growth rates on a year-on-year basis exceed 100%.

There are now independent regulatory authorities established in 33 of Africa's 55 nations and these have opened up the opportunities for companies all over the world to become involved. The equipment manufacturers, the telecoms system providers and the telecoms maintenance providers all have large opportunities to become involved in the African telecoms market and to reap the rewards from the potentially explosive growth.

Many of the global telecoms companies and manufacturers of mobile telecoms equipment are keen to be involved with the emerging market in Africa. Many of these companies are already multinational telecoms companies or are leading companies in their geographical part of the world. However, there are also large numbers of small, new companies establishing themselves in the newly liberalised markets. AfriTel is one of the many new companies in Africa that have been specifically established to investigate, and possibly become involved in, the mobile telecoms market in Afri.

The market analysis prepared by the Afri government shows that the market size in the country of Afri could be as high as 8 million subscribers within five years of launch of mobile telecoms networks in Afri. A summary of its market surveys is shown opposite:

Number of subscribers (end year) 000	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*
Forecast total Afri urban mobile telecoms market:					
High growth	200	1,000	2,000	5,600	8,000
Mid growth	100	500	1,000	2,800	4,000
Low growth	20	100	200	560	800

In addition to the above subscriber numbers, which will be from the nine major towns and surrounding areas, it is also anticipated that there could be a small number of subscribers from the rural population. However, the rural subscriber numbers are estimated to be 250,000 subscribers by the end of Year 5, which represents approximately a 1% penetration level of the rural population. The forecast phased growth of rural subscribers is expected to be as follows:

Number of subscribers (end year) 000	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*
Forecast total Afri rural subscribers	10	40	80	140	250

The Afri government has indicated that it will grant a number of licences for a 10-year period.

In a neighbouring country with a population and land area some 50% smaller, two licences were granted almost 2 years ago. The mobile subscribers for both networks currently total approximately 150,000 subscribers, growing at the rate of 20,000 subscribers per month. These statistics support the mid-growth scenario that was forecast by the Afri government's market surveys.

A wider market than just mobile telecoms

As well as providing voice links within Africa, the telecoms market is also under increasing demand to provide other telecoms-based services including Internet access, long-distance learning, and online medical and financial information.

There is surging demand for online connections for the business community and also a growing number of Internet cafes. In many countries around the world, the growth of Internet cafes has seen an explosion in the demand for communications links, and in some countries in the Far East, there are Internet cafes on most street corners.

Internet subscriber numbers across Africa doubled in 2001 to reach more than 5 million, and the demand for Internet connections should also help boost demand for mobile phones across all of Afri.

Telecoms fraud and lost revenues

A growing concern around the globe is the fast-growing area of telecoms fraud and lost revenues. Few industries could afford to lose the estimated US$ 90 billion (one billion is equal to one thousand million) in revenue that the world's telecoms operators fear is currently being lost to them each year, either by inadequate billing systems and procedures, or fraud. Furthermore, the problem is growing.

Accurate statistics on fraud are hard to establish, but most telecoms operators admit to losing between 3% and 5% of revenues, and some start-up telecoms operators can lose up to 15%. Some of the large global companies, which have taken positive steps to combat fraud, have been able to reduce losses down to 0·2% of turnover, but this still represents large revenue losses on their significant turnovers.

All new network operators will have to ensure that their software systems are designed to protect consumers, to prevent fraud when goods and services are bought by subscribers via mobile phones. Furthermore, in order to prevent payment default, many network operators have decided to introduce pre-paid subscription. It is expected that every telecoms operator will have to become involved in combating fraud, by ensuring that systems within the company are monitored closely, to control revenue losses, protect the company's bottom line, and protect customers. As telecoms fraud has become so prevalent in the industry, many companies have been established specifically to fight telecoms fraud.

Broadband

Around the world, some telecoms service providers are starting to offer broadband access to their customers. Governments in many countries are promoting the introduction of broadband technology as they see this as a major advantage to the business community. Additionally, some governments are offering large tax advantages to companies to provide broadband connections to under-served and rural areas of their countries.

Some countries have been more successful than others in offering broadband services, and the concern among industry analysts is that countries that do not have an adequate broadband network will be largely excluded from the new electronic environment. As new network services are planned in many countries in Africa, it is important that the latest technology is introduced so that the African continent does not continue to fall behind the rest of the industrialised world. In Africa, one reason for the introduction of broadband services is that it could bring with it the potential for good distance-learning services. If broadband is not introduced in Africa, it will widen the "digital divide" between Africa and Europe, denying Africa new digital electronic services.

Equipment manufacturers

As soon as Tanda Lew was appointed to AfriTel, he was approached by all of the world's major equipment manufacturers, which all wanted to expand into the new market place in Afri. These global telecoms equipment manufacturers are working closely with all of the companies which are thought to be considering applying for a licence to run a mobile telecoms network in Afri. These global telecoms equipment manufacturers want to sell their cellular network equipment into Afri as well as having their handsets and other cellular products distributed in this new market.

The handset manufacturers also see the growing African market as the place to expand, as demand for handsets in many other areas of the world is now declining. There are over ten major worldwide handset manufacturers which are all eager to enter, or become involved with, the growing African market.

It is planned that the division of Constro that sells domestic electrical appliances will add the sale of mobile handsets and accessories to its growing portfolio of products. The Marketing Director, Sol Endi, is very keen for Constro to enter this market irrespective of whether or not AfriTel is successful in obtaining an operating licence to run a mobile network in Afri.

The third generation of mobile phones (3G)

While the African continent is still introducing mobile telecoms networks to the current European standard, GSM, the rest of the world is facing the next major step in mobile telephony, 3G.

3G is a new breed of network and handsets that offer many more features than GSM, including a mobile internet service with the ability to make bookings online, access to music and videos and even cameras, enabling mobile users to see who they are talking to.

It is envisaged that within the 10-year licence period, the GSM technology that will be installed in Afri will become outdated. Furthermore, it is expected that the network infrastructure that will be established by all network operators in Afri after licences are granted will have no commercial value within the 10-year licence period.

Additionally, as technology changes, it is even possible that the mobile network operators may need to update their network infrastructure within the 10-year licence period, which would necessitate further capital expenditure.

The Afri regulatory authorities

Unlike many of Afri's neighbours, whose governments acted swiftly to grant operating licences to telecoms companies to run mobile telecoms networks, the government of Afri has only now announced that it will grant operating licences in April 2003, following licence applications that are due to be submitted by February 2003.

There are many companies (some Afri national companies and some global companies) that are keen to become a mobile telecoms network operator in Afri, despite the large initial investments in the infrastructure. It is expected that the number of companies that will be applying for an operating licence will be greater than the number of licences that the Afri regulatory authority will issue.

Discussions with global telecoms companies

Malan Beka reported to his senior management team that he had been contacted by a number of global telecoms companies that were interested in the Afri market, and that he had invited representatives from four global companies to Constro's headquarters in Afri for discussions. Some other global companies declined to meet with Constro and clearly had only made contact to try to find out market data for their own purposes.

Malan Beka was keen to gather whatever information he could from the four global companies, and to understand their intentions, before Constro made the decision to commit itself to applying for a licence to run a mobile telecoms network in Afri. The four companies that Constro had agreed to meet with included the two telecoms companies that Tanda Lew had previously worked for.

At the preliminary meetings with the four global telecoms companies, Malan Beka and Tanda Lew represented Constro. The details of the four meetings are given below.

Meetings with global telecoms companies

1. Meeting with Global Company A

Global Company A had sent two representatives, its International Investment Director, James Brown, and its African Continent Telecoms Development Manager, Anthony Vine. The meeting was held at Constro's headquarters and there was a lively debate about the need to speed up the roll out of cellular telephone networks across Africa.

Malan Beka reported to the Constro Board that he and Tanda Lew were impressed with the way James Brown and Anthony Vine saw the market in Afri developing. Furthermore, James Brown was open about Global Company A's intention to bid for a licence in Afri and he discussed his concern that the Afri government may not grant a licence to Global Company A if it bids on its own.

James Brown invited Malan Beka to consider a joint venture arrangement, so that together the two companies could apply for an operating licence and, if successful, they could then construct and operate a mobile telecoms network together in Afri. James Brown stated that this offered both companies opportunities that may not materialise if they did not operate together. James Brown outlined the experience his company had in launching and operating mobile telecoms networks in other parts of the world, as well as two other African countries, and all the other expertise that Global Company A could bring to Afri.

Malan Beka reported to the Constro Board that Global Company A considered Constro to be lacking experience in marketing and customer registration, and that James Brown had particularly pointed out Constro's complete lack of experience with billing large numbers of customers. Malan Beka also reported that he had informed James Brown that Constro did not feel it needed a joint venture partner, but was exploring a number of avenues. He had also discussed with James Brown the close government connections that Constro had from its experience of working on construction projects for the Afri government, and that he was fairly confident that Constro would be successful in obtaining a licence without a joint venture partner.

Malan Beka reported that James Brown had stated quite openly the reason why Global Company A would like to enter a joint venture. James Brown considered a joint venture would increase Global Company A's chance of becoming involved in the telecoms market in Afri. Malan Beka reported that he had been impressed with Global Company A's frankness and that he had found this refreshing.

It was established that Global Company A has two other joint ventures in Africa, in each of which it holds a 50% stake. In both countries the networks are growing rapidly. James Brown stated that in one of the African countries, where there are two competing networks, its joint venture currently has achieved a 60% share of that country's market. In the other African country in which it has a joint venture, all three network operators have almost equal market shares.

The last point that James Brown had made at the meeting was that if Constro did agree to a joint venture, Global Company A would be prepared to fund approximately half of the necessary financing.

Malan Beka reported to the Constro Board that both Tanda Lew and himself had established a good foundation for a future working relationship and that he had undertaken to consider Global Company A's joint venture offer.

2. *Meeting with Global Company B*

Malan Beka had originally agreed to meet with the Overseas Investment Director and another representative of Global Company B, but just the day before the planned meeting, they contacted Constro and rescheduled the meeting for a few weeks later. As Malan Beka wanted to meet with them as soon as possible, because of the February 2003 licence application deadline, he was not pleased.

Malan Beka was even more displeased when he finally met with Chris Harvey, who was sent to represent Global Company B. Chris Harvey was one of its Overseas Investment Managers and he was ill-prepared for this high-level strategic meeting with Constro. Additionally he was unable, or unwilling, to fully discuss what Global Company B wanted from the meeting. While some discussion of joint ventures was touched upon, Chris Harvey was simply unable to make any commitments to Constro. He stated that he would report back to his senior managers that Constro was possibly considering entering into a joint venture arrangement.

Malan Beka was insulted that this rescheduled meeting was so unproductive. He was, however, reminded by Tanda Lew that Global Company B had an excellent record of overseas investments and of working in joint venture arrangements with national companies in other areas of the world. Also, it is involved in mobile telecoms networks in five other African countries.

The only firm commitment that Chris Harvey was able to make to Constro was that if they were to enter a joint venture arrangement together, Global Company B would be in a position to provide much of the financing at competitive rates.

Although Tanda Lew did not know Chris Harvey, he knew Global Company B well, as he had worked for it for four years, prior to joining Constro. He still had many senior contacts there. Tanda Lew also knew that he was well respected by some of Global Company B's senior managers, and that if he wanted to work for it again, he was sure that it would make him a generous offer.

Tanda Lew was keen that Malan Beka should not be too annoyed at the lack of direction from the initial meeting and he found himself making excuses for Global Company B's poor representation at the initial meeting. Tanda Lew remarked to Malan Beka after the meeting that if Constro were to pursue a joint venture arrangement, then he and his team could work well with a company such as Global Company B, which he felt he knew well and could trust.

3. Meeting with Global Company C

Malan Beka and Tanda Lew met with Global Company C's Chairman, Robert Duvall, and also its International Division's Director, Victor Masters, at Constro's headquarters. Malan Beka was flattered that Global Company C's Chairman was able to attend and the tour of Constro's impressive HQ building had demonstrated to Global Company C's representatives that Constro was more than a backwater construction company.

Tanda Lew had met with (but had not worked for) its International Division's Director, Victor Masters, on a previous occasion, when he had been involved in the construction of a cellular network in Europe some years before. Victor Masters, now 58 years old, had been impressed by the young engineer and was pleased to meet with him again.

Victor Masters had negotiated a number of joint venture arrangements with companies in the Far East and Pacific Basin and industry gossip suggested that Global Company C wanted to be involved with as many mobile networks in African countries as possible. It already had joint ventures in four other African countries, all with fairly equal market shares.

At the start of the meeting, Malan Beka felt a little dismayed that Global Company C was more or less dictating its standard terms for a joint venture, without even considering what Constro had to offer, or even wanted, from a joint venture arrangement. It was clear that Global Company C felt that it was the dominant party.

When Malan Beka asked Global Company C how the financing of the project could be shared, Global Company C stated that it would not be prepared to invest more than $100 million in the network. However, Robert Duvall stated that his company would require a majority shareholding. He also stated that his company would provide marketing and operational expertise, but was not prepared to tie up vast sums of capital expenditure in Afri.

The rest of the meeting was cordial but Malan Beka was disappointed with Robert Duvall's attitude. After the meeting, Malan Beka explained how he felt to Tanda Lew, who agreed that he felt that Global Company C only wanted to use Constro for its influence in hopefully obtaining a licence and to share in the profits from the venture, while risking little of its own capital.

4. Meeting with Global Company D

This meeting had also been rescheduled (twice) and Malan Beka was beginning to doubt whether Global Company D wanted to hold preliminary joint venture discussions at all. Tanda Lew thought that maybe they had already agreed a joint venture with one of the other local Afri companies preparing a licence application. As he had worked in Europe over ten years earlier for Global Company D, he used his contacts in that company to try to find out; however, he could not establish any specific reasons for the meeting with Constro having been deferred.

Finally the meeting was fixed. The Overseas Director of Global Company D, Martyn Holland, together with his Overseas Investment Accountant, Joanna Sharp, arrived at Constro's headquarters. Martyn Holland made it clear that this meeting was only to establish initial contact and to see whether there were any common grounds for working together. He indicated that after the meeting, he would be flying to the Far East to review the company's business investments and handset manufacturing operations there. Global Company D was also a major manufacturer of mobile handsets.

Martyn Holland, a 42-year old executive, clearly had a very challenging international schedule and Malan Beka formed the impression throughout the meeting that he would rather have been elsewhere. Martyn Holland outlined Global Company D's desire to be involved in a mobile telecoms network in Africa. He reported that it had formed a joint venture with a national company in a different African country two years before, but this consortium had not been successful in being granted a licence in that country. He stated that his company was keen to be involved in the country of Afri, which was the last country of significant size in Africa to be issuing licences for mobile telecoms networks. Martyn Holland saw this as possibly the last opportunity for Global Company D to be involved in the African continent.

Martyn Holland had not known or worked with Tanda Lew when the latter had worked for Global Company D, but he knew of his determination and of the good reputation he had gained at Global Company D. He stated that with Tanda Lew's technical expertise and Global Company D's marketing and customer service expertise, they could make a formidable team.

The Overseas Investment Accountant, Joanna Sharp, reported that her company had sufficient funds that could be made available for this investment if a suitable joint venture arrangement was agreed. She was not, however, prepared to state what the terms for this funding would be.

At the end of the meeting, Malan Beka and Tanda Lew agreed that they did not like Martyn Holland. However, they both felt that if Constro were to enter a joint venture arrangement with Global Company D, the skills of the two companies could complement each other, despite Malan Beka's lack of rapport with Martyn Holland.

Summary of the meetings with the global companies

After the four meetings, Malan Beka reported back to his fellow Directors. At the next Board meeting he presented the following table, which provides some key financial data in respect of the four global companies with which discussions had been held.

All financial data relates to the latest published financial year. All of the data has been converted at current exchange rates to US dollars for comparative purposes.

	Global Company A	*Global Company B*	*Global Company C*	*Global Company D*
Turnover	$19,000 million	$55,000 million	$42,000 million	$32,000 million
% increase in turnover over previous year	+15·2%	+1·3%	-0·1%	+9·1%
Operating profit	$2,200 million	$3,400 million	$4,700 million	$3,250 million
Gearing *	23%	44%	40%	57%
Capital expenditure (including joint ventures)	$3,100 million	$8,500 million	$1,100 million	$1,400 million
Number of African countries the global companies are involved in	2	5	4	0

*Gearing is defined as loans and borrowings as a percentage of total equity shareholders' funds plus loans and borrowings.

Constro's financial data

Ben Knowle reported that Constro's plans for a mobile telecoms network have forecast that the capital investment required will be of the magnitude of approximately $300 million over 3 years based on the mid-growth level of subscribers. However, no further funding will be required for working capital, as working capital requirements are forecast to be negligible due to a mix of prepaid network income and monthly mobile billings.

A consortium of local banks has agreed to a 10-year loan to Constro for up to $200 million at 13%. Furthermore, finance is also obtainable from an overseas bank (outside of Africa) at 14%

for a maximum loan of $50 million, which is repayable after five years. All loan interest payable is eligible for tax relief at 30%.

Constro is currently all equity financed and has surplus cash invested in a variety of short-term instruments. Because of the mix of investments, some of which have been of a speculative nature, Constro has currently been able to achieve a return on its cash investments of 11% overall in the last year, although this is unlikely to continue. The interest receivable on these investments is subject to tax at 30%.

At present Constro evaluates all its capital investment projects using a discount rate based on its equity cost of capital, to which it sometimes adds a further risk premium for especially risky projects.

Ben Knowle has estimated that Constro's cost of equity is approximately 14·5% and the Afri market return is currently assessed to be 12%. The current risk-free rate in Afri is 6%. Constro's Beta, based on its current sphere of trading, and using a proxy company, is estimated to be 1·4.

Appendix A gives details of Constro's profit and loss account and balance sheet for the previous two financial years. All figures are presented in US dollars, although this is not the local currency for Afri. However, the Afri local currency does align itself to movements in the US dollar.

Appendix B shows extracts from Constro's current five-year plans, which analyse turnover, operating profit and capital expenditure by the main areas of current and possible future business categories. These exclude all financial data in respect of sales of mobile phones and mobile telecoms network financial data. Data for Constro's last financial year is also shown for the purpose of comparison.

Appendices A and B are overleaf

Appendix A

Constro Balance Sheet for last two years:

	2001	2000
	$ million	$ million
Fixed assets	143	126
Depreciation	66	59
Net fixed assets	77	67
Current assets:		
Amounts due within 1 year:		
Stocks	26	22
Debtors	39	34
Cash and short-term investments	145	114
Sub-total current assets	210	170
Current liabilities:		
Amounts due within 1 year:		
Trade creditors	47	42
Corporation tax	15	13
Other tax creditors	2	2
Proposed dividends	20	16
Sub-total current liabilities	84	73
Net current assets	126	97
Debtors falling due after 1 year:		
Retained construction payments	30	50
Net assets	233	214
Financed by:		
Owners' share capital	20	20
Profit and loss account	213	194
Equity shareholder funds	233	214

Constro Profit and Loss Account for last two years:

	2001	2000
	$ million	$ million
Turnover	310	285
Operating costs (including depreciation)	268	244
Operating profit	42	41
Interest receivable	14	11
Tax	-17	-16
Net profit after tax	39	36
Dividends proposed	20	16
Retained profit for the financial year	19	20

Appendix B

Extracts from Constro's five-year plan

	ACTUAL			FORECAST			TOTAL
	2001	2002	2003	2004	2005	2006	5 years
	$ million	$ million	$ million	$ million	$ million	$ million	$ million
Turnover:							
Road-building – Afri	136·0	140·0	80·0	40·0	30·0	10·0	300·0
Road-building – other countries	2·0	10·0	20·0	50·0	70·0	100·0	250·0
Other major construction projects – Afri	100·0	80·0	50·0	40·0	30·0	30·0	230·0
Other major construction projects – other countries	0·0	0·0	0·0	10·0	20·0	50·0	80·0
Construction of residential property – Afri	51·0	60·0	80·0	100·0	125·0	150·0	515·0
Sale of electrical appliances (excluding mobiles)	21·0	30·0	40·0	50·0	55·0	65·0	240·0
Total turnover **(excluding sales of mobiles and mobile network income)**	**310·0**	**320·0**	**270·0**	**290·0**	**330·0**	**405·0**	**1,615·0**
Operating profit:							
Road-building – Afri	19·7	19·6	10·4	4·8	3·6	1·2	39·6
Road-building – other countries	0·2	0·8	2·0	5·0	7·7	11·0	26·5
Other major construction projects – Afri	10·0	8·0	5·0	4·4	3·3	3·3	24·0
Other major construction projects – other countries	0·0	0·0	0·0	1·0	2·0	5·0	8·0
Construction of residential property – Afri	9·2	10·8	14·4	17·0	21·3	24·0	87·5
Sale of electrical appliances (excluding mobiles)	2·9	4·2	6·0	8·0	9·3	11·1	38·6
Total operating profit **(excluding sales of mobiles and mobile network profitability)**	**42·0**	**43·4**	**37·8**	**40·2**	**47·2**	**55·6**	**224·2**
Capital expenditure plan:							
Road-building – Afri	2·0	3·0	2·0	0·0	0·0	0·0	5·0
Road-building – other countries	2·0	2·0	2·0	6·0	10·0	12·0	32·0
Other major construction projects – Afri	2·0	3·0	2·0	2·0	5·0	10·0	22·0
Other major construction projects – other countries	0·0	0·0	0·0	4·0	10·0	15·0	29·0
Construction of residential property – Afri	5·0	5·0	5·0	5·0	10·0	10·0	35·0
Sale of electrical appliances (excluding mobiles)	6·0	2·0	2·0	8·0	8·0	10·0	30·0
Total capital expenditure plan **(excluding sales of mobiles and mobile network capital expenditure)**	**17·0**	**15·0**	**13·0**	**25·0**	**43·0**	**57·0**	**153·0**

6.5 Brief review of Constro (Pty) Ltd.

You should subject the Constro case to the sort of analysis demonstrated in Chapter 5 using the checklist below:

Technique	√
The four elements of strategy (Competitive, Financial, Investment and Risk)	
Using ratios to conduct a financial analysis of a company's position	
Assessing a business portfolio	
Industry analysis	
Position audit	
Conducting a managerial and organisational audit	
Critical success factors	
Assessing information systems strategy	
Assessing corporate risk	
Assessing the cost of capital	
Conducting a corporate appraisal	
Business valuations	
Generating strategic options	
Sources of capital	
Evaluating strategic options	

The case study is set in the context of the African construction and telecommunications industries. Specifically it concerns the strategic position of Constro (Pty) Ltd and its fledgling telecoms subsidiary AfriTel. The pre-seen material for Constro is more compact than for some of the earlier cases, provides less opportunities for forensic analysis and presents an unusual context for business information gathering. Some knowledge of telecoms technology and issues will be helpful but the stated aim of the TOPCIMA syllabus is to assess your ability to demonstrate strategic management accounting skills. This means that you should focus on the factors affecting revenues, costs, investments and risks and advise management on the business case for a course of action. The technology is just the context and you are unlikely to need a detailed understanding of it.

The following narrative analysis is intended to help guide you towards some of the key points in the case:

The background

Afri is the last substantial country on the African continent to liberalise its telecoms rules and permit private sector involvement in mobile telecoms. Its government has invited bids in Feb 2003 for 10-year mobile phone licenses. These will be awarded in April 2003. Constro (Pty) Ltd. is a construction company based in Afri that has built its business on government infrastructure contracts. It has relied on the government contacts of its Chairman and CEO, Malan Beka, and his predecessor to get work. Beka wants the firm to gain a license to boost its growth through diversification beyond the construction work that currently accounts for 93% of its turnover. In 1998 Constro set up a subsidiary, AfriTel, and in 1999 appointed a telecoms expert, Tanda Lew, to manage it. The network will cost \$300m to build and would represent a 129% increase in the net assets of Constro. Any fee levied for the license will need to be added to this sum. The five year forecast provided shows that other business opportunities may grow the business by 26% over the next 5 years and

increase profits by 32% for a capital investment of only $153m. Given the magnitude of the investment and the risks it poses significant members of Constro's board are against Beka's plans, yet he presses ahead. Despite claiming that Constro is able to exploit this opportunity alone Beka has met with four foreign potential joint venture partners, each of who brings varying amounts of capital and expertise to the project.

Financial position of Constro

Constro, like the firms in previous case studies, is fictitious. This said, by taking a summary look at some real world African construction firms you will get a better sense of their business strategies which may be helpful. It is also worth recalling that construction companies have a high mortality rate as they take on bigger projects and then overstretch themselves. The amounts of investment are huge and a delay in payment or major project problem can quickly turn a healthy balance sheet into a hospital case. Some indication of this is given in the preseen we can see that Constro is owed $30m of 'retained construction payments'. This is equivalent to 71% of its 2001 operating profit.

On first appearance Constro appears to be a cash rich firm. It has $145m in liquid assets and has agreed a line of credit of $200m. Providing the license does not cost more than $45m it can afford to go it alone as Beka claims. However there are some other things to bear in mind:

- Its present Afri infrastructure construction business is set to decline over the next 5 years. For example, profits on these will fall by 48% between 2001 and 2003 and by 85% by 2006. It hopes to make the deficit over the next 5 years by increasing its annual earnings from residential construction work by 194%, foreign road building by 400% and electrical products by 210%. How likely is it that shareholders and banks will let Constro borrow for the telecoms project if its earnings depend on realising these ambitious targets? Also who put the forecast together? It is possible that Beka's opponents on the board have deliberately inflated prospects to show the venture into telecoms is unnecessary.
- Its plans for developing its non-telecoms business requires capital expenditure of $153m over the next 5 years. Will the free cash flows from its operations enable it to afford to fund all its plans or will competition over the funds lead to boardroom splits or force it to accept a joint venture partner to obtain the extra finance?
- The founders are becoming more ambitious in the dividends they extract from Constro in return for allowing Beka autonomy and for not selling their shares. Between 2000 and 2001 dividends increased by 25% against an increase in distributable profits of only 8.3% thereby reducing dividend cover from 2.25 times to 1.95 times.
- Given that as much as $450m has been offered for Constro this means shareholders enjoyed a dividend yield of only 4.4% in 2001. If compared to the risk-free rate of 6% available in Afri this suggests that they are forgoing potential shareholder wealth by not selling up.
- It may have difficulty affording the project. For example, if the telecoms project absorbed the $345m of liquid assets and credit available then taking it on unaided would mean sacrificing $14m of earned interest on its investments and paying interest of $26m on its borrowings. In other words, it would eliminate almost all Constro's distributable profits until the network started to yield profits. Beka may find the shareholders too are unhappy about his venture into telecoms unless he gains capital from a joint venture partner or elects to raise some of the capital from the more expensive overseas loan with a deferred interest balloon of 5 years.

If the unseen material provides additional revenue and capex information on the telecoms project the data in the preseen could be the basis for a cash flow forecast. This would be essential in any assessment of project feasibility.

The country of Afri

The country of Afri is fictitious most probably an amalgam of aspects of several real African states. Because the pattern of its exports indicates a county in North Africa you might spend some time familiarising yourself with the business environments of countries like Tunisia, Nigeria, Algeria, Ethiopia and Egypt to give some insights into the practical situation facing Constro and global telecoms firms wishing to do business in Afri. The strategic potential of Constro is bound up with that of Afri. From the information in the case several conclusions can be drawn:

- Afri is still an agrarian economy with only nine cities and the majority of its exports being agrarian produce; its GDP is rising at 1.2% pa whilst its population grows at 2% p.a. This means the per capita national income of Afri is falling. It is likely that urban standards are rising and that it is the rural areas that have the falling living standards. This will affect future demand for services such as telecoms and electrical durables.
- Its currency, though shadowing the $US will be affected by the value of its exports. These are oil, foods and textiles. Given that oil is always paid for in dollars, the ability of the country to repay debts or purchase materials denominated in foreign currency will be highly dependent on the world price of oil. This is of course subject to wide variations depending on the success of the OPEC cartel. Earnings from the food exports will be affected by climatic conditions (we are all aware of the tragic drought affecting Africa from time to time and the crop failures and misery that have ensued). These risks will be borne in mind by lenders if Constro seeks to incur borrowings denominated in a foreign currency.
- Government finance in Afri and elsewhere on the continent will depend on export earnings and taxes. These will influence their ability to afford civil projects and hence the earnings from Constro's traditional business. Its population is split between a densely populated urban contingent (42% in its 9 cities) and a sparse agrarian population. Providing mobile connections to the urban population is likely to be profitable but its unlikely to be profitable to supply villages with service unless cheaper technologies can be found or subsidies obtained.
- The political leadership of Afri is not proactive. Although this is exemplified in the case of telecoms (9 years behind South Africa) it seems likely that other areas of industrial and agricultural policy may be slow to develop. This means that the 100% pa growth rates quoted on page 6 for telecoms in other countries may not be available in Afri. For example, how deep is the government's commitment to on-line education?

One factor which should not be overlooked is the differences in the operation of political authority in countries like Afri compared to Western Europe. For example, European contractors to African governments often find that considerable power and influence remains at village or tribal level. In addition to central government's support, the support of these powerful groups must also be gained if a project is to succeed. Constro has proven itself able to do this with infrastructure projects in its own country. It may have problems trying to operate in other African countries. However its experience and contacts will be invaluable to a multinational telecoms firm seeking to build masts in Afri.

The viability of the telecoms project

It is noticeable that the pre-seen material provides no information on the potential revenues from winning the license for Afri. However, there is a lot of information given that may be

useful if revenue data is provided in the unseen material and an investment appraisal calculation is called for. The high number of marks on the assessment matrix available for numerical skills suggests that a DCF is on the cards (which there was!).

- The financial data indicates that calculating a cost of capital for Constro using the CAPM may be required. However there are also bank loans available at different rates, a tax shield element, plus at least one credit source may involve forex risk.
- There are several references to the uncertainties in the situation. Most notably these are: the hi/lo forecasts of subscriber growth; the uncertainty over the number of licenses available and hence potential market share per license; revenue loss through fraud ranging between 0.2% and 5%; and the potential obsolescence of GSM technologies in the face of developing 3G.
- A key uncertainty will be the conditions under which the licenses will be granted. Of particular concern is whether the providers will be permitted to cherry-pick just the densely populated urban areas or whether they will be obliged to provide service in rural areas too. Similarly there may be regulatory constraints on prices and service quality.
- There is the un-quantified potential of greater earnings from value-added networks. These are either via mobile phone handsets or will utilise the fixed cables laid between masts and also the main backbone of the network.
- The sale of telephone handsets would be a valuable source of additional earnings for Constro. However, at least one potential joint venture partner wants to reserve this business for themselves.
- Reference is also made to political instability in the region which could easily sweep aside the government contacts upon whom Constro is relying to maintain its existing business and to win the telecoms license.
- The case tells us that Afri is the last significant country in Africa to liberalise its telecoms market. This piece of information seems to exclude the need to factor in to the appraisal the value of future contracts abroad.
- The preseen indicates that the license fee will be a sunk cost and that it will have no residual value at the end of 10 years.

One mystery remains: what role does Beka see AfriTel taking in mobile telecoms? The case mentions three kinds of involvement: equipment manufacture; telecoms systems provision; and telecoms maintenance provision. Is it Beka's intention to stick to the civil construction aspects by laying cables and erecting masts, or does he intend to make the equipment and provide the billing systems too? James Brown told Beka quite candidly that Constro lacks experience in marketing and billing. And in the UK Marconi's shareholders have regretted permitting a new CEO to try to take a mature business into telecoms equipment manufacture. Constro's private shareholders would be aware of this too.

A probabilistic investment appraisal using decision trees could be of use in tackling this problem providing broader strategic issues of suitability, acceptability and feasibility were also considered.

Choice of joint venture partners

The meetings with the four joint venture partners are described in detail. There is a lot of soft data provided about personalities and shared backgrounds and some indication of the likely market shares that AfriTel can expect by linking up with each. In the event of being

asked to recommend which partner to work with you should consider:

- The extent of relevant expertise that each will bring to the JV. For example, it is noticeable that Global Company D has no African experience.
- What each requires from AfriTel and its motives for linking up.
- The amount of interest each has in the venture and hence the effort they'll put in. The cancelled meetings are one factor here but also Company D would not see Afri as part of a strategy to build a network on the African continent whereas the others, particularly B & C, might.
- Its ability to finance the project and the terms on which it will do so. Company A is less than half the size of either B or C but is low geared. Company B speaks of 'providing finance at competitive rates' rather than assuming the risks of direct investment.
- Whether the management teams will be able to work together. The pre-seen material does emphasise this quite a lot by discussing Lew's employment record with two of the suitors and detailing Beka's feelings about the people he met.

Beware of taking Lew's opinion of the joint venture partners at face value. He was initially reluctant to join Constro because he did not want to spend years developing the telecoms project. That was three years ago and his last job lasted only 4 years. His appointment to the board was unpopular and he seems over-promoted given that his division is small and does not trade. He still seems to be on the receiving end of hostility from the board via Ben Knowle. Without the powerful support of Beka he would have no future and Beka's position seems to depend on the patronage of key shareholders, notably Mani Freel. Perhaps his vulnerability and the possibility of being accepted back by Global Company B is one reason he is making excuses for its apparent lack of interest. Similarly Martyn Holland's oblique reference to Lew's rather than Constro's value as part of a team may indicate that Company D too is sizing him up for re-employment to manage the contract with a rival Afri-based partner. Given that the bids must be in by Feb 2003 and his help would be needed its likely that his resignation would be submitted by November 21st, the day of the exam.

The four Global Companies mentioned in the case may also be synthetic and hence it may not be a good use of time to seek to identify each. However it would certainly be sensible to review the global strategies of some major players like Vodaphone, and to consider their interest in Africa and the issues they face in these sorts of investments.

The strategic position of Constro

As a preliminary to evaluating the telecoms strategy or suggesting ways forward for the company you will need to have conducted a SWOT analysis. Here is a SWOT based on the pre-seen material:

Strengths	Weaknesses
• Good relationship with Afri government (gain contracts) • Owned and managed by Afri nationals (politically acceptable) • Good project management skills • Cash rich at present • Lew's experience of telecoms projects • Supportive private shareholders • Credit available from banks	• No experience in crucial telecoms skills • Little foreign business experience • Board disunited • Heavily dependent on declining Afri infrastructure contracts • dividend yield to shareholders is below the risk-free rate available
Opportunities	**Threats**
• Bidding for Afri mobile telecoms license in April 2003 (value unknown) • Piggy-backing network services on ground lines • Forecast growth in residential and foreign contracts	• Slow down of core government contracting business • Competition for licenses from overseas firms • Loss of political contacts • Shareholders sell out • Poaching of Lew by rival operation

6.6 Research of the business environment for Constro (Pty) Ltd.

The summary above indicated some of the considerations in the pre-seen material and has suggested some possible requirements. Your close analysis of the case will no doubt suggest others to you.

You should attempt to gain some more insight into the situation and context of the case. This should include:

- appreciation of the telecom technologies and applications mentioned in the pre-seen;
- awareness of the trends in telecoms markets and in particular the fate of GSM;
- the availability of funding from the World Bank or elsewhere for telecoms or educational projects;
- the experiences of other telecoms firms which have entered joint ventures in Africa;
- economic assessments of the general outlook for African economies and the policies their governments follow and their impact on telecoms.

Here is a record of an on-line information search conducted to research the background of Constro (Pty) Ltd.

Search on Google for 'mobile telephones in Africa': reveals 118,000 documents.

Search in www.africaintelligence.com provided information about economic outlook for parts of Africa, specific information about competing telecoms technologies and the names of several African telecoms providers.

Technical terms researched via further search on Google 'what is GPRS and GSM' revealed over 2m documents of which the first, www.gsmworld.com, provided explanations of the technologies.

Search on Google for 'International Telecommunications Union' revealed the organisation existed and gave links to over 1m documents on it. The home page of ITU at www.itu.int contained links to documents specifically on Africa and its work there.

Final search on Google 'united nations and telecoms in Africa' revealed 80,000 documents of which the third was a 1998 report produced by the World Bank on the issues facing telecoms operators in Africa and the potential sources of finance available to them.

The entire search and reading took 23 min. Subsequent close reading of the documents, together with following a few of the links and terms in them, allowed the following briefing document to be written.

6.7 Briefing document on African Telecoms

6.7.1 Technologies of mobile phones

Older systems use global system for mobile (GSM) communications. This Second Generation (2G, 1G was analogue based) is slow and use a lot of bandwidth. Cannot cope with more than voice traffic.

Newer systems are 3G and use general packet radio services (GPRS) or global mobile personal communications by satellite (GMPCS). These have much higher bandwidth and use the wireless application protocol (WAP) to enable users to access the Internet.

Competition to mobile telephony is coming from substitutes such as voice over internet protocol (VOIP) and wireless fidelity (WiFi), which could allow users cheap access to the Internet from mobile handsets.

Issues for Constro will be: whether license permits 3G. This is where the future value will lie and not GSM; which technology to use. GMPCS would be very expensive but would allow cost-effective service to remote areas that fixed line or mast-based systems would not serve so cheaply. May be possible to lease use of a low earth orbit satellite (LEO) from another provider (e.g. Globalstar or Iridium Satellite LLC have satellites over Africa) or perhaps one of the JV partners has one already. Impact of newer technologies on prices and volumes of mobile telephony used.

6.7.2 Telecoms in Africa

United Nations supports telecoms development in Africa and hosts National Information and Communications Infrastructure Conferences to press for action.

World Bank has an Information for Development Programme but will not fund the actual development of networks.

Africa is a continent starved of telecommunications access with about 130 inhabitants per fixed line disproportionately skewed towards the urban areas. Rural areas have 'phone shops' which population walk to from villages to make calls and access email.

Incomes are low and hence to many the telephone is an unaffordable luxury.

Issues for Constro: project must be judged on commercial grounds although Beka seems to have become caught-up in the vision peddled at conferences of an Africa that jumps the 'digital divide' into development by use of telecoms.

Quite obviously a very uncertain investment with possibility of insufficient take-up if Afri economy does not boom.

6.7.3 Structure of telecoms Industry

Telecoms provision includes several levels of operation from equipment manufacturers (make handsets, switching equipment, transmitters, etc.).

Network providers (holds license and provides network and some content), through Service providers (promote network, appoint dealers and brokers and services customer accounts) to sales operations that retail handsets and top-up services as well as provide business packages.

Major competitors in Africa are Vodacom (South Africa and Nigeria), Malaysia Telecom (East Africa), France Telecom (Francophone countries) and Vivedi (North Africa).

Issues for Constro: Constro must decide whether to go it alone or whether to enter a joint venture. If latter, can it avoid being a network provider and simply be a service provider and sales operation?

Constro should assess the ability of the potential JV partners to offer these services and expertise.

Constro should assess what competences it can offer to a JV in telecoms (e.g. construction of network, sales of appliances, access to government contracts).

6.8 Constro (Pty) Ltd. – unseen and requirement

Try working through this real case study yourself before progressing to Chapter 7. This will help you to appreciate some of the problems in analyzing the requirements and material in the unseen. Chapter 7 will explain some techniques to help you.

After you have read the unseen and the requirement, you should consider how your planning and research have helped you. There were NPV's to calculate. There was the possibility of joint ventures to consider (although in the unseen the choice was limited to two companies instead of four) and the report asked for recommendations of how Constro should expand – in a joint venture or alone. Additionally the requirement also asked for comments on its expansion strategy into selling handset and overseas road building. There were lots of potential to pick up marks in your report, as there were so many factors to consider and discuss.

Constro (Pty) Ltd – unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages un-seen material for Constro.

Read all of the additional material before you answer the question.

[This page is detachable, for ease of reference]

Constro (Pty) Ltd – Unseen material provided on examination day

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Additional (unseen) information relating to the case is given on pages 19– 23.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are a Strategy Consultant, working for an international firm of consultants, which has been appointed by the Chief Executive of Constro.

Prepare a report that recommends to the Board whether Constro should, or should not, apply for a mobile telecoms network licence. The report should assess whether Constro should apply on its own or in a joint venture with one of the two selected global telecoms companies.

The report should additionally discuss whether Constro should also expand the business with construction projects (including road-building) outside of Afri and / or by retailing mobile telephones (as set out in the unseen material – *The alternative strategies available for Constro* – on page 20).

For simplicity, ignore taxation and capital allowances.

Constro (Pty) Ltd – Unseen material provided on examination day

Read this information before you answer the question

Application to the Afri government for a mobile telecoms operating licence in Afri

By November 2002, all of the companies that are interested in applying for a licence to run a mobile telephone network in Afri are in the process of preparing their business plans and their applications. These are due to be submitted to the regulatory authority in Afri in February 2003, and successful licensees will be announced in April 2003.

The Afri regulatory authority has indicated that it will make its selection based on all of the data submitted, and that it will grant ***only two*** licences, each for a 10-year period. The regulatory authority has also stated that for the first five years of both licences, no further licences will be granted, but it reserves the right to issue further licences to other potential network operators after five years.

In early October 2002, the Afri regulatory authority unexpectedly announced that it would ***only*** grant the two licences to companies that are owned by Afri nationals, or a consortium of companies including Afri-owned companies. Therefore, all of the global telecoms companies that were interested in entering the Afri mobile telecoms market would only be able to participate if they formed a joint venture consortium with one (or more) local Afri companies. However, the Afri regulatory authority has made no comment on the level of holdings within any joint venture that global companies may, or may not, hold.

If Constro decides to apply for a mobile telecoms licence, and it is subsequently successful in being granted a licence, it will be bound by the licence to construct and operate a mobile telecoms network in accordance with the licence conditions laid down.

Constro's market intelligence understands that five other large Afri-owned companies are also intending to apply for a mobile telecoms licence. These Afri companies currently operate in such diverse fields as banking, media services, clothing manufacture and oil production. It is understood from sources that all five of these companies are interested in forming joint ventures with global telecoms companies.

Constro Board Meeting in October 2002

At the Constro Board meeting held at the end of October 2002, Malan Beka reported that he had received telephone calls from five of the six global telecoms companies that were considering applying for a mobile telecoms licence in Afri. They were now very keen to discuss a possible joint venture with Constro, because of the announcement by the regulatory authority concerning the involvement of Afri-owned companies in any licence application. Market intelligence had identified that one of the global telecoms companies that was understood to be intending to apply for a licence, had already formed a joint venture with another Afri company.

Malan Beka reported on the preliminary discussions that he had held with a global telecoms company that he had not previously met with. It had contacted him after the regulatory authority's announcement. He stated that after discussion, he considered that its terms were unreasonable and that it was not in Constro's interest to pursue discussions any further.

Malan Beka had previously discussed with the Board the outcomes of the meetings that had been held with Global Companies A, B, C and D. At a preceding Board meeting, a decision had been taken ***not*** to pursue negotiations with two of the four companies, Global Companies B and C. Malan Beka reported that both Global Companies B and C had contacted him following the Afri regulatory authority's announcement, but he had repeated the Board's previous decision, which was that Constro did not want to enter into a joint venture with them.

Malan Beka confirmed to the Constro Board that both Global Companies A and D were still very keen to enter into a joint venture and that a final decision would have to be made shortly, when the Constro Board had discussed the alternative strategies available.

The alternative strategies available for Constro

1. *Constro could make a licence application on its own.*

   Malan Beka stated that he was keen for Constro to be involved in the rapidly growing mobile telecoms market in Africa, and saw this as a "once in a lifetime" opportunity.

2. *Constro could enter into a joint venture to apply for a licence.*

   Global Company A and Global Company D were both still very positive about entering into a joint venture with Constro. Final details of any joint venture would need to be negotiated, if a joint venture was the chosen course of action.

   In preliminary discussions, Global Company A had agreed to fund over 50% of the investment required. It had a good reputation for its dealings in the other African joint ventures that it was involved in, but had advised Malan Beka subsequent to their initial meeting that it would require a significant shareholding in a joint venture with Constro.

   Global Company D was not currently involved in any joint ventures in African countries, although it has a number of joint ventures in other countries around the world. Global Company D did not want to commit to any desired level of funding or percentage holding until Constro confirmed its intention (or not) to enter into a joint venture.

3. *Constro could retail mobile handsets.*

   Malan Beka reported that many of the global handset manufacturers were keen for their products to be stocked and sold in Afri. He reminded the Board that Constro already had electrical retail shops in all nine major towns, as well as the necessary stock control and retail sales systems in place to handle these new products. This would be an easy way for Constro to be involved in part of the retailing side of the mobile telecoms business, whether it was involved as a mobile telecoms network operator or not.

4. *Constro could expand its road building and other major construction projects business to other countries.*

   Constro's current five-year plan (shown as Appendix B in the pre-seen material) shows an expansion to other countries of its road-building business and also its other major construction projects business. In 2001, Constro started its first ever construction project outside Afri, with a three-year road-building project, which has a contracted turnover value of $25 million. The remaining $225 million turnover for road-building in other countries, in the five-year plan, has not been contracted, although Constro has already submitted bids for part of this future work. The entire $80 million forecast in years 2004 to 2006 for other major construction projects in other countries has no contractual basis at present.

The Constro Board of Directors' comments on the alternatives

Tanda Lew stated that he had completed his business plans and he was in the final stages of selecting the equipment supplier for the proposed mobile telecoms network. He reported that he was confident that at least the mid-growth level of demand for mobile telecoms services would exist in the main towns of Afri. He stated to his Board colleagues that Constro has the personnel and the skills required to build and deliver a high-quality mobile telecoms network in Afri.

Tanda Lew also stated that he had been recruited into Constro to prepare for and hopefully operate a mobile telecoms network, and if the Board decided not to apply for a licence to operate a network, he would be forced to offer his resignation.

Andani Noon stated that he had been involved in construction projects all of his life, but that he was very concerned about such a large investment for the company. He stated that if Constro were to fund the investment of $300 million and the demand is lower than the mid-growth level, then this would have a major impact on the entire company.

Ben Knowle agreed and stated that he would not recommend the project unless it was in the form of a joint venture with one of the two global telecoms companies with which Constro was still in discussion. Ben Knowle reported that the company could fund around $170 million from Constro's current cash reserves and that loans of over $150 million would be needed to meet the investment in the first few years, before cash in large quantities could be generated.

Sol Endi commented that he was very keen for the Constro Board to approve the application for a licence. He stated that this was the direction that the company should be taking and his experience in marketing domestic electrical products led him to believe that Constro could be very successful. He also saw this as a way to increase his influence in the company, his staff and his marketing budget.

Malan Beka stated that he saw the proposed Constro licence application as a unique opportunity to grow the company, so that it can participate in an exciting new era of high technology. He reported that the founder, Mani Freel, also thought that the company should embrace this opportunity.

Malan Beka reported that while he fully understood all of the benefits of a joint venture, he felt strongly that Constro could be successful on its own, given its resources. However, Malan Beka reported that he had recently employed a Strategy Consultant from an international firm of consultants to advise the Board. A final decision will be made after receipt of the Strategy Consultant's report, which is due at the end of November.

Market size

Tanda Lew and Sol Endi are both confident that the mid-growth level of subscribers is realistic and achievable. This has been estimated to be approximately 4 million urban subscribers in Afri within five years of the launch of both mobile networks, as shown under Market Opportunities in the pre-seen material.

Cash flow forecasts for mobile telecoms network operations

Ben Knowle's and Tanda Lew's teams have prepared detailed financial plans, which estimate the forecast turnover, variable and fixed costs of operating a mobile telecoms network. The total net operating cash inflows (in nominal terms) based on the mid-growth level of subscribers, and assuming each of the two network operators achieves an equal 50% market share are shown in the table overleaf:

Constro's total net operating cash inflows for the mid-growth scenario *	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*For each year 6-10 ** 2009-2013*
	$ million	*$ million*	*$ million*	*$ million*	*$ million*	*$ million*
Total net operating cash inflows – urban	2	14	48	143	308	362
Total net operating cash inflows – rural	0	1	4	8	18	23
Total net operating cash inflows	2	15	52	151	326	385

Notes: * Net operating cash inflows are defined as turnover less all cash-based variable and fixed operating costs, but exclude all capital expenditure.

** Years 6 to 10 (2009 to 2013) assumes no further growth in subscriber numbers after the end of Year 5 (2008).

The total net operating cash inflows for the high-growth and low-growth scenarios (for both urban and rural subscribers), assuming a 50% market share, are as follows:

Constro's total net operating cash inflows for alternative growth scenarios	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*For each year 6-10 2009-2013*
	$ million	*$ million*	*$ million*	*$ million*	*$ million*	*$ million*
High-growth total net operating cash inflows (urban and rural)	4	30	104	302	652	770
Low-growth total net operating cash inflows (urban and rural)	0	4	14	37	80	95

It should be noted that if Constro were able to achieve a higher (or lower) market share than 50%, the effect of each 10% movement [for example, to 60% (or 40%)] would be to increase (or decrease) the NPV ***based on the mid-growth scenario*** by approximately $150 million.

Capital investment requirement for mobile telecoms network operations

A fast rollout of the network infrastructure across the urban areas and part of the rural areas is planned, in order to support a growing subscriber base. For ***each*** of the two mobile telecom network operators granted a licence in Afri, this will require an investment of approximately $300 million phased over three years, as follows:

Total capital investment for each network operator in Afri, based on mid-growth level of subscribers	*Year 0 2003*	*Year 1 2004*	*Year 2 2005*	*Total 2003-05*
	$ million	*$ million*	*$ million*	*$ million*
Urban areas	40	87	110	237
Rural areas – limited coverage	10	25	28	63
Total capital expenditure for each network operator	50	112	138	300

It is envisaged that no further capital investment will be required after the end of Year 2 (2005), and this will be sufficient to maintain the expected subscriber numbers up until the end of the 10-year licence period for both mobile networks, unless subscriber numbers grow considerably beyond the end of Year 5 (2008).

If growth does not achieve the mid-growth level, but instead achieves only the low-growth level, then capital expenditure requirements for both networks would remain as above for 2003 and 2004, but no further capital expenditure would be required in 2005.

For the high-growth option, the capital expenditure requirements will be double the above levels for each year for urban areas, but capital expenditure for rural areas will remain as shown in the table above.

According to extensive market surveys, the probabilities of the alternative growth levels are as follows:

- High growth 20% probability
- Mid growth 75% probability
- Low growth 5% probability

Ben Knowle has decided that Constro's weighted average cost of capital of 14·5% is ***not*** appropriate for this investment in a mobile telecoms network, and he has decided that a more appropriate discount rate of 18% should be used. This discount rate is based on the increased risk of the mobile telecoms investment and the substantial borrowings that Constro may have to undertake.

Because of the fast-changing technology, it is anticipated that within the 10-year licence period, most of the network infrastructure will become obsolete and have no resale value at all. Furthermore, substantial additional investment in new technology, probably 3G technology, will be required beyond the 10-year licence period, by the companies applying to renew their licences or new companies wishing to enter the marketplace in 10 years time.

Cash flow forecasts for sales of mobile handsets

The forecast sales of mobile handsets and net operating cash inflows are based on Constro selling handsets in its retail outlets only. It is anticipated that handset sales could be even greater if Constro also has a licence to run one of the mobile networks.

No material capital expenditure is forecast if Constro were to retail handsets only. The table below shows the forecast unit sales and relevant net operating cash flow forecasts based upon the mid-growth level of subscribers in Afri:

	Year 1 2004	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*Total 5 years 2004-08*
Sales of handsets (units)	10,000	40,000	50,000	180,000	120,000	400,000
Net operating cash inflows per handset sale	$110	$130	$130	$130	$130	
Total net operating cash inflows (nearest $ million)	$1 million	$5 million	$7 million	$23 million	$16 million	$52 million

For simplicity, taxation and capital allowances should be ignored.

End of unseen material

Maths tables follow

Present value table

Present value of $1, that is $(1 + r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Periods	Interest rates (r)									
(n)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	0.683	0.672	0.661	0.650	0.640	0.630	0.620	0.610	0.601	0.592
3	0.564	0.551	0.537	0.524	0.512	0.500	0.488	0.477	0.466	0.455
4	0.467	0.451	0.437	0.423	0.410	0.397	0.384	0.373	0.361	0.350
5	0.386	0.370	0.355	0.341	0.328	0.315	0.303	0.291	0.280	0.269
6	0.319	0.303	0.289	0.275	0.262	0.250	0.238	0.227	0.217	0.207
7	0.263	0.249	0.235	0.222	0.210	0.198	0.188	0.178	0.168	0.159
8	0.218	0.204	0.191	0.179	0.168	0.157	0.148	0.139	0.130	0.123
9	0.180	0.167	0.155	0.144	0.134	0.125	0.116	0.108	0.101	0.094
10	0.149	0.137	0.126	0.116	0.107	0.099	0.092	0.085	0.078	0.073
11	0.123	0.112	0.103	0.094	0.086	0.079	0.072	0.066	0.061	0.056
12	0.102	0.092	0.083	0.076	0.069	0.062	0.057	0.052	-	-
13	0.084	0.075	0.068	0.061	0.055	-	-	-	-	-
14	0.069	0.062	0.055	-	-	-	-	-	-	-
15	0.057	0.051	-	-	-	-	-	-	-	-

Cumulative present value of $1 per annum, Receivable or Payable at the end of each year for *n* years $\frac{1-(1+r)^{-n}}{r}$

Periods	Interest rates (*r*)									
(*n*)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Interest rates (*r*)									
(*n*)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	7.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Periods	Interest rates (*r*)									
(*n*)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	1.509	1.492	1.474	1.457	1.440	1.424	1.407	1.392	1.376	1.361
3	2.074	2.042	2.011	1.981	1.952	1.923	1.896	1.868	1.842	1.816
4	2.540	2.494	2.448	2.404	2.362	2.320	2.280	2.241	2.203	2.166
5	2.926	2.864	2.803	2.745	2.689	2.635	2.583	2.532	2.483	2.436
6	3.245	3.167	3.092	3.020	2.951	2.885	2.821	2.759	2.700	2.643
7	3.508	3.416	3.327	3.242	3.161	3.083	3.009	2.937	2.868	2.802
8	3.726	3.619	3.518	3.421	3.329	3.241	3.156	3.076	2.999	2.925
9	3.905	3.786	3.673	3.566	3.463	3.366	3.273	3.184	3.100	3.019
10	4.054	3.923	3.799	3.682	3.571	3.465	3.364	3.269	3.178	3.092
11	4.177	4.035	3.902	3.776	3.656	3.544	3.437	3.335	3.239	3.147
12	4.278	4.127	3.985	3.851	3.725	3.606	3.493	3.387	3.286	3.190
13	4.362	4.203	4.053	3.912	3.780	3.656	3.538	3.427	3.322	3.223
14	4.432	4.265	4.108	3.962	3.824	3.695	3.573	3.459	3.351	3.249
15	4.489	4.315	4.153	4.001	3.859	3.726	3.601	3.483	3.373	3.268
16	4.536	4.357	4.189	4.033	3.887	3.751	3.623	3.503	3.390	3.283
17	4.576	4.391	4.219	4.059	3.910	3.771	3.640	3.518	3.403	3.295
18	4.608	4.419	4.243	4.080	3.928	3.786	3.654	3.529	3.413	3.304
19	4.635	4.442	4.263	4.097	3.942	3.799	3.664	3.539	3.421	3.311
20	4.657	4.460	4.279	4.110	3.954	3.808	3.673	3.546	3.427	3.316

6.9 Facilitator's Answer for Constro (Pty) Ltd.

The Facilitator's Answers for Management Accounting – Case Study

REPORT
To: **Members of the Board of Constro**
From: **Strategy Consultant**
Report on Four Alternative Strategies for Constro
Report Contents:

1.0 Introduction
2.0 Terms of reference
3.0 Main strategic issues for Constro
4.0 Discussion of the four alternative strategies:
4.1 Constro to apply for a mobile network operator licence on its own
4.2 Constro to form joint venture with a Global Telecoms Company to apply for a mobile network operator licence
4.3 Retailing mobile telephones
4.4 Construction work outside of Afri
5.0 Other strategic issues affecting Constro
6.0 Conclusions and recommendations

Appendices:

1. Strengths, weaknesses, opportunities and threats (SWOT) analysis
2. Cash flow forecasts for Constro with 50% market share – mid growth
3. Cash flow forecasts for Constro with 50% market share – high growth
4. Cash flow forecasts for Constro with 50% market share – low growth
5. Cash flow forecasts for Constro for rural subscribers only (mid growth)
6. Cash flow forecasts for retailing mobile phones

1.0 Introduction

Constro has been operating successfully as a private company in the country of Afri for 40 years and all of the main four shareholders are no longer actively involved in the company.

Constro's five year plan shows a planned expansion of their construction and road building business to other countries in Africa, to counter the decline in construction and road building projects that is forecast in Afri. The company has recently started its first road building project outside of Afri, as demonstrated by $2 million of income in 2001.

The regulatory authorities in Afri are finally planning to issue cellular mobile network licences to two companies (or consortia) in April 2003. Constro has been planning to expand its business into running a mobile telecoms network for the past three years and has already recruited a number of key personnel to prepare business plans for operating a mobile telecoms network. Constro is currently preparing its licence application to the Afri

regulatory authorities pending a final Constro Board decision on whether Constro should apply for an operating licence on its own, in a joint venture, or whether it should not apply at all.

2.0 Terms of reference

The Chairman and Chief Executive of Constro, Malan Beka, has appointed me as a Strategy Consultant to prepare a report that recommends to the Board what expansion strategy Constro should adopt. My report also discusses whether Constro should also expand the business with construction projects outside of Afri and by retailing mobile telephones.

The time frame that Constro is working to is very tight, as a final Constro Board decision will have to be made quickly following receipt of this report and its recommendations. Additionally, time needs to be allowed for the Constro Board to conduct negotiations with the global telecoms companies (if a joint venture is agreed) prior to submitting the joint venture licence application to the Afri regulatory authorities in February 2003.

3.0 Main strategic issues for Constro

Constro's turnover in 2001 was $310 million and its operating profit was $42 million, a return of 13.5%. By 2006, it is forecast that turnover from some existing business divisions will have declined rapidly, while other areas are forecast to increase. For example, road building in Afri is currently generating $136 million turnover, some 44% of the company's turnover, but by 2006, it is forecast to decline to a mere $10 million (only 2% of the company's forecast turnover).

The key questions to be asked are what areas of business can Constro move into that will generate profitability, and what risks is Constro prepared to take to achieve these strategic moves? Clearly, the company cannot be allowed to slowly slip into decline, and it has recruited some key personnel to assist it to implement its strategy to expand into the emerging mobile telecoms market in Afri.

Constro is, therefore, at a turning point in its history, poised to either leap forward into the telecoms market and expansion outside of Afri, or it could slip into decline. It is recommended that the senior management team should be heavily involved in all large projects that Constro decides to bid for, and this may necessitate recruitment (or outsourcing) of additional senior project management expertise.

The company does not have a Development Director and there is no mention of a planning manager, as in the past each divisional director presumably managed his own area. While contracts were being won and growth and profitability were being delivered, this was presumably not a major concern.

It is recommended that Constro should recruit a more experienced senior management team, with more focus on achieving an agreed five-year plan, or possibly a longer planning cycle. Furthermore, there is no mention of staff remuneration or bonuses, and it is suggested that key senior members of staff have contracts for a set number of years with performance related pay and bonuses linked into achieving agreed objectives. This should motivate key players to help Constro achieve its plans.

The strengths, weaknesses, opportunities and threats of Constro entering the telecoms market are analysed in Appendix 1.

4.0 Discussion of the four alternative strategies

4.1 Constro to apply for a mobile network operator licence on its own

4.1.1 Overview

Since Constro recruited Tanda Lew and his experienced team over three years ago, the company is well placed to operate a mobile telecoms network in Afri, providing it is successful in obtaining an operating licence from the Afri regulatory authorities. Constro needs to ensure that it examines the advantages and disadvantages of applying for a licence on its own or as a joint venture carefully, as there will be only one chance. If Constro fails to win a licence, it will then not have the chance to participate in the mobile telecoms market in Afri for another ten years (or possibly in five years), except to retail mobile phones.

4.1.2 Forecast financial results

The NPV calculations shown in Appendix 2, which is the mid-growth case, assumes that Constro achieves a 50% market share (that is the two licensed network operators are each as successful as each other in achieving subscriber growth). Consequently, Constro could achieve a NPV over the ten-year licence period of $547 million.

(Based on using a discount rate of 18% given in the un-seen material)

There are no figures available for turnover, but bottom line cash flows grow to almost $330 million per annum by the end of Year 5 (2008) which is about 6 times greater than the forecast operating profit for Constro in total for 2006.

(Per the 5-year plan in Appendix B of the pre-seen material)

	Constro NPV *$million*	*NPV change from Constro mid growth* *$million*
Mid growth with 50% market share (details shown in Appendix 2)	547	
High growth with 50% market share (details shown in Appendix 3)	1,145	+598
Low growth with 50% market share (details shown in Appendix 4)	51	−496

The NPV calculations have been prepared for the ten-year licence period, and assume, rather conservatively, that the subscriber base does not grow beyond year 5. The mid-growth subscriber level with 50% market share shows that the project pays back (discounted) in 4.9 years, but the bulk of the positive cashflows are generated in the last five years of the ten-year licence.

The un-seen material stated that if Constro were able to achieve a higher, or lower, market share then each 10% change would affect the NPV by $150 million. Therefore, if Constro were to only achieve a 40% share of the Afri market then the NPV would be only $397 million, a reduction of £150 million. However, if Constro was to be very successful and was able to achieve a dominant market share of, say, 60%, then the NPV would increase (assuming network capacity was available) from $547 million to $697 million, an increase of 27%.

Therefore, for each 1% increase or decrease in market share, the NPV of the investment in the network infrastructure is worth $15 million in NPV terms. Therefore, it should be

worth Constro marketing its network service extensively, providing that the extra marketing spend to generate additional subscribers to boost market share, was lower than the additional positive cashflows.

It should be noted that the discount rate of 18% has been used throughout the calculations in the appendices, but that this is higher that Constro's current cost of equity of 14.5%. However, the 14.5% cost of equity had been based on a beta of 1.4, which would change if Constro were to enter this new, riskier market. Furthermore, if Constro were to apply for a licence on its own, and was successful, it would also have to take on substantial loan capital, which would affect the cost of equity. The cost of equity would rise to reflect the risk of debt being introduced, and this would offset the benefits of cheaper debt. Whether the new weighted average cost of capital is approximately 18% or whether it would be greater, given the increased risks, would also have a bearing on the size of the NPV's and also the discounted payback period (which would be longer if the discount rate were to be higher than 18%).

Appendix 5 shows the NPV for the rural subscriber base and shows that a small loss of $5 million is made over the ten-year licence period. It would be expected that the mobile telecoms licence would have certain conditions on coverage area, and that rural areas would be 'subsidised' by the urban subscribers. This loss is fairly small and each of the two network operators would have to accept this loss as part of their licence conditions.

Furthermore, it should be remembered that all of the forecast revenue and cash flow figures are only forecasts, and that much depends on the market, possible price wars, competition for market share and speed of subscriber growth.

It should be noted that the project is expected to pay back in year 5, but because of the high risks of changing technology and the large investment in infrastructure required, this is still quite a long payback with so many unknowns. It is also necessary for Constro to invest substantial sums ($237 million in urban areas, plus $63 million in rural areas) by the end of year 2 when cash inflows have only just started to trickle in (only $15 million in the mid growth scenario) by the end of year 2. The rewards of being granted a licence are large, but so are the risks.

The key strategic issue is how can Constro win a licence. Being a network operator could be hugely profitable and if the forecast subscriber growth and the forecast cash flows are accurate, these results could overshadow all of Constro's other activities. Constro needs to examine the factors that will give it the best chance of winning a licence. Without a licence, all of the best laid plans and ambitions of Constro and its staff will be wasted.

4.1.3 The Afri regulatory authorities

The Afri regulatory authorities will want the two companies (or joint venture consortia) which are granted a licence to be successful, so that Afri, as a country can continue to develop economically, as mobile telephony will bring with it wealth and jobs across many industry sectors. The regulatory authorities will therefore choose the two companies that it feels will best deliver competing, but profitable, mobile networks. It will also want the two networks available to the Afri population in the shortest possible timeframe.

The regulatory authorities have also stated that both licences will only be granted to companies that are owned by Afri nationals, or to consortia that include Afri-owned companies. Therefore, Constro is clearly in a good position as a leading Afri-owned company (and also is one of the government's preferred builders), to win a licence.

4.1.4 Key issues

The questions that Constro needs to address, therefore, are:

- Whether Constro has access to sufficient funding for the required capital expenditure. It would seem that it could raise enough funds (or could raise debt financing) for the expected level of subscribers. However, if the high growth scenario occurred, then it would not have the required funding under current borrowing arrangements. However, it is highly likely that sources of debt financing could be identified if this occurred.
- Constro is heavily dependent on Tanda Lew and his small team. Constro would need to ensure that these key players had contractual commitments, and they should also be rewarded through bonuses (or performance-related payments) for achieving agreed financial and non-financial targets (such as agreed subscriber numbers, bills produced on time, network infrastructure built on time etc). Contingency arrangements would also need to be made in case any of the key managers were ill or broke their contracts (as it is a very competitive market and experienced telecoms managers are head hunted by other companies, in the same way that Tanda Lew was recruited into Constro).
- Tanda Lew and his team are, no doubt, skilled engineers and could construct the network infrastructure, but are the necessary skills to operate the network available in Constro, or could they be brought in quickly enough or outsourced? Marketing is one key area in which Constro lacks skills. There is no benefit in Constro having the best technical network if the subscribers do not perceive the overall service provision to be good.

4.1.5 Customer registration and billing issues

There are a number of other key areas that Constro needs to urgently address if it decides that it does wish to apply for a mobile telecoms licence on its own. One of these key areas is customer registration and billing. Have Constro personnel the necessary skills to select the customer service and billing software, or should an experienced software company be employed to recommend the desired software?

The Customer Service manager is depicted as ‘inexperienced’. This knowledge gap needs to be filed and this key area of customer service must be improved to the satisfaction of the entire Constro Board. Constro is completely lacking experience in running a telecoms network. How are Tanda Lew’s managers going to prevent and detect fraud and lost revenues and how are they going to recruit sufficient administration personnel to manage a subscriber base of possibly two million customers within five years (based on 50% share of 4 million for Afri)?

Constro could outsource its IT requirements at the beginning, at a cost, to a leading global IT company (such as *Logica*) to manage its customer registration, fraud detection and billing requirements.

If the network infrastructure is built and in place, but the administration and service given to customers is poor, customers will switch to the other network operator, which could lead to rapidly falling revenues, and would be very difficult to reverse. Constro must get it right from the start.

4.1.6 Marketing

There does not appear to be a Telecoms Marketing Manager, or a marketing programme in place. Who will manage this, Tanda Lew or Constro's Marketing Director, Sol Endi (who is inexperienced in telecoms)? There is a need to recruit a new telecoms marketing manager urgently if Constro should win a licence.

In order for Constro to achieve a 50% market share, it would also need to have the marketing and administrative expertise to manage its customer base, which it clearly does not have at present.

If Constro spends $300 million on the network infrastructure and then only achieves a 40% market share, this will reduce the NPV by $150 million. Customer service and marketing expertise are keys to success if Constro does win a licence. This area does not seem to have been adequately addressed by Constro so far.

4.1.7 Other issues

There is also the risk that if the low growth scenario occurred, or if Constro failed to achieve a reasonable market share (say 40–50%), and the company has invested all of its available cash into the mobile network, it could have a catastrophic effect on the company.

Another concern is whether Constro could afford the interest payments in the early years, on the basis of taking on loans of over $150 million, which would have to be funded by other areas of Constro's business. Also, since Constro has never used debt financing previously, has Ben Knowle been able to negotiate the best debt financing arrangements.

If the demand was high, Constro could be a victim of its own success. How could Constro, its IT systems and its personnel cope with the high growth scenario?

A further issue is whether Constro could recruit and train sufficient sales and marketing and administration personnel to run a telecoms network in the short term, to enable a launch of the network as soon as possible.

4.1.8 Constro management resources

A large amount of senior management time will be focussed on the building and the launch of the mobile telecoms network if Constro wins a licence, which would detract management attention away from other areas of the business. Could Constro realistically continue to expand its business outside of Afri with all of the constraints on its time? More senior management resources would need to be brought in, which could change the whole culture of the company.

After several years of successful operation, there is the possibility that AfriTel could be listed on an international stock exchange. There are no details given concerning management remuneration packages which may be necessary to retain key personnel and for them to achieve the planned expansion into telecoms. The remuneration package for key personnel should be carefully considered and perhaps, in the future, they could be eligible for shares in this multi-billion dollar company.

4.1.9 Summary and recommendations

Overall, the conclusion is this is a very high-risk venture, and Constro is unlikely to be awarded a licence on its own. However, if it were to be awarded a licence on its own, it would

struggle with lack of experience, systems and accumulated telecoms knowledge to deliver a competitive mobile telecoms network in Afri. This assumes that the other licence is issued to a joint venture consortium, which includes an Afri owned company or companies.

Constro could take the chance that it would be awarded a licence on its own, and it is probably the most prepared of all the Afri companies that are planning to apply for a licence. Overall, however, it would achieve a greater chance of success if it entered into a joint venture.

It would be better for Constro's wealth maximisation to be a majority shareholder in a joint venture arrangement that was able to achieve a good market share, than to be on its own, and either fail to obtain a licence at all, or to only achieve a low market share.

4.2 Constro to form a joint venture with a Global Telecoms Company to apply for a mobile network operator licence

4.2.1 Forecast financial results

The key issue with entering a joint venture is that Constro will have to share profits with the global telecoms company in accordance with its agreed percentage shareholdings. However, while Constro would not receive 100% of the forecast profits, but may only receive 40% or 60% (or whatever), depending on their negotiations, this may result in higher long-term cash flows. Higher long-term cashflows could materialise if the joint venture consortium was very successful and additionally if fraud and lost revenues could be minimised.

Therefore, if the mid-growth NPV of $547 million was achieved, Constro would only receive a proportion, say 50%, which would be $274 million. However, if the consortium managed to increase its market share by 10% to 60% of the Afri market, this additional 10% market share is worth $150 million.

Overall, Constro could share $697 million ($547 million plus $150 million), resulting in an NPV of $348 million, it was a 50/50 joint venture partner. This compares to a NPV of $397 million, if it operated on its own and only achieved 40% market share. These results are not too dissimilar, and the risks are far less.

Furthermore, if Constro was able to negotiate a higher than 50% share of the joint venture, it would therefore receive a larger share of the joint venture results, which could even put it in a better position than if it operated a not so successful network on its own. Additionally, the other consideration is that if Constro were unsuccessful in being granted a licence on its own, 100% holding of zero income is zero, whereas, a percentage holding of a joint venture that **is** granted a licence will generate large cash flows.

4.2.2 Key issues with a joint venture

Constro needs to assess whether a joint venture with a global telecoms company would reduce business risk. Additionally, would a joint venture help Constro to achieve a 50%, or greater, market share in Afri?

A joint venture arrangement would bring prestige and publicity (although this could be a disadvantage if, for example, the global company was American, and American companies were not highly respected in Afri, given the anti-US sentiment in some countries at present).

All of the global telecoms companies are also looking for a decision as to whether Constro will form a joint venture with them or not, as they are keen to enter the Afri telecoms market, but cannot do so without an Afri-based partner. If Constro does not decide quickly, it may find that the global telecoms companies have found alternative joint venture partners with other Afri-owned companies.

Business risk and Constro's inexperience in some areas could be overcome by the global company seconding key personnel to the joint venture to set up systems and procedures. Additionally, a global company will probably be in a better position to loan additional resources to speed up the launch date, and to help to win early dominant market share.

The overriding key strategic issues are whether Constro feels that having a global telecoms company in a joint venture will help it to (a) win a licence and (b) deliver a successful mobile telecoms network in a competitive market.

A risk associated with Constro entering into a joint venture is that it is a much smaller company than any of the global companies, and may lose some control to a more dominant joint venture partner, particularly one that has more extensive telecoms experience than Constro. This could frustrate Tanda Lew, which could even result in Constro losing its key manager with telecoms experience, therefore exacerbating the problem.

4.2.3 The benefits to Constro of entering into a joint venture

The main benefit to Constro of entering into a joint venture with a global telecoms company is shared and reduced risk, as global telecoms companies already have experience of operating mobile telecoms networks in other countries.

One of the largest benefits would be access to telecoms operating experience, work methods and IT systems. Mobile telecoms networks have already been established in other countries, so why should Constro try to reinvent the wheel? With a joint venture partner it would have free (or reduced cost) access to knowledge and technology. This will translate into increased ability to compete, which should hopefully lead to the joint venture having equal, or even a dominant, market share in Afri.

A joint venture would also allow Constro to have access to the experience of telecom fraud prevention and detection and to improved IT systems, which should ensure lost revenues are minimised. There is a large amount of accumulated wealth of knowledge within all global telecoms companies that Constro should be able to tap into in a joint venture situation. Otherwise, it would have to go through the learning curve on its own, which could prove costly.

An additional benefit would be the sharing of the large amount of capital expenditure necessary to establish the mobile telecoms network. Additionally, the global telecoms joint venture may enable Constro to access cheaper sources of finance, as there would be less perceived risk by lenders.

4.2.4 IT systems

A mobile telecoms network requires that its IT systems should be built to be future proof (given the rapidly growing subscriber numbers). A global company would have more experience of upgrading software and hardware as the business grows. Constro would probably have limited vision of the size that systems would need to be. Prior to launching a network,

when systems are being selected, it is difficult to imagine 100,000 customers, let alone possibly 2–4 million customers.

4.2.5 Which global telecoms company to select for a joint venture

Constro is in a very good negotiating position as no global telecoms company can obtain a licence on its own, due to the Afri regulatory authority's announcement that an Afri company must be involved. Of the six Afri companies that are understood to be interested in applying for a licence, Constro is probably in the best position due to three known factors, which are:

(a) it already has Tanda Lew and his telecoms team in place and has been planning for this new business for over three years;
(b) it has good political connections with Afri government ministers;
(c) it has available cash resources to invest.

These three factors put Constro in a very strong negotiating position with either Global Company A or D. Furthermore, as this is the last African country to licence mobile telecoms and the NPV (mid-growth case) is in excess of $500 million for each of the two licensees, both of the global companies will be very keen to obtain a share, albeit smaller than they may have wanted, of this new market.

Constro needs to consider which of the two companies it could work well with, as this will be a long-term relationship. The size of the NPV of the project (of over $500 million) further emphasises the need to negotiate carefully for a key long-term partner.

Another issue that could assist the possible joint venture in being successful in obtaining a licence is whether Constro entered into a joint venture with a global telecoms company and **also** another Afri company (possibly giving them a small, say 10% shareholding). Many of the existing African countries have joint ventures, with the global company holding 51% and 1 to 4 other partners from that country.

Vodaphone is a global telecoms company that has a majority shareholding in a mobile telecoms network in many African countries. In some of its joint ventures it has just one local company involved, whereas in other countries it has several partners in the joint venture arrangement.

If Constro entered into a joint venture, it needs to decide which global company it should select, Global Company A (referred to as 'A'), or Global Company D (referred to as 'D'). The key question is which global company would give Constro the best possible advantage for (i) winning a licence and (ii) generating the most long-term profitability.

If it formed a joint venture with A, Constro would not have a majority shareholding, but there is good senior management rapport. It is worth noting that if Constro were to have a 49% share of a joint venture with A, and the joint venture was successful in terms of subscribers and profitability, Constro may be financially better off. This is because a 49% share of a dominant network with, say, 60% of the Afri market will be worth more than say a 60% share in a joint venture that has not been as successful.

Constro should establish why D was not successful in its proposed joint venture in another African country, when it was not granted a licence. Was it just unlucky, as there are always more companies than licences available, or does it not have the acceptable skills or global image? D is far larger than A, but it has no joint ventures in Africa, and is perhaps not well respected in Africa. The Afri regulatory authorities could view this adversely.

However, Constro may be able to negotiate a better deal with D, as it needs Constro more than Constro needs it and it is keen to be involved in Africa. There is also the problem of the apparent clash in personalities between Malan Beka and Martyn Holland, although such problems could be overcome, if both companies do decide to work together.

Additionally, D is a major mobile telephone manufacturer and a joint venture with D could be useful to Constro in its ambitions to retail mobile phones. Strategically, Constro needs to decide which global company, A or D, it would be most successful with. Alternatively, could it set up a joint venture with **both** A and D? However, it may be that they would not be willing, but this again is worth establishing.

4.2.6 Recommendation of joint venture company

Which of the two global companies should be selected, A or D? The decision will rest on what each of the two companies can offer Constro, a wider consideration than just financing issues. Which of the two companies can offer the skills and IT experience that Constro is lacking? Overall, from the limited data available, I would recommend a joint venture with Global Company A. I would also recommend that Constro should try to negotiate a majority shareholding, perhaps 51%–60%.

4.3 Retailing of mobile telephones

4.3.1 Overview

Constro already has nine outlets, in all of the major towns in Afri, selling domestic electrical appliances, and is therefore well placed to move into this new market, irrespective of whether it is successful in obtaining a network operating licence or not. Constro needs to undertake market research and possible competitor analysis, to put itself in the best possible position to exploit this new market. It also needs to research the successes, and failures, of retailing mobile telephones in other markets (in other African countries and elsewhere) so that it does not make the same mistakes as others in this competitive market.

4.3.2 Financial results

Assuming the net cash flows given in the unseen material are realistic, sales of mobile phones could generate cash flows of almost $52 million over the next five years (see Appendix 6), which, discounted at 18%, results in an NPV of $28 million.

Whether Constro could really generate net cash flows of $52 million over the next five years depends on whether it could achieve the sales volumes given, which are high. The sale of 400,000 handsets represents 10% of the total Afri market of 4 million subscribers (mid-growth level). Also, whether the net cash flows take into account all of the, as yet unknown, factors of selling phones in a competitive marketplace. A lot of large, and untested, assumptions underlie these promising results. They could all too easily reduce substantially.

The profitability of handset sales also looks high, given what a competitive market this will be. Constro figures show net operating cash flows rising from $1 million in 2004 (year 1) to $23 million in 2007 (year 4) – is this realistic or are profits likely to be higher. Constro is a relatively inexperienced retailer (current turnover $21 million, and current profitability only $2.9 million).

4.3.3 Constro's ability to achieve mobile phone sales

While Constro already has the electrical retail outlets in place in Afri, can it procure handsets at a suitable price from global manufacturers to enable an adequate margin?

Furthermore can Constro's IT systems, such as invoicing and stock control, be able to handle the large numbers of mobile phone sales. By 2007, year 4, the forecast volumes are 180,000 units. It can be difficult to track and invoice such large numbers of relatively small value goods such as mobile phones. It is quite a different market to retailing other domestic electrical appliances such as washing machines.

4.3.4 Marketing issues

Constro would need to appoint a mobile phones sales and marketing manager to manage this proposed new area of Constro's business. If Constro were to be involved in operating one of the two licensed mobile networks, there is a greater opportunity for sales than if Constro did not become a network operator.

It is likely that a large number of entrepreneurial businesses will try to enter the mobile phone retailing market, as seen in other countries. What experience and skills does Constro have that will enable it to compete against the many other players, and would Constro realistically be able to establish such a large market share (sales figures indicate 10% market share).

How is Constro going to retail the phones so that it adds value to the end user? Will Constro be able to secure good deals with the global handset manufacturers, or will they give better deals (both price and availability) to the two Afri network operators (which may or may not include Constro)?

There are still large profits to be made by handset retailers (for example *Carphone Warehouse* in the UK), if they can deliver the right products to the market at the right price. Constro has limited experience in this field. Can it accommodate this level of sales in its existing nine retail outlets, or will more outlets and perhaps a bigger distribution centre be required?

The net operating cash flows given in the unseen do not state whether all of these items have been included, but it is of some concern that net operating cash inflows per handset appear static at $130 per handset sales from 2005, year 2, onwards. The figure is bound to change and would probably fall, due to two main factors, increased competition and falling retail prices.

What other, perhaps more experienced, electrical retailers are there in Afri? What other companies will enter and compete in this new market.

4.3.5 Other strategic issues

Constro would need to establish whether it could still do business with D, a major handset manufacturer, if it decides not to enter a joint venture with that company.

Another major issue that Constro would need to address if it were to retail mobile phones is whether it could manage the difficult job of stock control. It would have to ensure that it was not left with large value un-saleable handset stock, as handsets quickly get obsolete and are falling in price all the time.

What would happen to Constro if it purchased a quantity of handsets that are retailing elsewhere in Afri at less than it paid? Large stock write-offs and sales of handsets at a loss are not uncommon. Could Constro afford this embarrassing dent in its profits?

4.3.6 Summary and recommendations

Sales of mobiles, based on financial data in the question, are only planned to generate net profitability of approximately $52 million over five years, with much uncertainty and risk. It is recommended that Constro enters this market, albeit cautiously. It needs to ensure that its retail outlets and its sales staff do not overstock. Additionally, there will be the new need to monitor competitors very closely.

4.4 Construction work outside of Afri

4.4.1 Overview

Constro cannot wait to find out if it has been successful in obtaining a telecom licence; it needs to continue to look for other sources of income. Constro's five year plan looks very optimistic in being able to generate $250 million turnover from road building in other countries over the next five years, given that it has only just won its first contract in another country. It also has never undertaken construction projects in other countries and there will no doubt, be many other bidders for these contracts. Therefore, the $80 million in years 2004–2006 appears to be rather optimistic also.

If Constro is unable to generate substantial business outside of Afri by 2006 its turnover could fall from its current level of $300+ million to under $250 million, providing it can achieve the growth that is anticipated in other areas of its business within Afri, which also looks challenging.

4.4.2 Forecast financial results

The five year plan in Appendix B to the pre-seen material shows that road building in other countries could generate profits of $26.5 million in the next five years, a return on turnover of 10.6% over the five years, but would require capital expenditure of $32 million. This capital expenditure would presumably be to purchase heavy machinery for operations in each country that would have a long life. Road building, therefore, will not generate in the short term (next five years) any large cash flows for the company.

However, it should be noted that the only data available for the construction work shows profits, which would include depreciation of machinery. There are no cash flow figures available, so strictly, profits and capital expenditure cannot be directly compared. However, this comparison has been made for the purpose of demonstrating the need for fairly large capital expenditure in construction plant before sizeable profits in other countries could be generated.

Other major construction projects outside of Afri are forecast to generate a turnover of $80 million and profits of $8 million, a 10% return on turnover, but again these require substantial upfront capital expenditure of $29 million to get these longer-term projects established. Therefore within the planned five-year framework, there is a negative effect on cashflows from expansion outside of Afri.

In summary, the capital spend to establish bases and equipment in other countries, prior to profits being generated, adversely affects cashflows in the next five years.

Additionally, the forecast overall Constro net operating profit at 13.9% over the five-year plan is higher than construction work in other countries (road building is 10.6% and other construction projects is 10%). The overall return has been boosted by the 17% return from

construction of residential property and a 16.1% return from the sale of electrical appliances. Perhaps management time would be better spent ensuring that the continued expansion of business in these profitable areas is achieved.

It is suggested that a breakdown of the forecast construction work revenues and costs analysed by country and by project should be examined before a decision is taken to expand outside of Afri. Additionally, a longer planning timeframe of, perhaps, ten years should be considered by Constro. Also are there any countries that Constro is planning to expand into that are politically unstable?

Longer term profits are possibly there to be made, but short-term capital requirements for both road building and other construction projects, both exceed profits within the next five years. There is also no guarantee that forecast operating cost levels are correct, as Constro would be operating in countries that it has previously not worked in.

If Constro fails to succeed in expanding its construction and road building business to other countries, it will not generate $34.5 million of operating profit in the next five years, some 15% of the entire forecast company's profitability.

4.4.3 Key issues

Constro needs to train its staff (and possibly recruit more experienced staff) to ensure that it has construction project management teams that will assist the company to successfully transfer construction skills to other African countries and win contracts. It also needs to identify its local competitors in other countries, and whether it can win contracts with its lack of Government connections in other countries.

Constro needs to consider whether it could actually win contracts in other countries. The current five-year plan shows it has started its first ever road building in 2001, which generated a turnover of $2 million. This is part of a larger contract for $25 million which spans three years. However, the balance of $225 million for further work has not yet been contracted, which would be usual for work that would not commence until 2003 and onwards.

How realistic is the rapid growth in turnover that has been forecast (from $10 million in 2002 to $100 million in 2006, some $250 million in five years).

If Constro is unsuccessful in winning some or all of these contracts, but has incurred some or all of the planned $32 million for capital expenditure, then it could have purchased expensive machinery in other countries that has limited utilisation and a limited useful life (with perhaps some realisable value).

What steps can Constro take to ensure that contracts are successfully bid for and won, and also how can Constro manage to deliver the forecast levels of profitability?

Additionally, can Constro recruit and train local construction workforces to achieve required safety and quality standards in other African countries, or can it use its existing workforce in another country. Are teams of the current Afri-based workers willing to move away, or will they face redundancy?

4.4.4 Recommendations – road building and other construction work outside of Afri

There is no reason why Constro should not attempt to expand its road building and construction work to other countries, even if it is successful in winning a mobile telecoms licence on its own or as a joint venture. The key concern is that contracts are managed

effectively, so that they are correctly bid for and to ensure that contracted timeframes and fees are realistic.

Constro should not adopt a 'scatter gun' approach at winning contracts that will be unable generate reasonable profits. Constro needs to have an effective strategy to expand its business to a limited number of African countries in a planned and well-managed manner. Constro's five-year plan should be reviewed and amended according to the agreed expansion strategy and for the countries that Constro has specifically agreed that it intends to expand into.

Constro should have sufficient cash flows, generated from on going business, to fund the required capital expenditure needed to expand the construction business. However, perhaps some of this equipment could be hired (or leased, if possible) until Constro has generated a large enough amount of business in each country to justify the relatively high levels of capital spend.

The five-year plan shows a rapid increase in turnover and profitability for the construction of residential property in Afri (showing a return on turnover of 17%). Is this realistic and achievable, and is this an area that Constro should perhaps concentrate on, rather than expanding to another country?

The recommendation is that Constro should attempt to expand its construction business to other countries, but very cautiously. Constro should ensure that any proposed projects can be effectively managed and that net cash flows are realistic, prior to bidding for any contracts, so as to ensure that it does not take on large contracts that end up being unprofitable. It should also be careful as to which countries it works in.

5.0 Other strategic issues affecting Constro

If Constro were to decide to enter a joint venture, it will acquire a long-term alliance with a company that is far larger than itself and who may be experiencing many problems within the telecoms industry at present. Most of the global telecoms companies have seen their share values fall dramatically over the last few years and this has, for some companies, resulted in cutting back on capital expenditure and even exiting from joint venture arrangements. Constro would have to consider these factors, as it would not want its new AfriTel network to be cash constrained, particularly in the early days when large investment in the network infrastructure is required.

Furthermore, Constro would not wish to find itself in the position that the global company that it entered a joint venture with, was forced by global circumstances, to 'pull the plug' on the Afri joint venture because of cash constraints or slower than forecast payback some years after investing heavily in the network infrastructure. The global company could survive such a dramatic about face, but could Constro, if its chosen joint venture partner was to break its agreement within the ten-year period. Constro would be particularly vulnerable if this happened in the first few years before the project produced positive cashflows.

Constro needs to establish whether its investments can easily and swiftly be turned into cash, if it decides that it needs the cash for investment in the mobile telecoms network or for expansion into other countries. If it owns large blocks of shares, could it achieve the current balance sheet value should they be sold off suddenly?

Constro has a balance of $30 million for retained construction payments in the balance sheet. When these are paid, assuming no reason for them to remain unpaid after the contractual date, this could be used to fund the limited capital expenditure required for construction work in other African countries.

Constro as a company will change dramatically in the next five years if it is granted a mobile telecoms licence. Has it the necessary management team and expertise to take the company through this huge period of change?

Staff numbers will grow rapidly and even new office accommodation will be needed in the next few years to cope with the levels of staffing that AfriTel would need if it were granted a network licence.

The cultural changes and the opportunities available are huge, but many of Constro's staff may be slow to change, and this could affect Constro's ability to compete.

6.0 Conclusions and recommendations

Constro is lacking in the necessary personnel and skills to apply for a licence on its own, and would be more likely to be granted a licence if it applied in a joint venture with a global telecoms company.

Global Company A would be the preferred joint venture partner as the rapport with Constro's Chief Executive, Malan Beka, is present and also because they are already successfully involved in other African joint ventures *(unseen material also stated that it had achieved a dominant market share in one of the joint ventures it was involved with – this would only have been achieved if it had the correct marketing and customer service skills).*

Retailing of handsets is risky, but this large new market could reap huge rewards or large losses. Much depends on whether Constro is involved as a network operator or not. If it is, it could supply many of its network customers with a handset as part of a package. If it is only selling handsets, perhaps it should form a strategic alliance with one of the two network operators.

It is recommended that Constro should also continue to bid for profitable construction business, both in Afri and in other African countries. I would recommend a joint venture with Global Company A, with Constro holding a minimum of 40%, but hopefully able to negotiate a 51–60% holding.

Appendix 1

SWOT analysis for Constro entering the telecoms market

Strengths
- Successful Afri company
- Constro is an Afri national company and telecoms licences will only be offered to Afri national companies or consortia which include an Afri national company
- Large cash surplus available
- Good government connections
- Good track record of success in other major construction projects
- Strong management team
- Constro Board supported by founders
- Constro is several years ahead of some Afri companies in its plans to expand into telecoms
- Constro already operates retail outlets that could sell handsets
- Has recruited Tanda Lew who has a good reputation in the telecoms industry

Weaknesses
- No previous experience in telecoms
- No marketing experience in telecoms
- No experience in large customer base and billing and debt collection issues

- If Constro entered into a joint venture, it would be very small compared to any prospective joint venture partner
- Constro Board disagreement with strategic direction of the company
- Current dependence on the Afri market
- Commitment and ability of Tanda Lew to operate a successful network and recruit staff with the necessary skills
- Possibility that Tanda Lew could leave or be head hunted by another Afri company or a Global telecoms company
- IT strategy for telecoms unclear and IT experience for telecoms very weak
- If high growth occurred, Constro could have financing problems
- Constro workforce experience mainly in construction and not telecom network operations – wrong skill mix

Opportunities
- Telecoms offers Constro an opportunity to diversify into a new market
- Constro has an opportunity to apply for a licence now, that will not be repeated for many years (it is unlikely that further mobile telecoms licences will be issued in Afri for another ten years, or five years at the earliest)
- Retailing of mobile handsets in existing retail shops
- Possibility of offering other telecoms services in the future if it wins a mobile telecoms licence (internet services, broadband etc)
- Large rural population that telecoms services could be offered to, which could have a favourable impact on their lifestyles
- Greater prosperity for Afri would arise from improved communications, that could reflect favourably on other areas of Constro's businesses

Threats
- Many competitors (both Afri companies and global companies) trying to win one of the two available licences
- Rapidly changing mobile technology
- If Constro entered a joint venture, it would be very dependent on its partner for some areas (for example fraud detection and billing issues)
- If Constro obtained a licence on its own, has it the manpower and the skills to deliver a successful telecoms network to the Afri population?
- Highly competitive market for the sale of handsets
- Profitability on the sale of handsets could be far lower than forecast if the market is more competitive than expected
- Afri GDP is low and the country's prosperity is not certain
- Accuracy of cash flow forecasts is unknown and investment is large in the early years, which could result in a lower NPV and a slower payback

Appendix 2

Constro – Mobile Telecoms Network Income

Mid-growth with 50% market share	*Year 0 2003*	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*Year 6–10 2009–13*
Subscribers – Urban (end year 000)	0	50	250	500	1,400	2,000	2,000
– Rural (end year 000)	0	5	20	40	70	125	125
Subscribers – Urban (average 000)	0	25	150	375	950	1,700	2,000
– Rural (average 000)	0	3	13	30	55	98	125
Cash Flows:	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*
Capital – Urban	−40	−87	−110	0	0	0	0
– Rural	−10	−25	−28	0	0	0	0
Net Op. Cash flows – Urban	0	2	14	48	143	308	362
– Rural	0	0	1	4	8	18	23
Net Cash Flows	−50	−110	−123	52	151	326	385
Discount rate @ 18%	1.000	0.847	0.718	0.609	0.516	0.437	1.367
DCF	−50	−93	−88	32	78	142	526
Cumulative DCF	−50	−143	−231	−199	−121	21	547
Total NPV	**547**						
Discounted payback	**4.9 years**						

Appendix 3

Constro – Mobile Telecoms Network Income

High Growth with 50% Market Share	*Year 0 2003*	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*Year 6–10 2009–13*
Subscribers – Urban (end year 000)	0	100	500	1,000	2,800	4,000	4,000
– Rural (end year 000)	0	10	40	80	140	250	250
Subscribers – Urban (average 000)	0	50	300	750	1,900	3,400	4,000
– Rural (average 000)	0	5	25	60	110	195	250
Cash Flows:	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*
Capital – Urban	−80	−174	−220	0	0	0	0
– Rural	−10	−25	−28	0	0	0	0
Net Op. Cash flows – Urban & Rural	0	4	30	104	302	652	770
Net Cash Flows	−90	−195	−218	104	302	652	770
Discount rate @ 18%	1.000	0.847	0.718	0.609	0.516	0.437	1.367
DCF	−90	−165	−157	63	156	285	1,053
Cumulative DCF	−90	−255	−412	−349	−193	92	1,145
Total NPV	**1,145**						

Discounted payback **4.7 years**

Appendix 4

Constro – Mobile Telecoms Network Income

Low Growth with 50% Market Share	*Year 0 2003*	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*Year 6–10 2009–13*
Subscribers – Urban (end year 000)	0	10	50	100	280	400	400
– Rural (end year 000)	0	5	20	40	70	125	125
Subscribers – Urban (average 000)	0	5	30	75	190	340	400
– Rural (average 000)	0	3	13	30	55	98	125
Cash Flows:	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*
Capital – Urban	−40	−87	0	0	0	0	0
– Rural	−10	−25	0	0	0	0	0
Net Op. Cash flows – Urban & Rural	0	0	4	14	37	80	95
Net Cash Flows	−50	−112	4	14	37	80	95
Discount rate @ 18%	1.000	0.847	0.718	0.609	0.516	0.437	1.367
DCF	−50	−95	3	9	19	35	130
Cumulative DCF	−50	−145	−142	−133	−114	−79	51
Total NPV	**51**						
Discounted payback	**7.6 years**						

Appendix 5

Constro – Mobile Telecoms Network Income

DCF of Rural only – mid growth – 50% market share	*Year 0 2003*	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*	*Year 6–10 2009–13*
Cash Flows:	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*	*$m*
Capital – Rural	−10	−25	−28	0	0	0	0
Net Op. Cash flows – Rural	0	0	1	4	8	18	23
Net Cash Flows	−10	−25	−27	4	8	18	23
Discount rate @ 18%	1.000	0.847	0.718	0.609	0.516	0.437	1.367
DCF	−10	−21	−19	2	4	8	31
Cumulative DCF	−10	−31	−50	−48	−44	−36	−5
Total NPV	**−5**						

Appendix 6

Constro – Sale of Handsets

	Year 0 2003	*Year 1 2004*	*Year 2 2005*	*Year 3 2006*	*Year 4 2007*	*Year 5 2008*
Constro sales (handsets 000)		10	40	50	180	120
Data from unseen:						
Net Operating Cash Flows $/handset sale		110	130	130	130	130
		$m	*$m*	*$m*	*$m*	*$m*
Total net operating cash flows (from unseen)		1	5	7	23	16
Discount rate @ 18%		0.847	0.718	0.609	0.516	0.437
DCF		1	4	4	12	7
Cumulative DCF		1	5	9	21	28
Total NPV		**28**				

7 Developing an Answer to the TOPCIMA Requirement

7.1 Introduction

Chapters 5 and 6 focused on developing the skills you will need before exam day. The purpose of this chapter is to demonstrate the skills you will need on exam day.

The techniques demonstrated here appear in Chapter 3, the Skills Toolkit. Here they have been applied to the November 2003 FLCS case on Homejay.

Before you can use these skills you first need to analyse the pre-seen material for the Homejay case. We have left you to practice the skills in Chapters 5 and 6 but have included a summary at the end following the pre-seen material to ensure you have spotted the relevant points.

7.2 Pre-seen material November 2003

Homejay Incorporated

Background

Homejay Incorporated (Homejay) has been trading for over a hundred years and has a number of areas of business that include some global brands that are highly profitable. It is a multinational company that predominantly manufactures and retails consumer goods for its home market in the USA and in Europe. It has few business interests in the Far East at present.

It has three main lines of business, which are do-it-yourself (DIY) stores, furniture stores and electrical consumer products. It also owns a cosmetics company and a chain of greeting card shops.

Homejay's shares are traded on an international stock market and are widely held by leading financial institutions and pension funds. Over a period of 50 years up to 1994, Homejay's share

price growth has exceeded market analysts' expectations and it has been widely regarded as a good investment. However, for the last nine years its share price has not achieved the expectations of market analysts and the company's earnings per share has fluctuated and is now below the level achieved nine years ago. A number of management initiatives have been undertaken to improve growth, profitability and the company's share price.

Homejay has five business units, which are run as autonomous decentralised businesses, each with a general manager. The business units are:

Fixitco

Fixitco operates over 270 do-it-yourself stores throughout Europe, and retails both branded and own brand goods. It stocks a wide range of consumer goods including paints and other DIY materials and equipment, as well as garden equipment and garden furniture. It also retails some furniture products and electrical products manufactured by other Homejay business units. Fixitco has contracts with several DIY manufacturers which manufacture ranges of products under the Fixitco brand name. It has no DIY stores in the USA. Fixitco expanded the number of stores in the early 1990s, but has not opened any new stores for the last eight years.

Woodyco

Woodyco manufactures and sells mid to lower priced domestic furniture in the USA and in Europe. It has expanded its geographic coverage mainly by acquisitions of small competitors in areas where it did not operate. Its acquisitions have included manufacturing plants as well as retail outlets.

Woodyco manufactures domestic furniture including a number of ranges of kitchen cabinets, living room furniture, bedroom furniture, home-office furniture and storage units. It has nine manufacturing plants. It has 60 retail outlets in the USA and in Europe selling its own brand furniture as well as retailing selected ranges of kitchens and some other furniture through Fixitco stores in Europe. It also sells some of its ranges of products to other furniture retailers. It has not opened any new retail outlets in the past three years.

Electryco

Electryco manufactures its own brand of domestic electrical consumer products. These include laundry products, dishwashers, ovens, hobs, some lighting products and some smaller electrical appliances including food processors, kettles and toasters. It sells 97% of its products to a wide range of retailers in the USA and to some parts of Europe. The remaining 3% of sales are made through Fixitco stores in Europe. Electryco does not have any sales outlets of its own.

Cosmetco

This business unit is a cosmetics manufacturing company, which produces branded low-price cosmetics aimed at the bottom end of this competitive market. It sells its products in the USA and in some European countries, directly to high-street retailers.

Cardco

This business unit retails greetings cards in high-street shops in two European countries. Cardco purchases its greetings cards from a large range of both small and large manufacturers of greetings cards. Cardco owns or leases over 150 outlets in key high-street positions.

Location of Homejay's business units' management

The Homejay head office is located in a large city in the USA, and includes all corporate functions, including Human Resources, Corporate Finance and Corporate Planning departments. Each of the five Homejay business units is located in a different city. Woodyco, Electryco and Cosmetco's senior management are based in different cities in the USA, and Fixitco and Cardco's senior management are based in two different European cities.

Homejay's recent financial results

During the 1970s and 1980s the company went through a period of rapid growth and high profitability was achieved, together with substantial growth in its share price. It acquired a

variety of businesses, some at large premiums. Some businesses have continued to operate in much the same way as before acquisition, and now report into one of Homejay's business units.

A summary of the turnover, operating profit and capital employed for each of the business units for the last two financial years is shown as *Appendix 1* (on page 14). This appendix also shows the latest forecast results for 2003/04.

Appendix 2 (on page 15) shows a summary profit and loss and balance sheet for Homejay for the last two financial years.

Since 1994, Homejay has experienced an overall decline in its earnings per share, although it has fluctuated within this period. Homejay's earnings per share at $0·22 in the year to February 2003 was some $0·06 per share lower than that achieved in the year to February 1994. *Appendix 3* (on page 16) shows Homejay's actual earnings per share compared to its expected earnings per share. The expected figures represent its annual planned results that had been communicated to the market.

Key personnel

Ralph Black – Chairman

Ralph Black, aged 58, is planning to retire at the end of December 2004, after more than 12 years with Homejay. He became Chairman when the company was experiencing a period of expansion. However, in recent years he has been disappointed with the lack of growth that the company has experienced. While Ralph Black has blamed the economic conditions for Homejay's disappointing performance in his last few annual reports, he also understands that the company needs to change the way it manages its business, if results are to improve significantly in the future.

Andy Mottram – Chief Executive

Andy Mottram, Chief Executive, aged 48, joined the company in 1992. He had previously worked for over 20 years with another global retailer, and had enjoyed a challenging business life, with his previous company's financial results improving far beyond inflation level each year. He joined Homejay two years before the company's earnings per share started to decline, and he has had to critically review a number of areas of the business. He has been responsible for much cost cutting, some of it rather random, and he is feared, rather than respected, by most of Homejay's managers.

Barry Milo – General Manager of Fixitco

Barry Milo has been with Fixitco for 16 years and prior to that was a regional manager for a competing chain of DIY stores. He is 45 years old and has a personal philosophy of never leaving his desk until after 8 o'clock each evening. While he works very long hours, he enjoys his work and the challenge of managing the 270 Fixitco stores across Europe.

He joined Fixitco as a regional manager responsible for all stores in two countries. When the previous general manager resigned to join another larger competitor in 1998, he was promoted to general manager as he had produced an impressive growth record in some of the stores under his control.

Joseph Logan – General Manager of Woodyco

Joseph Logan joined Woodyco over 20 years ago. He is 52 years old with a career in manufacturing and is very well liked and respected within Woodyco. He has worked in the furniture business all of his life but has no professional qualifications. He has risen to his current position through a combination of sheer hard work and being in the right place at the right time.

He joined Woodyco in the early 1980s as one of its factory mangers, worked long hours, got noticed, and was promoted to become Woodyco's manufacturing operations manager. When Woodyco's previous general manager retired in 1992, Joseph Logan was the one manager within the company who understood the business unit best, and he was appointed general manager. Joseph Logan is responsible for both manufacturing and retailing of Woodyco's

products, but has limited retailing experience. He is, however, supported by an able senior management team.

Suzie Green – General Manager of Electryco

Suzie Green is a qualified electrical engineer who had worked in Japan for a leading electrical manufacturer in her twenties and then decided to return to the USA in 1990. She joined a small manufacturer of domestic electrical appliances as operations manager but the role and the responsibilities did not live up to her expectations.

She then moved to Electryco as manufacturing operations manager in 1992, and has enjoyed a challenging role for the last 11 years. In 2001, the general manager took early retirement because of ill health, and she eagerly accepted the offered promotion to become general manager.

Jayne Reed – General Manager of Cosmetco

Jayne Reed, aged 44, has worked for several cosmetics companies and has managed Cosmetco since before Homejay acquired the company. She has initiated a number of successful changes within the business unit and has driven forward much product development by her determination to see the business unit become more profitable.

Mitch Rayfield – General Manager of Cardco

Mitch Rayfield, aged 48, joined Cardco shortly after Homejay acquired it in 1982, as a shop manager. He worked his way up within the business unit and was appointed general manager in 1998. His experience in this business area was sound and his reputation as a tough, but fair, manager was well known.

Maxine Gill – Finance Director

Maxine Gill had qualified as a management accountant in the late 1980s while working for a car manufacturer, and stayed with that company for a further five years, holding the role of Chief Accountant. She left to join the head office team of a global electrical manufacturing company as group management accountant. She enjoyed this demanding role and was responsible for initiating a number of changes in both electronic data systems and the way that divisions were monitored. She was headhunted to join Homejay as Finance Director in April 2002, when the previous Finance Director, Peter Wade, left to join a larger global retailing company.

Mark West – Corporate Marketing Director

Mark West, aged 51, joined Homejay from another global retailer two years ago and has spent much of his time learning the businesses and trying to understand the rationale behind how the marketing budgets are spent by each business unit. He has also been researching how effective alternative marketing methods may be. He has worked in sales and marketing for a number of large multinational companies over the last 30 years. Andy Mottram has challenged him to deliver substantial turnover growth over the next two-year period to February 2006, and has left him to work with the general manager of each of the business units to see how this can be achieved.

Paul Simpson – Head of Corporate Planning

Paul Simpson has been with Homejay for over 15 years and has seen the company grow in both turnover and complexity. He had always worked very well with, and was a close friend of, the previous Finance Director, Peter Wade. His department was responsible for preparing one, five and ten-year plans and worked closely with finance and planning staff within each of the business units.

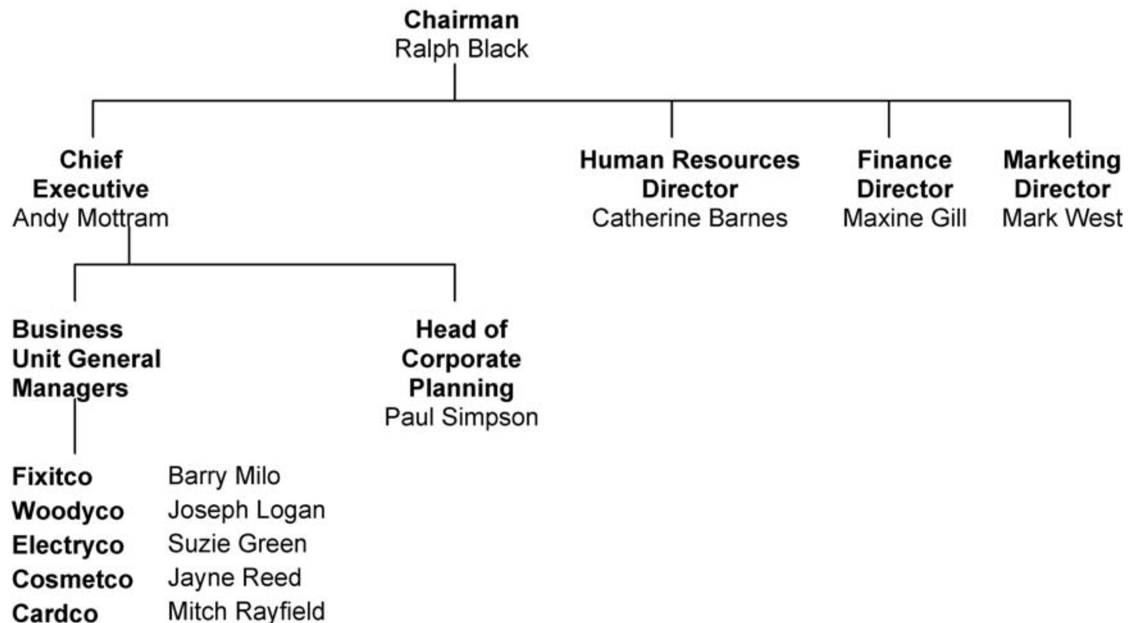
Since Maxine Gill joined Homejay in 2002, Paul Simpson's department has been under increasing pressure to produce a detailed analysis demonstrating where Homejay's results have differed from plans. Maxine Gill wanted to identify whether it was revenue shortfall or higher costs that resulted in lower net margins. Paul Simpson has also had to prepare reports justifying the basis of how future plans had been prepared. The working relationship between the corporate planning department and the Head Office finance team is not very good at present. Furthermore, there is a lack of rapport and trust between Maxine Gill and Paul

Simpson. The latter cannot understand why Maxine Gill is spending so much time analysing past plans.

Catherine Barnes – Director of Human Resources

Homejay employs over 28,000 staff in the USA and in Europe, and the company's Director of Human Resources is Catherine Barnes. She joined Homejay in 2000. She has been reviewing a number of areas of the company's HR policies and has recently started to make a number of changes. She has been responsible for encouraging staff not to work long hours and has seen the level of staff training increase for the first time in 2002, to meet the agreed corporate target for staff training days.

Homejay's current organisation chart is shown below.



There are also four non-executive directors.

TQM introduced

In 1992 Andy Mottram had introduced a total quality management (TQM) programme into all areas of the company. This was heralded with a new mission statement and a training programme that aimed to have all employees trained in the ethos of TQM by the end of 1992.

The company's mission statement in 1992 was "to be a leading manufacturer and retailer of quality consumer goods in our chosen markets, with all employees participating in achieving quality standards in every area of the business".

The TQM initiative was initially greeted by most of Homejay's managers with scepticism, but some progress has been achieved in most areas of Homejay. The company decided to focus on quality and improving efficiency. By the mid 1990s there were some improvements in all areas of Homejay's business units, but this had been mainly achieved by a disproportionate amount of cost cutting. However, it was considered by many managers that too much emphasis had been placed on achieving short-term performance targets.

All of Homejay's business units have met, or exceeded, quality standards in some areas of their business, but none of the business units has achieved all of the quality targets set.

The balanced scorecard

Ralph Black was at heart a salesman and had seen the company grow significantly, but felt that too much emphasis had always been placed by the Board on financial measures. By 1998, some five years after Homejay started to experience difficulties in increasing its earnings per

share, Ralph Black considered that the company should be looking at a more varied selection of performance measures.

Ralph Black decided to introduce the balanced scorecard concept to Homejay in 1999. The four different perspectives were measured and reported by all business units for the financial year ended February 2000. The measures that were agreed to be produced for the financial perspective included some that were already being monitored, such as growth in turnover, gross margins, net margins, return on capital employed and working capital measures. Some new financial measures were also introduced. The majority of the new performance measures that were introduced to each of the business units were in respect of the other three areas of the balanced scorecard. These are the customer perspective, the internal business process and the learning and growth process.

The general manager of each business unit is responsible for ensuring that appropriate measures for all four areas are produced. The measures are reviewed each month and are critically analysed as part of the planning cycle. The business unit general managers use the balanced scorecard measures to identify which areas of their businesses are improving and which areas need more management attention to address problems. For example, the general manager of Fixitco, Barry Milo, has identified that sales had been lost for certain product lines due to lack of stock, whereas at other times Fixitco has had to sell large amounts of stock at greatly reduced prices when seasonal lines have not produced the expected level of sales.

The customer perspective measures have also identified that Woodyco has a loyal customer base, as over 65% of customers who purchase Woodyco furniture or kitchens, have purchased goods previously from Woodyco.

Each of Homejay's business units has targets for the introduction of new products, which are currently as follows:

Business unit	*Target % of new products each year (as % of turnover)*
Fixitco	2%
Woodyco	15%
Electryco	10%
Cosmetco	20%
Cardco	10%

All of the manufacturing plants have met their safety targets. Furthermore, Homejay's initiative to invest in its staff has resulted in most business units meeting their targets for staff training.

The balanced scorecard statistical reports have confirmed that Electryco is having problems meeting customers' expectations in respect of quality. It is experiencing a higher than usual fault level on some of its products. Furthermore, it is not introducing new products, or new models, as quickly as some of its competitors. Many, but not all, of the current quality problems that Electryco is experiencing have been associated with new products. Some new products appear not to have had all of the manufacturing and design problems identified and rectified prior to launch. So while Electryco has met its innovation target, this has resulted in missed quality targets.

The Homejay business units

Fixitco

Homejay currently has over 270 DIY stores operating throughout Europe. The business unit is concentrating on improving turnover and identifying consumer trends, so that demand can be met at key times.

Barry Milo was concerned that the sales prior to Christmas 2002 could have been higher if a number of stores had been better stocked with some seasonal products. He had experienced the opposite in some stores, when they overstocked on Fixitco's own brand of paints that turned out to sell badly, despite a big marketing campaign.

Some slow-moving stock items, and even entire product ranges, have recently been rationalised as it was identified that they were not selling well and taking up too much floor space. More market research work is being undertaken to ensure that Fixitco stores maximise their sales potential.

It has been identified that the time taken by suppliers to meet orders is too long and Fixitco is working with its external suppliers to try to reduce lead times. It is also working closely with the manufacturers of its Fixitco own brand range of products to ensure that goods are manufactured in accordance with contract terms and are available to meet customers' demand.

Fixitco has been developing and improving its IT systems over the last few years and the latest phase of its management information system is specifically designed to speed up the procurement process and, in particular, to highlight fast-moving stock at an early stage. This should allow management to review its stock levels for these product lines and, where possible, ensure that stock is held at the right stores to meet demand. The new procurement and stock control system became operational in June 2003. The new system has already enabled Fixitco to meet demand for some product lines more quickly than previously achieved. However, the system appears to have prompted orders for items already in stock, causing Fixitco to carry larger than usual stock for some items. After investigation, it was found that this was partly caused by some items having more than one stock number. The reason for the rest of the extra stock has not yet been identified. Furthermore, Fixitco management has identified that the new system has created lower stock levels for some product lines, which has not helped the business to meet customer demand at peak times.

Barry Milo has identified that 25 stores need a major refit to make them more appealing to customers, especially where they are in direct competition with other local DIY chains. Some of these stores have seen declining or low growth in turnover in the last few years, and it is now becoming urgent to address the problem. It is estimated that the refit of these 25 stores will entail capital expenditure of around $45 million and reduced sales while the refits are undertaken. Sales at these stores during refurbishment could be up to 35% lower for the three months when work is being carried out. Additionally, increased marketing spend would be required to re-launch the refitted stores, estimated to be around $8 million. The re-launched stores are expected to compete more effectively with other local DIY stores.

Woodyco

Within the furniture market that it operates in, Woodyco manufactures and sells low-cost furniture in its own branded outlets in the USA and in Europe, and also supplies and retails furniture and kitchen cabinets through Fixitco stores in Europe. It also retails some product lines to other furniture retailers. Woodyco currently has 60 retail outlets.

Split of Woodyco actual sales	*2002/03*	*2001/02*
In Woodyco retail outlets	72%	69%
In Fixitco stores	18%	19%
To other retailers	10%	12%

During the 1980s and the early 1990s, Woodyco acquired over eight different furniture manufacturers or furniture retailers and by 1996 was a strong competitor in the highly fragmented furniture business. Many of the products that are manufactured in Woodyco's different factories, across several countries, complement each other, but there is some duplication of similar product lines. Woodyco operates three large manufacturing plants, as well as six smaller factories, that each produces its own brand of furniture. While the TQM approach has seen an increase in quality and improved operating methods in each of these nine furniture factories, Joseph Logan recognises that there is a need to review Woodyco's current manufacturing capacity and factory production methods.

The management capabilities in the companies that Woodyco acquired vary widely. The companies are still largely managed as they were pre-acquisition. Woodyco's business performance is subject to the vagaries of furniture design and fashion trends. In 1999, one of the Woodyco furniture manufacturing plants recruited a young design engineer, who has since

won a design award for several pieces of furniture. This has resulted in a strong growth of sales in that area of the Woodyco business, but has masked a decline in some other product lines.

Woodyco has a number of well-known brands of furniture, with high consumer awareness of some of its brand names. However, many customers, and potential customers, do not know that Woodyco owns all of the brands of furniture.

An analysis of Woodyco's actual operating profit for the last two financial years is summarised below:

	2002/03	*2001/02*
	$ million	*$ million*
Turnover	1,365	1,248
Cost of sales	737	661
Gross margin	628	587
Selling and distribution costs	405	373
Administration	63	61
Allocation of head office costs	95	90
Woodyco operating profit	**65**	**63**

Due to the competitive nature of the low-cost furniture market, Woodyco has experienced falling gross and net margins in the last few years. It has targeted a number of areas for cost reduction, but most of these have not materialised. Some efficiency improvements have been made, but more flexibility in production is required. Joseph Logan is planning to review the manufacturing capabilities of Woodyco's nine factories.

The nature of the furniture business is such that sales peak around the times of its twice-yearly reduced-price sales periods in the summer and in January. Sales targets were achieved towards the end of the last financial year by reducing prices further in its post-Christmas sales, but this had a detrimental effect on the margins achieved.

Electryco

This business unit manufactures its own brand of domestic electrical consumer products and does not trade directly with the consumer. It supplies a number of large high-street electrical retailers and department stores in both the USA and Europe. It also sells some of its appliances in Fixitco stores, but this amounted to only 3% of Electryco's turnover in 2002/03.

In recent years, despite the TQM and balanced scorecard initiatives, some appliances have suffered from an increased level of faults. The business unit management has been investigating how this happened and has identified a number of areas where quality control was lacking and also where product design has been the reason for the recurrent faults in some of its products. Electryco's management has been working hard to improve the quality of these products to retain its good brand image. This has necessitated a fundamental redesign of one entire range of products. It has also resulted in increased repair and replacement costs for faulty appliances that are under warranty.

Electryco's general manager, Suzie Green, is confident that these quality problems can be easily overcome and that they will have no long-term effect on Electryco's other products. However, the business unit has been slow in developing and launching new models in some of its ranges.

The electrical appliance market is highly competitive. It is becoming increasingly apparent that Electryco will have to review its pricing structure for those products that have not been selling as well as planned, mainly due to competitors' products being priced lower than Electryco's. Many of Electryco's products have a number of superior features and have achieved a good reputation in the marketplace, although the current fault problems may affect this image.

Electryco's marketing department is planning a major new marketing campaign to promote its products. However, market research has repeatedly confirmed that price is a key selling point, rather than the product's features. The business unit's pricing policy for its entire range of appliances is currently being reviewed.

Cosmetco

Cosmetco had undertaken a three-year product development programme following much market research, which concluded during 2001/02. During this three-year period, substantial marketing and product development costs were incurred. It has produced new ranges of products that are selling well and has established itself in this competitive market. Cosmetco achieved turnover growth of almost 16% in the last financial year to February 2003. Together with reduced product development costs, this helped to achieve a growth of $5 million in this business unit's operating profit to $21 million in 2002/03.

Jayne Reed is confident that she can continue to grow this business and has set her sales team challenging targets for the next two years. The marketing of the new product range appears to have been very successful and she feels that the business unit should continue to spend similar amounts on marketing over the next few years, to that incurred in 2002/03.

Cosmetco signed up a young actress for marketing purposes during 2000 for a four-year contract. In early 2003, the actress won an award, and this has resulted in a higher than forecast demand for Cosmetco products, mainly in the USA. However, early discussions about renewing the contract have indicated that a significant rise in the fee would be required. Furthermore, Cosmetco has experienced some problems with the actress fulfilling her contractual obligations at promotional events. Jayne Reed is confident that these problems can be overcome, and is hopeful of significantly higher sales in 2003/04.

Cardco

This business unit has seen its turnover and operating profit from the sale of greetings cards grow very slowly. The business was acquired in 1982. While it has always been a profitable business unit, it has not grown at the rate of several of its European competitors. Mitch Rayfield has welcomed all of the corporate initiatives to improve quality and customer service and his business unit has usually met all of the agreed targets.

Meetings with market analysts

When Maxine Gill joined Homejay in April 2002, it was just before the final financial results were due to be published for 2001/02. She was disappointed that the company had not warned the market that the company's earnings per share (EPS) for 2001/02 was likely to be much lower than the $0·24 expected by the market. The company achieved EPS of only $0·21 for the year to February 2002, which was its lowest level for 6 years. The business plan for the year to February 2003 indicated that EPS would increase to $0·25, and this level of EPS had been communicated to the market.

One of the first tasks that Maxine Gill undertook was to review Homejay's performance from the standpoint of its shareholders. She already knew that Homejay had not performed particularly well for its shareholders over the last few years and that its operating profit had not been as good as the directors and the business unit general managers' had planned for.

Maxine Gill arranged a series of meetings with some of the leading market analysts who were responsible for Homejay's market segments. She was rather surprised at the favourable reception she received from some of them. Apparently, the previous finance director, Peter Wade, as well as Ralph Black and Andy Mottram, had never met with any of the analysts to understand their views of Homejay.

Maxine Gill quickly established a good rapport with the key market analysts with whom she met, and learned much about the company and why the market had valued its shares down on many occasions. There were two main reasons for Homejay's low market valuation. First, some market analysts had believed that the prices paid for some of the companies that Homejay had acquired in the past were too high. The market analysts explained that they did not see any reason why some of the companies (some in the Woodyco business unit as well as Cosmetco) were worth more than their pre-acquisition values.

The market analysts had discussed with Maxine Gill that the company's performance was poor, particularly given the strong brands that it had in both Fixitco and Woodyco. Some analysts stated that they were also disappointed with the company's slow progress with building profits in other parts of the company.

One of the analysts with whom Maxine Gill met illustrated why the market lacked confidence in Homejay. The market analyst showed Maxine Gill a graph *(which is shown in Appendix 3)*, which demonstrated that Homejay's actual financial performance, as measured by earnings per share (EPS), has always been lower than the planned EPS that had been communicated to the market.

Homejay management remuneration

Homejay's company policy is to offer its managers a competitive salary and a performance-related bonus. This applied to over 7,000 of Homejay's managers around the company, from junior managers to senior managers.

The performance-related bonus for senior managers is linked to achieving each business unit's target return on capital employed (ROCE) each year. The target ROCE would be agreed before the start of the financial year, when business plans had been approved by the Homejay Board. Junior managers' performance bonuses were not related to ROCE, but instead were linked to achieving their individually set objectives, which include meeting key quality standards. Their line managers are responsible for setting objectives.

Over 85% of Homejay's managers received their performance-related bonuses in the year ended February 2003 despite the company not meeting its EPS target.

Competitor analysis

All of Homejay's business units monitor their market shares and their competitors closely. Except for Fixitco, Homejay's business units do not have any significant market share in their respective markets. Fixitco is one of eight dominant DIY chains in the countries in which it operates, with an estimated market share of about 12%. It is second to another large chain that has a market share of around 18%. There are also a large number of smaller chains of DIY stores that together account for just under 20% of the total market.

Woodyco has increased its market share over the last few years, partly as a result of winning a design award in 2000. However, its market share is still small, at less than 4%, as there are a large number of companies operating in the furniture business.

Electryco has a small market share, less than 4%, in the domestic electrical appliance market, but it has been able to command a price premium for some of its products.

2003/04 latest forecast

The original budget for Homejay for the year to February 2004 was a net profit before interest and tax of $240 million, which was a substantial increase on the previous year's actual results of $214 million. Maxine Gill and Andy Mottram had both been working closely with each business unit to ensure that they were able to deliver this planned level of operating profit. This level of budgeted profit had also been communicated to the market.

However, the half-year results showed that the planned increases in profitability were not materialising, although sales were almost as planned. The latest forecast also confirmed that Homejay was unlikely to meet its expected profits, as shown in *Appendix 1*. The latest forecast shows a forecast net profit before interest and tax of $223 million, which will represent only a 4·2% increase from 2002/03 assuming that this forecast is achieved.

Maxine Gill was very concerned that the market analysts who had started to trust her, would again be disappointed at Homejay's failure to deliver its expected level of growth and profitability. This would, no doubt, adversely affect Homejay's share price.

Introduction of new IT systems

Soon after Maxine Gill joined Homejay in April 2002, she decided to implement some new IT systems for the finance department. The first system to be implemented was a forecasting system. The previous system was cumbersome and did not allow business units to access and manipulate actual data from the company's other systems. The new financial and business

forecasting system was now linked into Homejay's other management information systems, thereby allowing staff to access what had happened, using actual data from the company's nominal ledger, and to prepare more realistic forecasts for the rest of the financial year.

Each business unit produces updated detailed forecasts for the rest of the current financial year, every quarter. The new forecasting system enabled each business unit to input new data for their rest-of-year forecast, which would then be added to the actual data for the financial year to date. The system has facilitated both local and head office management to view and interrogate the latest full-year forecast.

The system became operational at the start of the current financial year, in March 2003, and, despite a few teething problems and the need for staff training, the system has worked well. However, what Maxine Gill has found is that business units have continued to prepare over-optimistic forecasts. It appears that the integrity of the forecast for the rest of the financial year is too heavily dependent on unrealistic sales targets and achievement of margins. Margins have always been lower towards the end of the financial year (February), due to two main factors. These are the reduced prices in its January sales and the clearance of old and slow-moving stock at low margins.

Maxine Gill is hoping that cost control within the business units will improve as the next phase of the finance IT system is implemented. The next phase of the new finance system aims to deliver detailed data on costs across all product lines for each business unit, allowing management to monitor product profitability and control costs more effectively.

2004/05 business plans

Homejay's business planning cycle started in May 2003 with the Homejay Board agreeing the strategic goals and outline plans, which were cascaded down to each business unit for it to use in its plans. Ralph Black continued to issue a directive for strong growth in turnover, but he also wanted to see how each business unit could achieve a much higher level of profitability than they currently appeared to be able to deliver. He also wanted the business units to put together realistic and achievable plans given the problems the company was experiencing with over-optimistic plans in the current financial year.

The business units have prepared the first iteration of their business plans, and have submitted them to Paul Simpson's Head Office planning department. These plans comprise a detailed one-year plan and outline plans for a further three years, covering profitability, capital expenditure and working capital requirements for each business unit, together with a commentary that outlines major changes in business operations.

Paul Simpson was concerned that the plans that had been submitted by each of the business units for 2004/05 showed an overall increase in profitability of 19% from the latest forecast for the current financial year, with only a 17% increase in sales. He felt that every year plans were made that appeared to be over-ambitious. He was aware that each business unit's general manager had failed to deliver what he/she had planned in the past. A consolidated plan for Homejay was in the process of being prepared by Paul Simpson's department for consideration at the planning review meeting in early November 2003.

The general managers of Fixitco and Woodyco had defended their forecasts to Paul Simpson by stating that profitability in the past had fallen short of the original plans for a variety of reasons. These included external events beyond their control, including the poor economic conditions. In the Woodyco business, Joseph Logan stated that achieving margins was heavily dependent on selling products at their recommended prices, which in the past have had to be reduced significantly on several occasions to remain competitive and in order to sell slow-moving stock. Additionally, there had been several product lines that had experienced cost over-runs and higher than anticipated rectification costs of furniture items after they had been delivered and fitted in customers' homes. Both general managers considered that their plans for 2004/05 were realistic and achievable, although much, as always, was dependent on their competitors and the general trading conditions.

Andy Mottram has been critically reviewing the level of corporate Head Office costs, which are planned for 2004/05 at around $330 million. The Head Office costs are apportioned and

charged to each business unit in accordance with a number of criteria. Andy Mottram considers that the businesses are not generating sufficient profit to sustain the Head Office corporate functions at this level of costs, and is keen to make changes. He is considering decentralising some of the Head Office functions directly into each business unit, for each business unit general manager to control directly.

In order to improve the company's profitability, Andy Mottram is keen to acquire other companies. He has commenced early discussions with several suitable companies.

Mark West has proposed a major corporate marketing campaign and the cost implications were submitted to the corporate planning department for inclusion in the consolidated plans for Homejay. This proposed corporate marketing plan would be *in addition* to the marketing expenditure that is included in each of the business unit's plans for 2004/05. Mark West considered that Homejay should promote its corporate brand and this would have a direct favourable result on the volumes sold by all business units. The proposed marketing campaign was due to be discussed at the next planning review meeting in November 2003.

The forecast incremental effect on the turnover for 2004/05 for each business unit was anticipated to be increases of between 4% and 20%, as shown in the table below. The forecast incremental effect of the proposed corporate marketing campaign on each business unit's gross margin (defined as turnover less all direct variable costs) for 2004/05 has been evaluated. This is also shown in the table below.

	Forecast incremental effect of the proposed corporate marketing campaign on turnover for 2004/05	*Forecast incremental effect of the proposed corporate marketing campaign on gross margins for 2004/05*
	%	*$ million*
Fixitco	+6	+39 to 42
Woodyco	+4	+26 to 28
Electryco	+5	+7 to 8
Cosmetco	+20	+26 to 29
Cardco	+5	+2 to 3
Total Homejay		**+100 to 110**

Mark West is firming up on the cost of the corporate marketing campaign, which would include the use of various media, but it is expected that the increase over the existing corporate marketing budget would be over $80 million.

Appendices 1, 2 and 3 follow

Appendix 1

Note: All data in the Appendices are presented in UK format.

Homejay – Business analysis

(All figures for financial years to the end of February)

		Latest forecast 2003/04 $ million	*Actual 2002/03 $ million*	*Actual 2001/02 $ million*
Fixitco	Turnover	1,850	1,720	1,650
	NPBI&T	85	78	77
	Capital employed	1,170	1,135	1,110
Woodyco	Turnover	1,500	1,365	1,248
	NPBI&T	70	65	63
	Capital employed	601	594	557
Electryco	Turnover	680	750	713
	NPBI&T	30	41	40
	Capital employed	350	340	330
Cosmetco	Turnover	340	320	276
	NPBI&T	28	21	16
	Capital employed	120	119	105
Cardco	Turnover	140	135	131
	NPBI&T	10	9	8
	Capital employed	90	88	82
Total Homejay	Turnover	4,510	4,290	4,018
	NPBI&T	223	214	204
	Capital employed	2,331	2,276	2,184

Note 1: NPBI&T represents net profit before interest and tax.

Note 2: Net profit before interest and tax for each business unit includes an allocation of head office costs.

Note 3: The capital employed figures include head office net assets which have been apportioned to each business unit.

Appendix 2

Homejay – Summary balance sheet

	Actual End February 2003	*Actual End February 2002*
	$ million	*$ million*
Tangible assets (net of depreciation)	**2,075·0**	**2,056·0**
Current assets:		
Stock	411·0	407·0
Debtors	435·0	363·0
Cash and short-term investments	81·0	48·0
Total current assets	**927·0**	**818·0**
Creditors:		
Amounts due within one year	726·0	690·0
Net current assets	**201·0**	**128·0**
Creditors falling due after one year:		
Loans	820·0	780·0
Net assets	**1,456·0**	**1,404·0**
Financed by:		
Called-up share capital	240·0	240·0
Share premium reserve	200·0	200·0
Profit and loss reserve	1,016·0	964·0
Total equity shareholders' funds	**1,456·0**	**1,404·0**

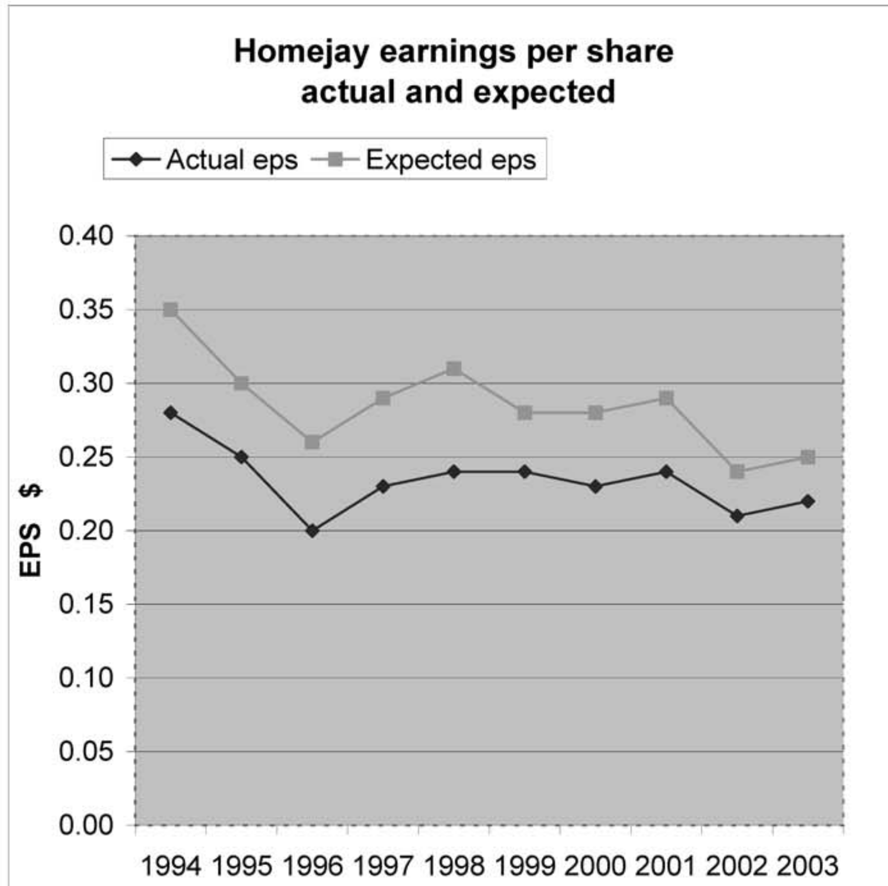
Note: Called-up share capital represents 480 million shares at $0·50 each.

Homejay – Summary profit and loss account

	Actual 2002/03	*Actual 2001/02*
	$ million	*$ million*
Turnover	4,290·0	4,018·0
Total operating costs	4,076·0	3,814·0
Net profit before interest and tax	214·0	204·0
Loan interest (net)	(64·0)	(62·0)
Tax (at 30%)	(45·0)	(42·6)
Net profit	**105·0**	**99·4**
Dividends	53·0	50·0
Amount transferred to reserves	**52·0**	**49·4**

Appendix 3

Homejay's actual and expected earnings per share since 1994



Data for earnings per share	*Actual* *$ per share*	*Expected* *$ per share*
Financial year ended February		
1994	0·28	0·35
1995	0·25	0·30
1996	0·20	0·26
1997	0·23	0·29
1998	0·24	0·31
1999	0·24	0·28
2000	0·23	0·28
2001	0·24	0·29
2002	0·21	0·24
2003	0·22	0·25

End of the pre-seen material

7.3 Analysis of Homejay pre-seen material

Use the techniques in Chapters 3 and 4 to help you unlock this pre-seen material for yourself.

Technique	√
The four elements of strategy (competitive, financial, investment and risk)	
Using ratios to conduct a financial analysis of a company's position	
Assessing a business portfolio	
Industry analysis	
Position audit	
Preparation of Homejay's Strengths, Weaknesses, Opportunities and Threats (SWOT)	
Conducting a managerial and organisational audit	
Critical success factors	
Assessing information systems strategy	
Assessing corporate risk	
Assessing the cost of capital	
Conducting a corporate appraisal	
Business valuations	
Generating strategic options	
Sources of capital	
Evaluating strategic options	

The analysis that follows will help you to check you are on the right lines.

Homejay's position

A key piece of the pre-seen material appears where we are told that Maxine Gill (FD of Homejay) has met with market analysts and has come away with the message that Homejay Incorporated is in danger of losing the trust of key investors. Two reasons are given:

- it has a 10-year history of failing to deliver both either earnings growth and its forecast earnings per share;
- it has lost its way strategically. On the one hand, it has been unable to build on the value of its core brands and businesses, whilst on the other it has not managed to integrated and rationalise acquired firms in a way that delivers shareholder value.

The rest of the pre-seen material confirms the analysts' assessment. It also warns that Maxine Gill's honeymoon period with the analysts is about to come to an end. She won their trust following her appointment in 2002 and will have been exonerated for the poor results of 2001/2 and 2002/3 on the grounds that these were the outcomes of plans put into place before she came into office. She will also have promised great things from the new forecasting systems she has put in place. However, at the mid year point (Homejay has a February year-end) the forecast for 2003/4 already shows that it will miss its published EPS target by more than 7%.

Maxine's dilemma is one of how to tell investors the bad news without losing their trust and, consequently their support for Homejay's share price. The dilemma for the Board is how to come up with a business strategy that can deliver earnings growth and shareholder gains in a way it has not hitherto managed during the reign of its present Chairman, Ralph Black, and CEO, Andy Mottram.

From the perspective of a potential acquirer (or perhaps the disgruntled General Manager of a business unit) Homejay is a candidate for demerger. It is a diverse conglomerate with a corporate centre that does not seem to add value.

The 2003/4 Business Plan

An obvious thing to notice about this case is the significance of the date of the final examination for which this pre-seen was issued. It seems to follow a planning review meeting at Homejay scheduled for 'early November 2003'. We are told that two sets of plans will be considered at this meeting:

- a consolidated group plan for 2004/5 forecasting financial performance for the coming year with indicative plans for a further 3 years;
- a major corporate marketing campaign costing over $80m, equivalent to an astounding 36% of the forecast total group profit for 2003/4.

You may speculate that the unseen and requirement may ask you to prepare a review of one or both of these plans, perhaps on behalf of Maxine Gill.

There is not much numerical preparation you can do in advance to evaluate the consolidated group plan because you do not yet have the forecasts from March 2004 to February 2005. However, you could get ready to express a view on the reliability of such forecasts (including the 2003/4 forecast) by looking at the information in the pre-seen material on past forecast errors and the methods used to assemble Homejay's forecasts.

You can practice your analysis of the numbers for the corporate marketing plan by applying the incremental effects described to the 2003/4 divisional forecasts. Assess whether it would recover the $80m investment and, if not, what sorts of forecasts would be necessary to justify such an investment. Perhaps you could conduct a sensitivity analysis on the projections.

The planning cycle for 2004/5 began 4 months ago and business unit managers have already submitted to Paul Simpson, Head of Corporate Planning, detailed forecasts for 2004/5 and indicative plans to 2008. These will be consolidated by early November for Board approval.

We do not know much about the content of these submissions although we are told that the GM of Fixitco, Barry Milo, must decide whether to spend $45m on upgrading 25 stores and suffer revenue losses during the period of the works without, apparently, any prospect of the investments improving revenues once the refit is complete.

What effect would this upgrade have had on Fixitco's ROCE if it had been undertaken in 2003/4? Barry Milo receives a bonus for attaining an agreed ROCE figure. Do you think he is likely to undertake this investment if it jeopardises his ability to reach his target?

We are also told that Cosmetco needs to agree a fee to extend its endorsement contract with an actress. You may be asked to express an opinion on a proposed fee.

However, the most important thing about the Corporate Plan, or any assessment of the strategies of Homejay, must be whether it deals with the issues raised by the analysts and the underlying problems of Homejay. Demonstrating that you could get to grip with these would be the source of the marks in the exam.

The underlying problems of Homejay

The underlying problems of Homejay include;

1. It lacks a coherent business portfolio. A combination of acquisitions and organic growth has turned the firm into a puzzling conglomerate which has gained critical mass in only one of its markets.
2. Its management seem unable or unwilling to innovate or develop its businesses.

3. It has a performance management system which contradicts its desire to innovate and grow.
4. Its unreliable strategic and financial planning systems have resulted in misleading forecasts. These have caused inappropriate stocking and have contributed to disappointing EPS figures.

The corporate portfolio

Homejay is a diversified corporation. This means that it has interests in several industries: DIY retailing, furniture manufacturing and retailing, electrical durable manufacturing, cosmetics and greetings cards retailing. It is possible to see that some are related diversifications, for example, furniture manufacturing and retailing through Woodyco and Fixitco. However, Cardco and Cosmetco are unrelated diversifications.

A key question that should be asked of the board of a diversified firm is 'what value does your corporate centre add?' This is sometimes called 'corporate parenting'. The job of the corporate centre of Homejay is to mould the business units to extract shareholder value. You should consider whether the board of Homejay is actually doing this. For example, do you feel that merely by requiring business plans and budgets from divisions and introducing initiatives such as TQM and Balanced Scorecards the board has done enough?

Homejay, as its name suggests, is primarily a retailer of DIY products and furniture to households. Fixitco accounts for 41% of group turnover and 38% of profits whilst Woodyco provides respectively 33% and 31%. Of the latter's turnover 90% is accounted for by sales from its own stores and through Fixitco. The remaining parts of the business together provide only about 26% of total group turnover. Cosmetco and Cardco are unconnected with Homejay's main businesses whilst Electryco gets only 3% of its revenues from sales within the group.

Fixitco is the only division with a significant market share in its industry. It is ranked number 2 with a 12% share against the 18% of its larger rival. Its sales grew 4.2% between the last 2 years and are forecast to grow by 7.6% this year. Following the rationale of the BCG matrix a division should receive investment only if it has a dominant market position in a growing market, or that such investment will enable it to achieve dominant share. Twenty percent of its market is in the hands of small players leaving the remaining 50% spread amongst 5 or more medium sized players. Acquiring another store with 6%+ of the market could leapfrog Fixitco into first position.

Despite the efforts of its workaholic manager Fixitco presently has a disappointing ROCE that struggles to achieve 7% compared to an overall group ROCE of above 9%. This said some central costs and assets have been allocated out to divisions and we cannot tell how much has come to Fixitco. Neither do we have the ROCE of rival DIY chains to compare it with. However it would be difficult to argue that Fixitco should receive additional funds for its growth at the moment whilst it continues to return the lowest rate of return in the group. There are problems to be addressed including:

- poor rate of innovation (only 2% of revenues are set to come from new products);
- a failure to maintain appropriate stocks;
- excessive space taken up with low value inventory. The pre-seen implies that Fixitco may not fully understand the profitability of its product lines.

Woodyco consists of nine production plants and 60 retail outlets in USA and Europe. It makes and sells furniture under a variety of brands, many of them bought in by acquisition.

Historically acquisition-led growth has been a feature of Woodyco's development although there have been no acquisitions for 3 years. Despite this Woodyco grew its turnover by 9.4% last year and forecasts nearly 10% growth this year: twice the rate of Fixitco. To some extent this may be attributable to its higher forecast earnings from new products (15%, the second highest in the group). It also has the second highest ROCE in the group (11.7%).

We are told that the furniture market is fragmented. This means that Woodyco's lack of a significant share (4%) need not be a drawback providing it has good brands. The case material tells us that it has several good brands and loyal customers despite being in the mid to low end of the furniture market.

However, the pre-seen suggests that Homejay's board are not following through the rationale of an acquisition. When Homejay buys another company it must compensate the present owners by paying them at least the present value of the future earnings of the business. Providing Homejay then takes steps to improve the earnings of the acquired firm it can make a good return on its investment. This is termed synergy.

The criticism levelled by the analysts has been that Homejay tends to leave the acquired firms running in the same way as they did before acquisition. Forecast earnings are not improved and so an acquisition merely changes the composition of Homejay's balance sheet: exchanging cash for future earnings (or raising debt to buy an asset of equivalent value). Of course, there will be acquisition fees to be paid to corporate finance and legal advisors and perhaps an initial fall in the target's earnings due to staff losses and uncertainty so the net effect is more likely to be a reduction in the wealth of Homejay's shareholders.

The analysts' criticisms cannot fairly be applied to Cosmetco, an acquired division, which has shown strong growth in sales and profits (16%/31.3%) and has increased its ROCE from 15% to 23% following its 3-year product development programme. Cosmetco should serve as a beacon to Homejay's management signalling the value of innovation.

Woodyco is growing too (9.9%/7.7%) but ROCE is only 11%. Furniture manufacturing will have low margins. Furniture retail is likely to be a more profitable part of the value system although it will need to compete with large players like Ikea. Woodyco has 9 plants, of which 3 are large and 6 small. It is not clear where these plants are located. It has lots of brands of which a few are respected. It also owns 60 shops of which some are in Europe and perhaps selling the same furniture are Fixitco (the latter buys 18% of Woodyco's output). We cannot separate the profitability of the two parts of Woodyco. Rationalisation and integration to increase value could involve:

- rationalising production into the three large factories to save cost, release assets and improve quality assurance;
- focus on the key brands in the portfolio that can provide margin (This will economise on marketing expenditure.);
- try to utilise Fixitco's retail power (270 stores in Europe) by exclusive supply arrangements or store-in-store agreements;
- co-ordinate the supply chain between Fixitco and Woodyco better to eliminate the inventories of both;
- increase sell-through of group products such as appliances;
- share logistics networks if supply chains coincide;
- consider buying-in more furniture and perhaps disposing of Woodyco if manufacturing is pulling down its profitability.

Electryco is the third division of Homejay in order of size, yet less than half the size of Woodyco. Its sells only a small part (3%) of its output of electrical appliances through the group. The majority is sold via other US retailers. Financially its results are disappointing. Its forecast ROCE of 8.6% is below group ROCE (9.6%) and its sales and profit growth have been historically sluggish (5.2%/2.5%) with both forecast to be negative in the present year.

Despite having a premium market positioning for its products the stated problems at Electryco are a lack of sustainable innovation. New ideas have led to faulty products and consequent rising repair costs. This suggests that the TQM initiative started by the CEO, Andy Mottram, in 1992 has not really permeated Electryco. Perhaps this is because Mottram undermined the TQM initiative by insisting on 'disproportionate' cost reductions and achievement of short term profit targets at the same time. TQM may reduce the costs of poor quality over time but initially it would have cost divisional General Managers more than it would have yielded. In addition, Electryco is competing from a high cost manufacturing location in a market characterised by low cost imports.

The board may be tempted to integrate Electryco better within portfolio by increasing its sales within the group. However, it would be foolish to drag down the performance of its retail divisions by yoking them to an inefficient and low quality supplier. You might take the view that giving greater autonomy to Electryco to force it to compete better and, later perhaps, demerge it would be a better option.

The remaining divisions seem absurd within the portfolio of Homejay. They are small in relation to group turnover (Cosmetco 7.5%, Cardco 3.1%) and it's hard to see any synergies in either operations or sales with the rest of the group. Cardco is presumably valuable for its store portfolio, although being in high streets these are unlikely to be valuable for furniture and DIY and would need to be liquidated. Cosmetco has shown impressive returns and growth and would presumably be easy to sell-off once the future of its brand is better assured by signing the endorsement contract extension with the actress.

Unless these two units can be bundled together, perhaps with Cardco repositioning itself towards the gift or accessories market and also stocking Cosmetco products, it might be worth the board considering selling them off separately either to their management or to interested firms. This would enable Homejay to focus its attention and financial resources on its core homecare businesses.

Certainly the proposal by Mark West, Corporate Marketing Director, to spend $80m on creating a corporate brand seems misplaced. There may be value in linking related businesses together under common brands providing this does not cheapen one range by association with a budget range. However its difficult to see what sort of brand values could be applied across a product range from cosmetics to cookers and from greetings cards to gravel. We should notice also that Woodyco has a lower market positioning than Electryco and that Woodyco already has several separate brands.

The situation of Homejay overall is reminiscent of that of Kingfisher Group plc. In 2000 the latter owned DIY businesses (e.g. in UK B&Q & Screwfix Direct, in France Castorama), electrical retail (e.g. in UK Comet & Norweb, in France Darty, in Holland BCC), cosmetics (e.g. in UK retailer Superdrug) in addition to its original business, the high street retailer Woolworth's. Since that date, and to some extent following investor criticism, it has demerged and sold-off many of its lines of business (most recently bundling its

furniture and electricals business into Kesa plc) and today presents itself as 'an integrated international dedicated home improvement business'.

Management at Homejay

Both the Chairman and the CEO have been in position for more than 10 years. During this time the EPS of Homejay has declined at least 28%. Both have sales and retail backgrounds. This seems to have led, in the case of Ralph Black, to a focus on growth in sales turnover whilst Andy Mottram seems to be concerned with cost reduction. They are both autocratic. Mottram drove forward the TQM initiative in 1992 whilst Black imposed a balanced scorecard in 1999. Neither initiative seems to have worked. They have encouraged a tradition of promotion from within the firm for the core businesses with the GMs of both Fixitco and Woodyco having been with the business for over 20 years. The Head of Corporate Planning has likewise served 15 years with the firm yet has not attained a board position.

An autocratic senior management team will amass power and responsibility to itself leaving divisional managers to wait on its directives and instructions. The comment that Chairman Ralph Black is 'disappointed with the lack of growth' is telling. As Chairman making the firm grow is surely a part of his responsibilities? Doing this takes more than the handing down of ambitious sales growth targets and making requests for balanced scorecard targets.

This brings us back to corporate parenting. The academics Goold and Campbell researched this and identified three different styles of strategic management exerted by the boards of diversified firms:

- The Strategic Planning style features top down planning of business units by the board with resources allocated in the interests of securing competitive advantage in key areas.
- Boards adopting the Financial Control style allocated funds tightly to divisions, requiring achievement of key financial performance targets (e.g. ROI/ROCE). It left the strategy of the business units to divisional management and instead busied itself with acquisitions and disposals.
- They named the third style, a halfway-house between the other two, Strategic Control. Here the corporate board were actively husbanding a strategy for the group as a whole whilst leaving considerable operating autonomy to divisions. It did this by setting a wider range of financial and non-financial targets to steer managers, but left the managers to find ways to reach them. Today Balanced Scorecards are an indicator of this third style.

Which style does Homejay exhibit? We can see that on the whole, and despite the facade of strategic planning systems and also balanced scorecards, it seems to be essentially a Financial Control style.

Which style should they adopt? Goold and Campbell argue that this depends on two considerations:

- The nature of the business: For example, whether the portfolio is related or unrelated; the stability of the competitive environment; the size and payback of investment.
- The resources in the organisation: For example, its financial condition; the personality of the CEO; the skills of senior and divisional management; the organisational culture.

The pre-seen contains plenty of information on some of these. In researching the industry to gain business awareness you should uncover the reminder. Consider what we know:

- We can agree that the prevailing culture within Homejay seems to be what Miles and Snow term a 'defender' culture, doing business the way it always has and with a resistance to new ideas.
- The Chairman, who has been asleep at the wheel for 12 years, is set to retire in 2004.
- In the manufacturing divisions they have appointed people with operational backgrounds whilst the GM of Fixitco has spent 16 years with the firm. It is significant that only Jayne Reed comes from outside the culture of the firm and it is she that has the best record in innovative investment and growing her cosmetics business. However, Joseph Logan is building a good business too despite limited commercial experience because he has a good team behind him.
- The planning system is almost guaranteed to exclude radical strategic initiatives being short-termist and predominantly financial.
- The largest part of the portfolio is potentially related, and the smaller part is unrelated.
- Andy Mottram's has suggested that divisions should have more autonomy. This would increase the dominance of the financial control style further as well as exposing the corporate centre further as a useless, value-destroying overhead.

The corporate centre needs to get a grip on the strategic future and shape of Homejay. Financial Control style would only be suitable for divisions they intended to de-merge. The board lack the skills to make a success of Strategic Planning and, in any case, the market is too competitive to risk the loss of flexibility this might cause. The solution seems to be some form of Strategic Control style, providing divisional managers are up to the job, and providing the board can first decide what strategic direction they want the group to head in.

But this would need broader performance measures.

Performance measures

Homejay focuses too much on short-term performance measures such as EPS and ROCE to the detriment of building its long-term business. This is because it has allowed itself to become boxed in by its poor relationship with investors. It must break out of this if it is to grow.

EPS is not an end in itself for any investor. Investors want the value of their shares to rise and/or to receive dividend. EPS and its growth rate is really only a flawed proxy measure for this. If a company raises its EPS from one year to the next then the market price of its shares will rise. This adjustment restores the firm's share to its historic P/E ratio. The P/E ratio itself is a reflection of the confidence the investors have that the earnings of the firm will increase through time. This is in part determined by its historic ability to grow its earnings. It also reflects the outlook for the industry and the faith investors have in the firm's strategic vision.

Homejay is unimpressive. Its EPS has fallen every year despite the fact that it retains nearly half of its profits each year and has increased its gearing. Put simply, since 1994 Homejay has been making lower profits on an increased capital base. To some extent the fact that it misses its forecasts is irrelevant. Its earnings are falling whilst its capital base is increasing so therefore it is destroying shareholder value. This is condemnation enough of its record. However by consistently failing to deliver on its forecasts over a period of at least

10 years it conveys the impression that it has lost control of its financial affairs. That it is set to do so again this year may crush investors hopes that Maxine Gill will turn things around.

By permitting its shareholders to become fixated by its EPS figure Homejay has boxed itself in. Investing for future shareholder value requires that the firm invest in projects with a positive NPV. However, such long-term projects will not repay the expenditures associated with them in the first year. Earnings can be shielded if we treat the investments as assets and not expenses by capitalising them. But it may not be enough. The firm will still incur costs that cannot be capitalised (the pre-seen mentions examples such as training and promotion) and these will reduce profits. As it stands, Homejay does not have sufficient earnings growth from its portfolio to enable it to invest for the future without harming its EPS.

Homejay compounds this problem by using ROCE as a managerial performance measure. Even if the board were prepared to weather the storm of a falling EPS in order to build for the future, the divisional managers still would not undertake the investment, regardless of its NPV, if it would jeopardise their bonuses. Any divisional investment without immediate returns would hike-up their capital employed whilst at the same time potentially reducing their profits. The issue of store refitting at Fixitco alerts us to this problem.

There are other interesting anomalies in the case around its managerial performance measures.

We are told that 85% of its managers receive ROCE linked bonuses despite the group not meeting EPS targets. Given that EPS is falling they are seemingly rewarding themselves for failure. There could be several explanations:

- The ROCE targets are not ambitious enough. If ROCE targets are to promote EPS growth then they should rise each year. Homejay pays out even if EPS falls!
- There is a mismatch between ROCE and EPS. Divisional profit is calculated before deduction of interest and tax, whereas EPS uses the earnings after interest and tax. This does not incentivise divisional managers to control interest and tax. Something of this effect can be seen in Appendix 1 where we can see Homejay's overall ROCE rising from 9.3% to a forecast 9.6% yet elsewhere we find that EPS has fallen over the period. Homejay pays tax at 30%, which may suggest poor tax planning, and its interest payments and loans are rising at a similar rate to profits.

An added problem to Homejay's use of ROCE is the fact that managers may not be fully in control of their balance sheets or profits. We have already discussed the problem of distortions created by allocation of corporate costs and assets to divisions. Another problem will be transfer prices between divisions.

Woodyco sells 72% of items from its manufacturing divisions through its own shops and a further 18% through Fixitco's stores. The transfer price of these items within a division (from factory to Woodyco's stores) and between divisions (from Woodyco and Electryco to Fixitco) will affect:

- the prices that retail charge for the product and hence their competitiveness in the market;
- their willingness to use the in-house supplier instead of buying on the market;
- the profits of the divisions involved;
- the stock values on the balance sheets of the divisions according to who owns the stock, where it is held and how much it costs.

You should ensure that you are aware of the practical problems that confront firms like Homejay in arriving at appropriate and acceptable transfer prices.

We are also told that the firm has adopted a balanced scorecard approach to performance management. However, the targets handed down by senior management are sales growth and margin targets. This leads to plans that are focused principally on short-term financial variables.

Only senior managers have bonuses based on ROCE. Others have bonuses based on personal targets, presumably sales and non-financial targets. This raises two concerns:

- are the targets of staff below senior level congruent with ROCE and the financial results the company seeks?;
- why do not senior managers have their bonuses based on a balanced scorecard of measures rather than just on a simple headline figure like ROCE?

Finally the two sets of financial targets set down by Ralph Black at the commencement of planning, as well as being short term, may not be congruent with the goals of achieving EPS growth. Increasing sales turnover may not increase profits if sales are achieved by cutting margins. Black also exhorts divisions to improve profitability but it is not clear if this is firmly laid down as targets nor whether he means profitability to mean 'gross margin' or ROCE. If he means margin he is ignoring the need to make a return to the firm's capital base and hence will harm group ROCE and EPS.

However, plans (and resulting KPIs) are only valuable if they are well formulated. This brings us to our third and final underlying problem.

Business planning at Homejay

The planning approach managed by Paul Simpson seems to relate more to financial forecasting than to strategic management. This needs to change.

The style of management at Homejay is what Hopwood describes as 'budget constrained'. Despite the interest expressed in TQM and balanced scorecards the fact remains that financial targets remain paramount. This affects the business planning process too.

The planning process starts in May with the Chairman setting some ambitious sales growth targets for divisions together with some other strategic goals. These are handed down to divisions and are the basis for the annual budgets and plans for each division to submit by September. The targets in these plans will also be used as the basis for the ROCE targets of the managers.

We might assume that the managers will submit conservative estimates in order to assure their bonus. In fact the budget bias seems to be towards optimistic targets. These are compounded up into the EPS projections that are subsequently missed by Homejay. There are several possible explanations for this:

- the divisional managers are using high forecasts to justify the case for additional resources to help them achieve targets;
- the managers lack the information, notably competitor and environmental information, to make better forecasts;
- in a sales-driven environment managers seek to look macho by submitting high forecasts.

Regardless of the reasons, once these forecasts form the basis of agreed business plans they lead to biased budgets. This causes divisions to take on more stock and make more output

than they can sell. This leads to overstocking and triggers the deep discounting of prices to shift stocks before year end that are detailed in the case.

This leads to the loss of integrity in the forecast and a failure to reach forecast EPS. Solutions that might be proposed include:

- improve the business forecasts by including forecasts from external models. Given that the majority of Homejay's business depends on household purchasing of durables and furnishing this should be possible;
- if forecasts are unreliable adopt a system of rolling (or continuous) budgeting to ensure that forecast errors are detected and future budgets corrected;
- pay closer attention to the reasons for forecast error in past plans and correct for these in future plans. Perhaps Maxine's interrogation of Paul shows she is already doing this.

Summary

The pre-seen material for Homejay has many themes and consequently many potential outcomes. Aspects we have discussed include:

- its portfolio of businesses;
- its performance measurement systems;
- its management style;
- its approach to budgeting and forecasting.

Throughout our discussion we have assumed that the board needs to develop a medium term strategy to restore earnings growth and extract value from the portfolio of businesses it has built and acquired. This seems to be what the investors require. One potential requirement on the day is to evaluate the consolidated business plan in terms of its ability to deliver this.

Some alternatives to consider include:

- approach by an external firm to purchase a division of Homejay;
- convince shareholders not to accept a hostile bid from outside by putting up a strategy to de-merge or sell under-performing units and improve performance of remaining ones;
- advising a bidder on a potential strategy to win Homejay by drawing attention to its problems and also suggesting actions to be taken to turn it around once acquired;
- evaluation of an acquisition suggested by Mottram in the light of the strategic position of Homejay;
- adoption of e-commerce strategy (we are told that West is researching effective alternative marketing methods) or implementation of an ERP system.

7.4 Dealing with the requirement and the unseen material

One of the abiding myths of CIMA exam techniques is the tyranny of the clock and the rule of 1.8 minute a mark as a guide to time allocation (i.e. 180-minutes exam and 100 marks available). This makes candidates think that if they are not writing they are not earning marks.

The 1.8 minute rule is probably unreliable for any exam in the CIMA syllabus. It certainly is NOT suitable for TOPCIMA. You need to allow time for:

- reading the unseen material (including updates to data given previously in the pre-seen material, such as latest share prices);
- reading and fully understanding the requirement set;
- analysing the extra information you have been given and assimilating it into your analysis of the pre-seen material (which you cannot take into the exam room so you must be able to recreate it);
- planning your answer.

Effective from May 2005 CIMA has changed the total time allowed for the TOPCIMA exam. In addition to the usual three hour exam time CIMA is now allowing candidates to have an additional 20 minutes of reading time to read and absorb the material given in the unseen material and the requirement.

The wording on your TOPCIMA exam booklet from May 2005 will show the following:

> *You are allowed 20 minutes reading time* ***before the examination begins*** *during which you should read the question paper and, if you wish, make annotations on the question paper. However, you will* ***not*** *be allowed,* ***under any circumstances****, to open the answer book and start writing, add any loose sheets/supplements to the answer book or use your calculator.*

Therefore some more of the precious 180 minutes can be spent in planning and writing your answer.

Use the following as a guide to allocating your time:

Reading, analysis and initial answer planning, including any necessary calculation (The calculation could take up to 15–30 minutes)	40–60 minutes
Writing final answer	110–130 minutes
Reading over final answer and checking format and tidying spellings, grammar and presentation	10 minutes

You will notice that we are recommending that you spend a third of the available exam room time preparing and planning, without writing your answer. Candidates who answer from the top of their heads before they figure out what they want to say rarely satisfy the criteria for high marks on the assessment matrix.

7.4.1 Reading the requirement

The requirement will appear at the front of the booklet of unseen material and will be clearly distinguishable from the rest.

Make an immediate note of the following elements on your rough working papers:

- *Your role or position*. For example, whether you work for the firm or an outside interest and your organisational position.
- *Format of response(s) required*. This is likely to be a report but could also involve a letter, presentation or memo.

- *Who it is addressed to*. This should influence the tone and content of what you write (e.g. your line manager, the board, a regulatory body).
- *What you are reporting upon*. There may be more than one thing required, for example a report that contains both a strategic analysis and an evaluation of a business plan.

When you read the requirement you may find it conforms to something you anticipated. This should give you confidence although you need to ensure that you do not write down the answer you prepared in advance because this may ignore some of the new information in the unseen material.

Alternatively the requirement may be quite unexpected or different to what you had anticipated. What matters in the next 180 minutes in the exam room, is that your report attempts the answer the requirement that has been set. Do NOT try to incorporate data that you had pre-prepared if it is not relevant.

Remember, however well your report is presented and whatever technical knowledge is displayed, if your report does not identify the key issues and address the actual requirement that has been set it will not earn high marks. If it helps you to remember the requirement, which is usually quite brief, then rewrite it out within your planning notes before you attempt to start to write your answer.

Here is the requirement for Homejay Incorporated:

> *You are the independent management consultant appointed by the new Chairman, Ken Kato.*
>
> *Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.*

We can see several things in this requirement:

We are an independent management consultant	• This means we have to be objective and professional. It also means we must consider a broader range of issues than just management accounting ones
We are writing to the Chairman	• This means we do not need to worry about criticising members of the Board of Homejay
The Chairman, Ken Kato, is a new name in the case	• This means we can criticise Ralph Black • It also means that we will need to explain things about Homejay in more detail because Kato may not know them all
We are writing a report	• Indicates required format of response
Review of the issues facing Homejay	• This means an updated SWOT analysis • It also asking for a position audit or discussion of the key issues (in priority order) that the Board of Homejay should be addressing • Look for changes between the pre-seen and the unseen
Evaluate each of the four strategic options	• We need to find out what these four options are
Conclude with recommendations	• We are supposed to advise Ken Kato on what to do with the firm he has just joined

7.4.2 Analyse the unseen material

Because the unseen material essentially updates the pre-seen material, you should focus on incorporating it into your pre-seen analysis. Pay particular attention to:

- where the unseen information confirms trends or factors identified in your analysis of the pre-seen material and hence confirms your impression of the situation;
- where the unseen information changes or contradicts the conclusions of your analysis of the pre-seen material;
- where the unseen material provides data that sheds light on the requirement.

The following steps should be taken.

1. Update your analysis of the position of the firm(s) in the case in your rough workings:
   - calculate ratios for profitability, liquidity and investor;
   - update organisation chart if necessary;
   - sketch down updated SWOT analysis.
2. Conduct preliminary rough analysis on any proposals in the unseen material. The sorts of things this could involve include:
   - evaluation of proposed project or acquisition;
   - feasibility of a business plan;
   - consideration of a recommendation for restructuring.
3. Perform any necessary calculations in a presentable form, clearly identifying the figures used, as appendices to the report. Try to avoid performing calculations in rough workings, and then rewriting them. Remember that it will be necessary to refer to the results of these calculations and explain their significance in the main report.

Homejay – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 19 – 23.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are the independent management consultant appointed by the new Chairman, Ken Kato.

Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.

Notes: Ignore taxation.

The Assessment Matrix, which your script will be marked against, is on the next page for your reference.

Homejay – Unseen material provided on examination day

Read this information before you answer the question

Ralph Black retires early

After Homejay announced its full year results for the year ended February 2003, at the end of May 2003, Ralph Black was criticised by both the financial media and the market analysts. He realised that his position was becoming untenable and he announced that he was retiring earlier than planned, and would leave the company at the end of September 2003.

Most of the senior employees of Homejay, and many market analysts, had expected Andy Mottram to succeed Ralph Black as Chairman, and felt that he had been preparing for the role for the last two years. However, Ralph Black considered that Andy Mottram was not suitable for the role and the Homejay Board agreed that the role should be filled by someone from outside of the company with more vision and better retailing skills.

A suitable candidate was quickly identified and the appointment was approved at a Board meeting. The new Homejay Chairman was Ken Kato, an entrepreneurial Japanese businessman who lived in the USA. He joined Homejay in early October 2003.

Homejay's new Chairman

Ken Kato had previously held the role of Chairman of a company which manufactured and retailed clothing and toys globally with a turnover equivalent to around $6 billion (1 billion equals 1,000 million). In the five years that he had been Chairman there, he had seen an increase in staff morale and staff loyalty. During that time the company's productivity had increased

(measured by sales per employee) by over 150%. The company's share price had grown by over 45% in the last three years, despite the global recession.

Andy Mottram was disappointed that the Board did not have sufficient confidence in his abilities to take on the role of Chairman and was considering resigning.

Ken Kato met with Andy Mottram in early October to discuss how he saw the business developing, and the need to change the focus of the company. Ken Kato discussed with Andy Mottram the management skills required to make changes and his knowledge of Homejay's businesses. Ken Kato asked Andy Mottram to stay with the company to help implement the changes that he considered were required. However, Andy Mottram was reluctant to give a firm commitment to Ken Kato. Ken Kato is still deciding whether or not he wishes to retain Andy Mottram on a longer-term basis.

The new Chairman spent most of October and early November visiting some of Homejay's manufacturing plants and some of its retail outlets in the USA and Europe and learnt much from Andy Mottram of historical events within each business unit.

Funding limitations

In Maxine Gill's opinion, Homejay is more highly geared than it should be. She wants to reduce the current loans, but is unable to achieve this from operating cash flows. Furthermore, Maxine Gill does not consider a rights offer would be successful at the current time.

In the past, Homejay's business units have been able to obtain funding for capital projects that have been approved by the business unit's general manager up to a limit of $10 million per project. Up to now there has been little direct control from the Head Office finance department or from the Homejay Board, except for larger capital projects.

The Homejay Board agreed with Maxine Gill's recommendation to limit capital expenditure on all projects across the company to $50 million in 2004/05. It is anticipated that this policy of limiting capital expenditure to $50 million per annum would continue for the next few years. This would necessitate each business unit referring any project over $1 million to the Head Office finance department for approval.

The Homejay Board agreed that no further loan financing would be obtained, irrespective of the NPV on any proposed project or acquisition. Furthermore, the agreed company-wide capital expenditure limit of $50 million for the next financial year would have to cover all planned projects unless funds could be generated by divesting some areas of Homejay's businesses.

Planning review meeting

At the planning review meeting held on 3 November 2003, Ken Kato stated that Homejay had not recognised that a key objective of the company should be the creation of value for shareholders. He stated that he considered that it would be necessary for some major strategic changes to be made.

Ken Kato announced that he had appointed an independent management consultant to undertake a strategic review of Homejay. The management consultant was present at the planning meeting and was introduced to the general manager of each business unit. During the planning review meeting, the consultant merely observed and made notes on areas for further investigation.

Ken Kato had been liaising closely with Maxine Gill and Paul Simpson whose departments were working on Homejay's business plans for the next financial year and beyond. Ken Kato was concerned that even if all of the business units actually achieved the forecast increased sales and profitability, the company's earnings per share would grow very little. He was also very concerned that historically the company had failed to achieve its financial plans.

Paul Simpson's department had received forecast financial data from each business unit for the next three years and a further estimate for later years. The forecast cash flow data from each

business unit were discussed at the planning review meeting. Maxine Gill was concerned that these forecasts did not address all of the problems that the business units were experiencing, particularly in respect of quality control in Electryco. Paul Simpson also wanted to review more closely the underlying forecast increases in sales volumes, as he felt that some of the forecasts had not addressed the competitive nature of the markets in which the businesses operate. Therefore, overall, it was considered that the forecasts might be overly optimistic.

Paul Simpson was also concerned that the capital expenditure required for the refurbishment programme of 25 Fixitco stores had *not* been included in the plan for 2004/05. Instead, Barry Milo had planned that this would be deferred a further year and not take place until 2005/06. In his plan for 2005/06 he had included capital expenditure of $45 million and an additional cost of around $8 million for increased marketing spend to relaunch the refitted stores. There was some discussion at the meeting as to whether the sales targets were too high in these 25 stores (which recently had seen sales declining further), if the refurbishment programme was deferred for at least another 15 months.

The level of communication between corporate Head Office and each of the business units' general managers is not very effective at present and there is a lack of corporate identity.

The level of corporate Head Office costs was also discussed. Joseph Logan was very critical of the high level of corporate Head Office costs that were allocated to business units, over which each general manager had no control. Andy Mottram stated that he had been looking at several ways to reduce the corporate Head Office costs, which were forecast for 2004/05 to be over $330 million.

Andy Mottram stated that one way of reducing corporate Head Office costs that was under consideration was the relocation of the Homejay Head Office. The proposal was for Homejay to relocate from the current site in a prestigious American city centre, to a lower cost, regional location. This would be expected to save $40 million each year. However, it is estimated that only 50% of Head Office staff would elect to stay with Homejay. In the short term, the proposed move could incur around $15 million on redundancy, recruitment and relocation expenses.

A further corporate Head Office cost that was planned for 2004/05, in addition to the $330 million corporate Head Office costs, was Mark West's corporate marketing campaign *(as detailed on pages 12 and 13 of the pre-seen material)*. Mark West stated that he considered the time was right to publicise the Homejay brands to make the company more visible in the public eye and to enhance its profile. He was highly confident that the planned campaign would generate additional sales. These additional sales would increase the forecast gross margin in 2004/05 by between $100 and $110 million, over all five business units.

Maxine Gill was concerned at the high level of management bonuses that had been paid in recent years, particularly since earnings per share had not grown. She informed the general managers of the business units that Catherine Barnes was planning to change the basis for calculating managers' performance-related pay. The current system is based around achieving a target ROCE for senior managers and individual performance targets for junior managers. Catherine Barnes is considering changing the management performance bonus scheme so that bonuses are linked either to Homejay's share price or to the company's earnings per share.

Ken Kato concluded the meeting by thanking the business unit general managers for their input into the business plans. He undertook to advise all of the business unit general managers of any proposed strategic changes for the company after he had had further discussions with the management consultant.

Review of Homejay's strategies

A week after the planning review meeting, Ken Kato met with the management consultant on his own to discuss ideas for change. A number of alternative strategies were identified at this meeting. Ken Kato considered that Homejay should concentrate on its core competencies, which were the Fixitco and Woodyco businesses only.

Ken Kato briefed the management consultant about the early discussions that Andy Mottram had held with a number of companies that Homejay could acquire. At this stage only one company looked like a promising acquisition. It was another company in the DIY business that would be complementary to Fixitco, called Makeitco. Ken Kato asked the management consultant to review this proposed acquisition (*see Option D below)*.

The Cosmetco business unit was discussed and Ken Kato commented that the forecast cash flow data for the Cosmetco business unit looked attractive. He was also very impressed by the recent growth in Cosmetco's sales and profitability. Furthermore, he liked the management style of its general manager, Jayne Reed. Both Ken Kato and the management consultant agreed that Homejay should retain Cosmetco in the short term and that this business unit should be reviewed in 18 months.

After much discussion, Ken Kato and the management consultant agreed that Homejay has four strategic options at present (which are not necessarily mutually exclusive). These are:

Option A: improve profitability within the existing business units

Option B: divest the Electryco business unit

Option C: divest the Cardco business unit

Option D: acquire Makeitco

Option A – improve profitability within the existing business units

Ken Kato has asked the management consultant to consider ways in which the company could improve its profitability. He has requested the management consultant to undertake a strategic review of each of the existing business units and to consider any changes that would help to improve profitability throughout the company.

Option B – divest Electryco

Electryco has reviewed its pricing policy and product ranges and has decided not to make substantial changes to its range of products and their features, nor to alter many of the current prices materially, although some individual products have been reduced in price to remain competitive with similar products offered by competitors. It is expected that any sales volume increase achieved would be eroded by reduced prices to remain competitive.

A competing electrical appliance manufacturer, Kitbeco, which is planning to expand its manufacturing capacity, has expressed its interest in acquiring Electryco. It plans to use some of Electryco's manufacturing capacity to build its own brand products and also to continue to manufacture selected ranges of Electryco's more successful products.

Kitbeco has had a series of detailed meetings with Homejay's senior management and has expressed a firm commitment to acquire Electryco. However, Kitbeco has stated that it would not require around 20% of the current workforce of Electryco.

The forecast net operating cash flows for Electryco (in nominal terms) are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Electryco	39	40	41	42

Kitbeco has now made a cash offer to Homejay of $310 million. However, this offer excludes the potential cost of future warranty claims on current year sales.

Option C – divest Cardco

Some enquiries have been made to companies competing with Cardco and it has been established that Cardco would be a particularly attractive acquisition, as the business owns or leases valuable retail sites in high streets that are difficult for other companies to obtain. Initial enquiries have found two companies that are interested. They have indicated that they would offer around $160 million.

The forecast net operating cash flows for Cardco (in nominal terms) are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Cardco	16	18	20	20

Option D – acquire Makeitco

Barry Milo has identified a chain of DIY stores in the USA named Makeitco which he considers would be a good acquisition for Homejay. If it were to be acquired, it would allow the company to expand Fixitco's geographic coverage. It would also provide further retail outlets for Woodyco's products.

The founding family members own the majority of shares in Makeitco. They have agreed that they want to enjoy the benefits of the success of Makeitco and to sell the company for cash. If Makeitco were to be acquired, it would be a friendly take-over and at present no other companies are competing to acquire Makeitco. Makeitco is a listed company and is currently valued at $350 million.

Makeitco has made available to Homejay its future plans and forecast of net operating cash flows (in nominal terms). These are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Makeitco forecast cashfows	33	34	35	36

It is expected that there would be synergy benefits of a further $5 million per year. There would also be a one-off re-branding cost of approximately $10 million.

Maxine Gill's initial reaction was that as the cost of acquiring Makeitco exceeded the agreed funding limitation, it could not proceed. However, Ken Kato is keen to build upon Homejay's core business competencies, and, in principle, is in favour of the acquisition. Maxine Gill considered that this business was very similar to Fixitco's business and should be assessed using Fixitco's discount rate of 10%.

For the purposes of evaluating all of the net operating cash flow data, taxation should be ignored.

Discount rates

Homejay has assessed the betas for each business unit based on suitable proxy companies. Maxine Gill has assessed the following discount rates as being suitable for each business unit, taking into account both business risk factors and exchange rate risks.

Business unit	*Discount rate*
Fixitco	10%
Woodyco	11%
Electryco	13%
Cosmetco	10%
Cardco	16%

The company's current weighted average cost of capital is 11%.

Present Value Table

Present value of $1 that is $(1 - r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Periods	Interest rates (r)									
(n)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	0.683	0.672	0.661	0.650	0.640	0.630	0.620	0.610	0.601	0.592
3	0.564	0.551	0.537	0.524	0.512	0.500	0.488	0.477	0.466	0.455
4	0.467	0.451	0.437	0.423	0.410	0.397	0.384	0.373	0.361	0.350
5	0.386	0.370	0.355	0.341	0.328	0.315	0.303	0.291	0.280	0.269
6	0.319	0.303	0.289	0.275	0.262	0.250	0.238	0.227	0.217	0.207
7	0.263	0.249	0.235	0.222	0.210	0.198	0.188	0.178	0.168	0.159
8	0.218	0.204	0.191	0.179	0.168	0.157	0.148	0.139	0.130	0.123
9	0.180	0.167	0.155	0.144	0.134	0.125	0.116	0.108	0.101	0.094
10	0.149	0.137	0.126	0.116	0.107	0.099	0.092	0.085	0.078	0.073
11	0.123	0.112	0.103	0.094	0.086	0.079	0.072	0.066	0.061	0.056
12	0.102	0.092	0.083	0.076	0.069	0.062	0.057	0.052	–	–
13	0.084	0.075	0.068	0.061	0.055	–	–	–	–	–
14	0.069	0.062	0.055	–	–	–	–	–	–	–
15	0.057	0.051	–	–	–	–	–	–	–	–

Cumulative Present Value of $1 per annum. Receivable or Payable at the end of each year for n years $1 - (1 + r)^{-n}/r$.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.689	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	8.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Periods	Interest rates (r)									
(n)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	1.509	1.492	1.474	1.457	1.440	1.424	1.407	1.392	1.376	1.361
3	2.074	2.042	2.011	1.981	1.952	1.923	1.896	1.868	1.842	1.816
4	2.540	2.494	2.448	2.404	2.362	2.320	2.280	2.241	2.203	2.166
5	2.926	2.864	2.803	2.745	2.689	2.635	2.583	2.532	2.483	2.436
6	3.245	3.167	3.092	3.020	2.951	2.885	2.821	2.759	2.700	2.643
7	3.508	3.416	3.327	3.242	3.161	3.083	3.009	2.937	2.868	2.802
8	3.726	3.619	3.518	3.421	3.329	3.241	3.156	3.076	2.999	2.925
9	3.905	3.786	3.673	3.566	3.463	3.366	3.273	3.184	3.100	3.019
10	4.054	3.923	3.799	3.682	3.571	3.465	3.364	3.269	3.178	3.092
11	4.177	4.035	3.902	3.776	3.656	3.544	3.437	3.335	3.239	3.147
12	4.278	4.127	3.985	3.851	3.725	3.606	3.493	3.387	3.286	3.190
13	4.362	4.203	4.053	3.912	3.780	3.656	3.538	3.427	3.322	3.223
14	4.432	4.265	4.108	3.962	3.824	3.695	3.573	3.459	3.351	3.249
15	4.489	4.315	4.153	4.001	3.859	3.726	3.601	3.483	3.373	3.268
16	4.536	4.357	4.189	4.033	3.887	3.751	3.623	3.503	3.390	3.283
17	4.576	4.391	4.219	4.059	3.910	3.771	3.640	3.518	3.403	3.295
18	4.608	4.419	4.243	4.080	3.928	3.786	3.654	3.529	3.413	3.304
19	4.635	4.442	4.263	4.097	3.942	3.799	3.664	3.539	3.421	3.311
20	4.657	4.460	4.279	4.110	3.954	3.808	3.673	3.546	3.427	3.316

Formulae

Valuation models

(i) Irredeemable preference share, paying a constant annual dividend, d, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_{\text{pref}}}$$

(ii) Ordinary (Equity) share, paying a constant annual dividend, d, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_e}$$

(iii) Ordinary (Equity) share, paying an annual dividend, d, growing in perpetuity at a constant rate, g, where P_0 is the ex-div value:

$$P_0 = \frac{d_1}{k_e - g} \quad \text{or} \quad P_0 = \frac{d_0[1 + g]}{k_e - g}$$

(iv) Irredeemable (Undated) debt, paying annual after tax interest, $i(1-t)$, in perpetuity, where P_0 is the ex-interest value:

$$P_0 = \frac{i[1 - t]}{k_{d\text{net}}}$$

or, without tax:

$$P_0 = \frac{i}{k_d}$$

(v) Future value of S, of a sum X, invested for n periods, compounded at r% interest:

$$S = X[1 + r]^n$$

(vi) Present value of £1 payable or receivable in n years, discounted at r% per annum:

$$PV = \frac{1}{[1 + r]^n}$$

(vii) Present value of an annuity of £1 per annum, receivable or payable for n years, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r}\left[1 - \frac{1}{[1 + r]^n}\right]$$

(viii) Present value of £1 per annum, payable or receivable in perpetuity, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r}$$

(ix) Present value of £1 per annum, receivable or payable, commencing in one year, growing in perpetuity at a constant rate of g% per annum, discounted at r% per annum:

$$PV = \frac{1}{r - g}$$

Cost of capital

(i) Cost of irredeemable preference capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_{pref} = \frac{d}{P_0}$$

(ii) Cost of irredeemable debt capital, paying annual net interest, i(1 − t), and having a current ex-interest price P_0:

$$k_{d\text{net}} = \frac{i[1 - t]}{P_0}$$

(iii) Cost of ordinary (equity) share capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_e = \frac{d}{P_0}$$

(iv) Cost of ordinary (equity) share capital, having a current ex-div price, P_0, having Just paid a dividend, d_0, with the dividend growing in perpetuity by a constant g% per annum:

$$k_e = \frac{d_1}{P_0} + g \quad \text{or} \quad k_e = \frac{d_0[1 + g]}{P_0} + g$$

(v) Cost of ordinary (equity) share capital, using the CAPM:

$$k_e = R_f + [R_m - R_f]ß$$

(vi) Weighted average cost of capital, k_0:

$$k_0 = k_e\left[\frac{V_E}{V_E + V_D}\right] + k_d\left[\frac{V_D}{V_E + V_D}\right]$$

7.4.3 Analysis of unseen material for Homejay Incorporated

The key points to notice from each page are as follows:

Page	*Main information*	*Significance*
19	• Resignation of Ralph Black in September 2003 following poor results • Appointment of Ken Kato, excellent turnaround record, as Chairman in October 2003 • Andy Mottram (CEO) passed-over as Chairman & considering leaving • Maxine Gill wants rights issue	• Kato has free hand and is powerful because shareholders want him to turn Homejay around • Will need to make recommendation on approach to take with Mottram • Financing of options needs considering in recommendations. Shareholders will want clear strategy before they supports rights issue
20	• $50 m cap on capex during 2004/05 and all must come from equity • EPS unlikely to rise without new projects • Forecasts over-optimistic • Refurbishment expenditure at Fixitco not included in forecast and now deferred 15 months • HQ costs forecast at $330 m and allocated arbitrarily	• All options must be evaluated in terms of ability to increase EPS or shareholder wealth against baseline forecast of no improvement • Head office costs likely to stay if divisions sold. Factor HQ costs into new profit forecasts
21	• New relocation option being considered • Corporate marketing campaign still needs approval • Proposal to change bonus system • Ken Kito favours retaining only Fixitco and Woodyco • Ken Kato likes management style of Jayne Reed (GM Cosmetco) • Cosmetco retained due to good cash flows and management • Four strategic options to consider of which three change scope of Homejay	• Evaluate viability and timing of relocation • Evaluate marketing campaign • Comment on bonus system • Chairman's personal preference should be born in mind when recommending options • All above are secondary issues, which require decision on main options concerning size and scope of Homejay to be taken first
22	• Option A is to increase profitability • Option B is divest Electryco. Partial cash flow forecast given against backdrop of nil growth and offer of $310 m • Option C is divest Cardco for $160	This is the start of the main work in this case • Absence of data for A means this requires you to suggest ideas based on Pre-seen and perhaps indicate profit impact of cost reductions • Assess offer for Electryco against PV of future free cash flow and comment on need to allow for termination costs • C is as Electryco but without termination costs
23	• Option D is to acquire Makeitco • Breach of funding limit an issue • Different costs of capital provided for each part of Homejay and compared to group WACC of 11%	• D should be evaluated as a PV with annuity after year 4 but comments made on problems of acquiring family firms • Comment on how funding cost could be reduced (e.g. staged buy-out)

Page	*Main information*	*Significance*
		● Need to use relevant discount rates for each calculation above ● Shows that value of Homejay could go up if Cardco and Electryco were sold because group WACC would fall ● Different rates could imply a 'sum of the parts' valuation for Homejay needed

7.4.4 Perform rough calculations

These are essential if you are to come to a consistent view on what you will recommend.

Divest Electryco

	2004/5	*2005/6*	*2006/7*	*2007 on*
Net cash flow	39	40	41	42
Disc @ 13%	0.885	0.783	0.693	1/0.13 (0.693)
PV	34.5	31.3	28.4	223.9
Total PV	318.1			

So offer of $310 is insufficient even before bearing termination costs. Reject and hold out for better offer.

Divest Cardco

	2004/5	*2005/6*	*2006/7*	*2007 on*
Net cash flow	16	18	20	20
Disc @ 16%	0.862	0.743	0.641	1/0.16 (0.641)
PV	13.8	13.4	12.8	80.1
Total PV	120.1			

Proposed cash offer of $160 m is favourable.

Purchase Makeitco

	Year 0 *2003/4*	*Year 1* *2004/5*	*Year 2* *2005/6*	*Year 3* *2006/7*	*Year 4* *on*
Net cash flow	(350) + (10)	33 + 5	34 + 5	35 + 5	36 + 5
	(360)	38	39	40	41
Disc @ 10%	1	0.909	0.826	0.751	1/0.1 × 0.751
PV	(360)	34.5	32.2	30.0	307.9
Total NPV	404.6 − 360 = $44.6 m				

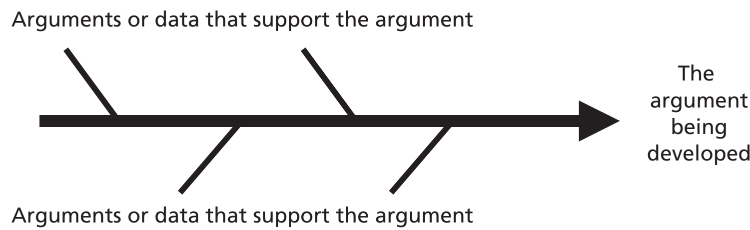
Acceptable providing forecasts are right and capex can be afforded. Will reduce 2003/4 profit due to $10 m re-branding.

7.4.5 Decide basic argument of report

The requirements set in the TOPCIMA exam must be met before you start branching off to discuss other issues you think relevant.

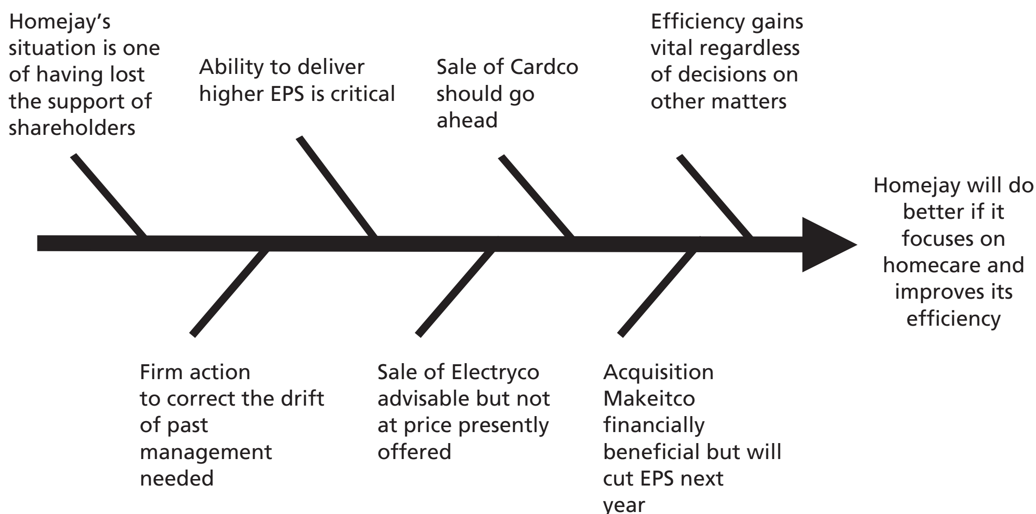
Candidates report that having a clear idea of what they want to say is the hardest part of passing an exam like this.

Some candidates have found *fishbone diagrams* a good way to plan their development sections.



You should draw the fishbone(s) in the rough workings section of your answer books. Using pencil helps you to shift ideas about, although sometimes it's just as quick to redraw them if a better sequence of ideas comes to mind.

- write the argument at the point of the fishbone;
- put each separate piece of data analysis or evaluation that lead to the conclusion of the argument as spines;
- ensure that each spine is essential to supporting the argument;
- ensure the spines are in the best sequence for leading the reader through your argument.



The spines are the main steps in the argument and build up left to right.

7.4.6 Start developing a skeleton plan

You will be given two answer books at the start of the TOPCIMA exam. We recommend you use them as follows:

- the larger one should be set aside for the written section of your final report;
- the first half of the second book (up to the double page containing the staples) should be reserved for presenting any appendices to your final report;
- the double page spread following the staples can be used for your skeleton plan;
- the remainder of the second book is for rough working.

Here is the first stage of a skeleton plan to answer the requirements for Homejay Inc.

Homejay Incorporated CONFIDENTIAL REPORT – Issues and future strategic options To: Ken Kato: Chairman From: A Consultant Date: 20th November 2003 Content	5. **Evaluation of Option to Divest Cardco**
1. **Introduction**	6. **Evaluation of Option to Purchase Makeitco**
2. **Current Strategic Issues facing Homejay**	7. **Other issues**
3. **Evaluation of Option to Improve Profitability**	8. **Conclusions**
4. **Evaluation of Option to Divest Electryco**	9. **Recommendations**
	Appendices

7.4.7 Adding content to your report

The next step is to decide what you wish to write under each section of your skeleton plan.

From your analysis of the pre-seen you should already have a pretty good idea or what you think of the current situation of Homejay and the issues it faces.

For example:

- it has lost the support of shareholders due to the failures of previous senior management (but note Black has gone);
- its performance evaluation and bonus systems are a contributory factor to this (but note this is going to be changed);
- it has acquired businesses that have little synergy with the core business of Homejay and should be rationalised if the price is right (this is the main part of the unseen);
- it needs to sort out it duplication of factories in Woodyco;
- it should improve its stock management.

The last two can be discussed as part of the section on improving efficiency.

Therefore be ready to write a SWOT as an appendix and draw these key conclusions out and put them in Section 2.

More difficult is evaluating the other aspects of the case. From rough calculations you could conclude as follows:

- sell Cosmetco,
- reject offer for Electryco,
- acquire Makeitco,
- press ahead with efficiency gains.

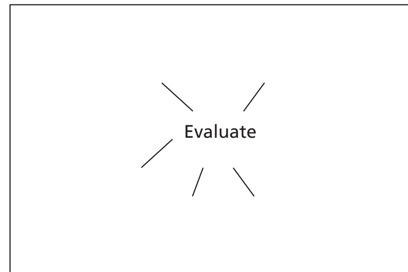
The remaining aspects of the unseen also need to be addressed but they seem to be secondary to the issues above. You were not specifically asked to address them and so only do them if you have time

- shall Homejay relocate to cheaper HQ?
- shall the corporate branding go ahead?
- what shall be done with Mottram?
- shall bonus system be re-based?

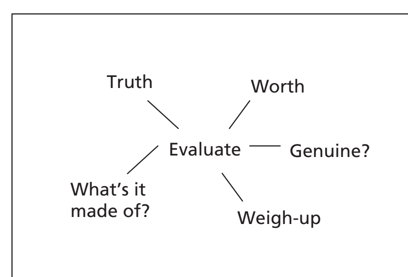
Finding enough to write can be a problem for some candidates. A technique that can help here is *word association*.

Write a key word or phrase in the middle of a sheet in the rough workings section of your second answer booklet (tip: put the sheet on its side) and then draw 4 or 5 rays from it.

For example, for Homejay 'evaluate the options'. Taking the sale of Electryco as an example:

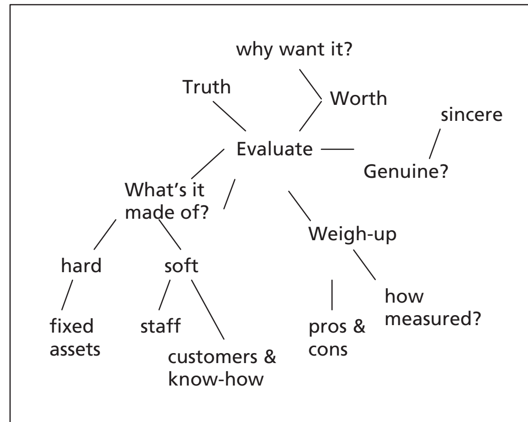


At the end of each ray write a word or phrase that comes to your mind as being connected with the central word. The important thing here is to suspend your critical filter. Rely on word association and do not worry if the words you write down seem silly or out of context. The fact you thought of them means that somewhere in your mind there is a connection between them.



A quick consideration of some of the words on this map may help us to realise that our report should discuss business valuation ('worth'), the future earnings, assets, management and technologies of Electryco ('what's it made of?), the reliability of information we have been given by Maxine Gill ('genuine', 'truth').

If you still have a problem getting ideas then repeat the exercise with the more promising words on the original rays, and so on:



These further associations have reminded us to consider the validity of the accounting information ('how measured'); to itemise the benefits and risks clearly in our report ('pros and cons'); to check on the assets and protections available ('hard and soft') and also to consider the strategic logic to Homejay selling it ('why want it?').

Reviewing the key word and word association exercises gives us a promising lit of things to talk about in our report:

- question why they are selling,
- what will be the termination costs of 80% of its workforce,
- what will be the warranty costs in the future and who will deal with the problems if Electryco is sold?
- how the cash might be used,
- what is right price for Electryco,
- impact on morale of Homejay staff if early decision of Kato leads to 80% of Electryco staff losing their jobs,
- whether Suzie Green can or should be retained within Homejay as a manager.

The skeleton plan can be further filled out:

Homejay Incorporated

CONFIDENTIAL REPORT – Issues and future strategic options

To: Ken Kato: Chairman
From: A Consultant
Date: 20th November 2003

Content

1. **Introduction**

2. **Current Strategic Issues facing Homejay**
   - lost the support of shareholders due to previous senior management
   - acquired businesses with little synergy with the core business (note WACC inflated by Cardco and Electryco)
   - it has efficiency problems: duplication of factories in Woodyco: poor stock management.
   - its performance evaluation and bonus systems are dysfunctional

3. **Evaluation of Option to Improve Profitability**
   - essential to improvement of EPS
   - low risk strategy
   - efficiency gains to be made by rationalising Woodyco factories and supply chain/stock
   - head office relocation not advisable due to effect on short term earnings

4. **Evaluation of Option to Divest Electryco**
   - Electryco does not build on core competences of firm and is at variance with Kato's vision for Homejay
   - Offer from Kitbeco not sufficient to compensate for loss of free cash flows

5. **Evaluation of Option to Divest Cardco**
   - essential in refocusing business
   - offer acceptable
   - may be possible to get better offer if rival firms can be encouraged to bid too
   - no employment or morale effects if buyer takes over staff too

6. **Evaluation of Option to Purchase Makeitco**
   - consistent with core business vision
   - offer price is acceptable (show maximum price in case bid war starts)
   - point out problems of anti-trust regulations and managing a family owned firm
   - recommend subject to finance being available and fall in next year's profits acceptable. Could suggest earn-out for management to spread costs of acquisition

7. **Other issues**
   - allow Mottram to leave as he is tarnished with past failure Suggest interview other divisional managers to replace him
   - base bonus scheme on share movement e.g. by share options
   - suspend branding exercise to save cash flow and await final decisions on disposals and acquisitions

8. **Conclusions**
   - more focused group will be more valuable
   - taking action will restore investor confidence
   - cash released by disposals will help pay for Makeitco

9. **Recommendations**
   - institute rationalisation and efficiency programme to increase profits
   - seek replacement for Mottram
   - invite more offers for Cardco
   - enter second stage negotiations with owners of Makeitco
   - seek replacement for Mottram
   - postpone branding campaign for 2 years
   - introduce new incentives and performance evaluation system

Appendices

A. SWOT Analysis for Homejay Inc.

B. Evaluation of sale of Electryco

C. Evaluation of sale of Cardco

D. Evaluation of purchase of Makeitco

7.4.8 Writing the introduction to your report

Remember that great thriller writers keep their readers in suspense until the last chapter or page to find out what happens. Sometimes there is a twist and the ending is the opposite of what the reader had been anticipating.

Your TOPCIMA report should be the **complete opposite** of a novel:

- the reader should be clear from the start what the conclusion of your report will be;
- the report should show the reader how you arrived at this conclusion in a way that builds the argument and shows how one point leads on to the next and makes your conclusion inevitable;
- it should end with a clear recommendation on what management should do next.

This opening paragraph has power and compels attention.

A useful discipline is to ensure the first sentence of your Introduction begins with one of the following phrases:

- 'This report will argue that . . .';
- 'This report will present the case for . . . (a given course of action or decision)';
- 'The central conclusion of this report is its recommendation that . . .';
- 'This report will demonstrate that . . . (the following situation is the case or certain actions are essential'.

This only works if this sentence is the first thing you actually write in your skeleton plan and final report. Do not cheat by leaving a space and inserting the sentence once you have finished your report and finally decided what you think.

7.5 The Case Writer's Answer to Homejay Inc.

This chapter concludes with the published answer to Homejay. You will note that it differs from the skeleton plan above. This is for two reasons:

- the published answer is likely to be far longer than a student's script. Its purpose is to indicate the sorts of analysis and arguments that would have gained marks;
- it illustrates that it is quite permissible to have your own opinion of what to recommend, providing you justify your recommendations.

Case Writer's Answer for Management Accounting – Case Study

REPORT

20 November 2003

To: Homejay's Chairman From: Management consultant

Review of Homejay that discusses the four strategic options identified and makes recommendations for changes

Report contents:

1.0 Introduction
2.0 Terms of reference
3.0 Review of the issues facing Homejay
4.0 Review of Homejay: Option A – improve profitability
5.0 Review of Homejay: Option B – divest Electryco
6.0 Review of Homejay: Option C – divest Cardco
7.0 Review of Homejay: Option D – acquire Makeitco
8.0 Recommendations for changes

Appendix 1	Strengths, weaknesses, opportunities and threats analysis
Appendix 2	Homejay draft budget for 2004/05 and EPS calculations
Appendix 3	Evaluation of the proposed divestment of the Electryco and Cardco business units
Appendix 4	Evaluation of forecast cash flows for the proposed acquisition of Makeitco
Appendix 5	Summary of the financial effects of the recommended changes for 2004/05

1.0 Introduction

Homejay has been in business for over 100 years but for the last 9 years, since 1994, it has seen earnings decline and shareholders are dissatisfied with the company's lack of growth in its earnings per share. It is operating in competitive markets and, despite a number of management initiatives, has maintained a turnover of over $4,000 million for the last two years but margins have declined.

The company's Chairman has recently retired and the new Chairman, Ken Kato, is proposing a number of strategic changes, involving possible divestment of some of the business units. The Finance Director has also introduced a funding limitation of $50 million per year for capital expenditure across all of Homejay's business units.

An opportunity has also arisen to acquire a complementary business, Makeitco, which is being evaluated.

2.0 Terms of reference

I have been appointed as a management consultant, to undertake a review of the issues facing Homejay. This review also discusses and evaluates each of the four strategic options that have been identified and the report includes recommendations of changes that would enable Homejay to achieve longer-term growth in its earnings per share.

3.0 Review of the issues facing Homejay

The over-riding key to success in these customer-orientated manufacturing and retail industries is having the right product available at the right time at the right price and marketed in such a manner to appeal to potential customers. It also involves close cost control to ensure margins are not eroded.

While there are a lot of ways in which Homejay can improve its profitability, it should be noted that it is continuing to be successful in achieving over $4,000 million worth of sales worldwide each year and profitability is still over $200 million each year. Many other businesses in the retail market have seen earnings fall far more drastically. Furthermore, many companies in the furniture industry have declined into loss-making situations, so Homejay has been relatively successful compared to some of its competitors. One of the global furniture retailers, Courts, has decided to refocus the company on its core business of retailing furniture and has ceased retailing all electrical products.

The last two years' actual results have seen the return on sales slip from 5.1% to 5.0% in 2002/03. The latest forecast for 2003/04 shows a further slippage of 0.1% to 4.9% return on sales assuming the forecast net profit before interest and tax is achieved. All figures are based on earnings before interest and tax as a percentage of turnover.

Homejay has been capable of producing growth in sales, which has historically been the focus, but it now needs to address growth in profitability so that shareholders can see

growth in earnings per share. Additionally, this strategic review will look at whether or not retaining or divesting two of its business units will contribute towards improving shareholder value. This review also considers the proposed acquisition of Makeitco.

A much greater level of control is required in Homejay's planning process. From historical evidence it is clear that financial plans have been prepared, approved and communicated to the market, which had been over-optimistic and unachievable. Maxine Gill and Paul Simpson need to address the planning issues and control procedures much more closely.

It seems that Homejay has been able to achieve turnover targets but at the expense of profitability, presumably due either to poor cost control or selling surplus stock off at cost or little margin. More flexibility is required from suppliers and also Homejay's own manufacturing units to achieve maximum sales.

Homejay has not expanded its geographical coverage at all, or even the number of its retail outlets, over the past few years. Many of the other global furniture retailers, such as *IKEA* and *Courts*, have continued to expand into new and developing markets. Homejay needs to looks for new markets for its products, or it will be facing increased competition from larger global retailers in its existing markets.

The company appears to be a little 'stale' and has not been pro-active or very innovative in its retailing. It has relied on bringing in repeat business from many of its Woodyco customers and the Fixitco stores have been allowed to fall behind those of its competitors in terms of attractiveness to its customers. If this downward spiral is allowed to continue, the company could find that it loses some of its market share to its competitors in a very short space of time and it would be difficult to redress.

The Homejay situation could be compared to the *Marks and Spencer* business that failed to spot changing market trends and saw a rapid decline in sales and its share price a few years ago. *Marks and Spencer* made a number of strategic changes and sold off some stores and improved its appeal to segments of the market that it had lost in the past, and this has resulted in improved turnover and share price.

The *Kingfisher* group has recently reviewed its core businesses and has used IT solutions to enable it to improve cost control in its *B&Q* DIY stores.

Fixitco and Woodyco should be more pro-active in their stores' design and layout to attract customers and to boost sales. They should not be competing on price alone, but should be trying to create a good sales environment and to build upon existing strong brand names.

The company's management performance bonus was paid to over 85% of its managers in the last financial year to February 2003. During this period, the company's EPS improved slightly from $0.21 to $0.22 per share. It is necessary for the managers' performance bonus to be realigned with shareholders' interests and this is discussed below, in Section 4.0 of this report.

4.0 Review of Homejay: Option A – improve profitability

The strengths, weaknesses, opportunities and threats to Homejay are shown in *Appendix 1*. Homejay needs to make a number of strategic decisions and should use the opportunity of this review to divest itself of two of its business units and acquire the complementary business in the DIY market in the USA. These proposed divestments and acquisition are discussed in depth in Sections 5.0, 6.0 and 7.0 below.

Each of the five Homejay businesses needs to be thoroughly reviewed so that Homejay's profitability can be improved.

Each of the Homejay business units should review its products and use the BCG matrix to confirm whether the products are worth retaining or should be withdrawn. It would also help to focus attention on which products are 'cash cows' and which products need more marketing to improve their level of sales. The company also needs to identify which products need to be changed or modified to improve their marketability. Each of the business unit general managers should re-examine the target market that its products are aimed at and ensure that its prices reflect whether it is operating as a low price cost leader or whether it is able to charge premiums for products that are differentiated from those of its competitors. Homejay needs to become more outward-looking and not just continue in the same way as it has always done. It needs to be more pro-active, rather than reactive, to its chosen markets. New senior managers should be recruited who can improve Homejay's responsiveness to customers needs.

The retailing markets are all much more competitive and fast-moving than they have ever been before, with consumers being more selective and aware of alternative suppliers and prices. Customer loyalty is a luxury that Homejay has had the privilege of for many years but it must not sit back and expect this to continue. Clearly Homejay is doing a lot to meet customers' requirements with the high levels of sales that it has been able to generate, but with more careful management of its customer base and targeting of new customers, sales could be much greater. The company needs to concentrate on controlling its costs so that net margins can be increased.

The company needs to review how innovative it is with introducing new products. Is Homejay always following its competitors or is it a market leader? In the Woodyco business, it has a target percentage of 15% of its turnover to be generated by new products each year. Is this achievable and are all of the new products successful? Should it increase or decrease this innovation target? Another way for the company to be innovative could be the way sales are made, perhaps by retailing via its website or by offering its customers new choices. Again, for the Woodyco business, a choice could be offered to its customers, whether they want flat-packed furniture, or ready-assembled furniture (at a higher price). Are customers offered the choices they are seeking? More market research is needed in the DIY and furniture businesses to identify how Homejay could be more innovative and appeal to a wider market.

The business units appear not to have been closely managed in the past, and general managers have not been held accountable for shortfalls from their forecasts. Homejay needs to identify the underlying reasons for not meeting planned objectives and financial forecasts. Until the difference and the reasons can be identified, it is difficult for forecasts to hold much credibility. More effective use of IT solutions is needed so that the company can react quickly to changing levels of demand, and so that forecasts can be updated to reflect actual events.

There is a need for improved cost control and management of margins across products, across all business units. This can only be achieved with good IT systems and better management control. A 1% reduction in its cost base (across all costs, including staff costs) could generate over $40 million to the company's bottom line.

There should be more emphasis on Homejay's procurement policy since it has a large cost base and it clearly needs to have better control over its supply chain. It is recommended that a new post of Procurement Director be approved and a suitably-qualified and experienced person recruited into this key post. The postholder should be responsible for all procurement issues across all business units and should liaise with and advise each of the business unit's procurement staff on best practice and help with re-negotiation of contracts where necessary. The company also needs to improve its distribution service and logistics, so that it can meet customers' expectations.

Corporate Head Office costs and possible relocation

The level of corporate head office functions and their associated costs also need critical review so that only value-adding services are retained. As each of the businesses is acting as an autonomous decentralised business unit, there should *not* be a need for vast levels of staff at Corporate Head Office. As much work as possible that is currently undertaken at Corporate Head Office should be reallocated back to each business unit and any duplication of tasks should be eliminated. More control by each business unit general manager is required.

It should be possible to reduce costs and headcount in Corporate Head Office departments by rationalisation and outsourcing. *Appendix 2*, which shows the draft budget for 2004/05, includes a target reduction of 10%, that is, $33 million for 2004/05. There should be scope for larger reductions in future years, and if two of the business units are divested, it is likely that some of the Head Office support teams should be reduced accordingly.

In respect of the possible relocation of Head Office that Andy Mottram stated was being considered, it is not recommended that this proceeds while the company is undergoing a strategic review of it businesses and with a new Chairman in place. At present, the Head Office is in a different USA city to that of each of the three business units that are based in the USA. Therefore, it would make logistical sense to defer moving Head Office, simply for the sake of finding a cheaper location that may cause further loss of communication between Head Office and Homejay's business units. Furthermore, until a decision is taken on the proposed divestment of Electryco, the move should be deferred.

When the Homejay review is complete and any proposed acquisitions and divestments are agreed, the Head Office should relocate to one of the cities in which Homejay already has management, such as the city that either Woodyco or Cosmetco is already in.

Furthermore, the possible loss of 50% of Head Office staff could lead to severe loss of knowledge and could damage Homejay's short and medium-term success. The relocation is not recommended at present.

Review of managers' performance-related bonuses

Homejay needs to change the company's culture and also the managers' performance-related bonuses to align them with the shareholders' interests.

Shareholders want to see an increase in the value of the company, which can be measured in many ways. One way is an increase in the future cash flows of the businesses, but this is difficult to monitor and to measure. Another way is an increase in earnings per share, which is easy to monitor. Also, targets in the past have been short-term, annual ROCE targets. For senior managers, particularly business unit general managers, targets should be over a longer time frame, to enable the effects of decisions to come to fruition. Therefore, longer-term targets linked to earnings achieved by the business unit, with a capital constraint, should focus each business unit to achieve improved bottom-line results.

At the planning review meeting, Maxine Gill stated that Catherine Barnes was considering linking the performance bonuses to either Homejay's share price or EPS. As the fluctuation in the company's share price is subject to market conditions which are outside the direct control of its managers, it is recommended that performance bonuses should be linked to EPS, but not on an annual target. Perhaps it could be over a rolling three-year period to allow the results of decisions to flow through to positive results. This would stop the current short-termism approach that seems to have been adopted by Homejay's managers.

Senior managers could also be given share options over a longer time frame, perhaps 5 to 10 years, to encourage long-term growth in the company's share price.

Other human resource issues

Staff morale within Homejay needs to be maintained during the strategic review, and redundancies handled fairly. If two of the business units are divested, the Homejay staff should be given the opportunity to transfer to another business unit within Homejay, if possible, if they wish to.

Review of Fixitco

Fixitco has not expanded the number of retail stores in recent years and with the current limit on capital expenditure, this would not be possible at present unless expansion could be financed in a different way, such as leased property or franchising of the Fixitco name.

The supply chain needs to be improved with shorter lead times for delivery to Fixitco stores, so that stores can react more quickly to market trends and customer demand. It is unacceptable for Fixitco to run out of stock on fast-moving products and its IT systems should be able to identify these products and ensure that supply is available by having on-line ordering with its key suppliers. Tighter contracts may be required with suppliers so that the time delay between ordering and delivery of key product lines is minimised.

The recommended improvement in Homejay's procurement policies should improve its ability to ensure that supply keeps up with customer demand.

In respect of the refurbishment of 25 Fixitco stores, Barry Milo stated at the planning review meeting on 3 November 2003 that he was planning to defer this expenditure until 2005/06. The standard and attractiveness of the Fixitco stores are key to maintaining and increasing customer loyalty and maintaining sales. Although this represents a large part of the overall funding limitation of $50 million during 2004/05, it is recommended that the capital cost of $45 million for this refurbishment project be incurred during 2004/05, as shown in *Appendix 5*. It should not be deferred until 2005/06.

As managers' performance-related pay has, in the past, been linked to ROCE, perhaps many capital projects of this nature have been postponed, as they would have adversely affected results in the short term. It is important to maintain the appeal of Fixitco stores and to increase sales, which is key to long-term profitability. The refurbishment project of 25 Fixitco stores is recommended, and it is proposed that this should take place in early 2004/05.

Review of Woodyco

The business should prepare a detailed product profitability analysis, and review the effectiveness of retailing low-profitability product lines. Some products may need to be redesigned or marketed more effectively to produce higher sales.

The Woodyco management should review whether it could outsource the manufacture for some product lines, as it may not be cost-effective to manufacture all furniture items in-house. Furthermore, a review of the manufacturing capacity in Woodyco's business should be undertaken to rationalise the nine manufacturing plants and reduce its in-house capacity. Any duplication in manufacturing of product lines should be eliminated, to ensure manufacturing capacity is used most effectively. Quality control needs to be maintained and improved so that customer satisfaction remains high. This is particularly important if some products are outsource so that quality standards are maintained.

Woodyco's manufacturing capacity should be reviewed, but if there is the possibility of rationalisation and closure of some sites, this should not happen until a decision on the Makeitco acquisition is agreed. Consideration needs to be given to the possible extra demand for Woodyco products if Makeitco stores in the USA were to be acquired, as this would provide new sales outlets for Woodyco products.

New design staff should be recruited into Woodyco to ensure that the company's products are successful in the longer term.

MFI and *IKEA* are two large international furniture manufacturers and retailers which have increased their sales by continuing to launch new product ranges and innovative ways to sell them, including comprehensive computerised planning services for customers. Both of these companies have used IT solutions to improve their control of their manufacturing and logistics, to speed up lead times and to control costs. Woodyco has much to learn from competitors such as these. Woodyco also needs to improve its ability to focus on its customer requirements.

Electryco

If the Electryco business unit were to be retained there would be a need to improved quality control.

There should be more focus on what the customer wants. There has been too much emphasis on producing goods and spending large sums on marketing to promote them. The company needs to identify customer requirements and meet or exceed them at a price to be competitive. At present, Electryco appears to be selling products with features that do not appeal to customers and many of the products are not competitively priced. Perhaps these additional features cost too much to manufacture and are not considered value for money by customers. If the products were redesigned, their manufacturing costs may reduce allowing a lower retail price without eroding margins.

Cosmetco

The Cosmetco business is not being reviewed at present but close monitoring is required to ensure that it continues to grow without the need for the high product development costs that have already occurred. The nature of this business is very fickle and subject to changes in fashion and consumer taste.

Marketing is very important and data provided infers that much of the success recently is related to the actress who promotes the products. Careful negotiations are required to ensure contract obligations are fulfilled, or careful consideration to what the effect on the business would be if the actress disassociated herself from the company. It is recommended that Cosmetco commences discussions with another model or actress who could step in if necessary, if the currently contracted actress fails to complete her contract. Additionally, the cost of contract renewal could be significant. It is not unusual in this industry for $5 to $10 million to be paid in fees alone.

The business unit needs to continue to carefully monitor the markets it operates in and should consider extending its geographical sales to other European countries after thorough market research.

Proposed corporate marketing campaign

If the forecast effects of the proposed corporate marketing campaign are correct, this could result in increased gross margins across all five business units of between $100 and $110 million in 2004/05. After the cost of the marketing campaign of $80 million, this could result in a favourable effect of between $20 and $30 million. However, if the estimates of volume increases are incorrect (and past forecasts appear over-optimistic), then the marketing campaign may cost more than the gross margin that it could generate. Additionally, until the strategic review is completed and the future of the five business units is decided, the time is wrong to undertake such a large corporate marketing campaign. If

the effect on the Cosmetco business is incorrect and volumes increase by only 5%, then most of the favourable effect of the campaign would disappear.

Additionally, would the marketing spend have a better effect in each of the businesses, rather than promoting the Homejay corporate name? The effect on Homejay's bottom line would be disastrous if the $80 million was spent and very little increase in the volume of business was generated. Furthermore, if some of the business units are divested, then this would reduce the forecast effect on Homejay's overall margin. Therefore the marketing campaign is *not* recommended at present.

Other organisational changes recommended: Business Development Director

The company appears not to have expanded its sales outlets in recent years. This was possibly due to business unit general managers not wishing to increase the capital employed, which would have had a negative effect on performance bonuses.

It is recommended that a Business Development Director be appointed. This postholder would be responsible for identifying areas that the existing Homejay business could expand into. This could be in one of two ways, first by increasing the number of Fixitco and Woodyco sales outlets (in countries that it currently operates in or in new countries) and secondly by selling Fixitco and Woodyco products through other sales channels. For example, Woodyco products could be sold on a franchising arrangement or through other furniture or kitchen shops.

Information provided shows states that Homejay currently does not have many interests in the Far East. Most multinational furniture manufacturers have shops/outlets globally in all continents. Therefore there is room for Woodyco to expand geographically. The Caribbean market and the Far East are growing fast and there is a high demand for 'Western' products.

Operations Director

It is recommended that an Operations Director be appointed to oversee all of the ongoing operations in Homejay's business units. This postholder would have direct control of the business units and would replace the role of Chief Executive.

It appears that each business unit general manager has been kept busy just keeping each business operating at the same level, and very little has been done to examine business operating methods and capacity. It is recommended that the Operations Director reviews the current manufacturing capacity of Woodyco. This should result in some rationalisation and perhaps closure of some of the smaller factories. Alternatively, if excess manufacturing capacity is identified, this could be used to manufacture furniture to be sold to new markets/new sales outlets identified by the new Development Director.

Chief Executive

It is not recommended that Ken Kato retain Andy Mottram.

Andy Mottram has failed to manage the five business units in order for them to deliver the planned levels of profitability over the last 11 years since he joined in 1992. While he has extensive knowledge of the business, this may not be sufficient reason to retain him, as the Homejay Board clearly does not have confidence in him and his management skills to improve the business results. While EPS have decreased over the last nine years, he has not initiated any major organisational or staff changes, and he is not well respected by the business unit general managers.

Realistically, Andy Mottram may have difficulties securing another senior position elsewhere (which could explain why he has not already left Homejay) as his track record and his

professional reputation is not impressive. It is suggested that Ken Kato retains him in the very short term, for the next few months, while some of the changes are being made, and that he is then asked to leave. Depending on his contract terms, it may be appropriate for Homejay to make a payment to him when he is asked to leave.

IT Director

As IT is so crucial to Homejay's future success, both in capturing data at point of sale and in helping management to identify sales trends and control costs, a main board director should manage the IT function. At present, all of the recent IT initiatives have been made by Maxine Gill, the Finance Director, but it is not entirely clear who is officially responsible for IT. It is proposed that a new IT department is established, outside of each business unit general manager's control, which provides this specialist service to all business units.

Procurement Director

The Homejay businesses do not have any one person who is responsible for procurement. With such a large cost base, this important role is key to establishing cost control and prompt service from Homejay's suppliers. It is recommended that a main board director should be appointed, who would be responsible for the company's procurement policy and maintaining best practice across all business units. The person appointed should be a specialist in procurement in the industry of fast-moving consumer goods, and also experienced in logistics.

Head of Corporate Planning

It is recommended that the current Head of Corporate Planning, Paul Simpson, be replaced with a more experienced planning manager who will help to ensure the integrity of Homejay's business plans. Paul Simpson has allowed over-ambitious plans to be repeatedly prepared and communicated to market analysts over the last nine years and has not helped Homejay's business unit managers to monitor their actual results to plans. It is also recommended that the planning department moves to be under the direct control of the Finance Director.

Summary of the review of Homejay

With improved IT systems and a stronger, more focussed management team which is working towards one goal of increased EPS in the medium term, rather than always looking at one-year targets, the company should be able to become more profitable.

Appendix 2 shows how the draft budget for Homejay for 2004/05 could achieve a growth in EPS to \$0.34 if Homejay were able to achieve the budgeted growth in sales of 17% and growth in profitability of 19%, that is, increase margins by 2% across the entire company. This could only be achieved if costs were controlled better than they have been in the past, as retail prices could not be increased without affecting Homejay's competitiveness. The only other change that has been incorporated in *Appendix 2* is reduction in Corporate Head Office costs by 10% in 2004/05.

However, the resultant EPS of \$0.34 looks very optimistic and a more reasonable EPS that could be released to market analysts would be around \$0.28, which is between the current actual EPS of \$0.22 and this optimistic budget of \$0.34. Even EPS of \$0.28 would be challenging to deliver.

5.0 Review of Homejay: Option B – divest Electryco

The Electryco business is currently profitable (even after its allocation of Corporate Head Office costs), and the business unit is forecast to produce a return on capital employed of 8.6% in 2003/04. However, the business unit seems to be a 'problem child' business, in terms of the BCG matrix.

To examine whether the business should be divested, it is necessary to consider its future forecast cash flows, discounted at the appropriate discount rate (to reflect the risk of the business) and these should be compared to any possible price that could be obtained if it were to be divested now. The evaluation of the future cash flows for Electryco is shown in *Appendix 3*.

Appendix 3 shows that the future forecast cash flows produce an NPV of $318.1 million, assuming year 4 cash flows continue into perpetuity. This is $8.1 million higher than the proposed divestment price to Kitbeco of $310 million. Therefore, on a simple choice based on numbers, Electryco should be retained. However, due to the funding limitations imposed by the Homejay Board, there are other issues that must be considered.

As part of the bigger corporate picture, Homejay could only finance the acquisition of Makeitco if both Electryco and Cardco were to be divested. Therefore, the strategic nature of these proposed divestments should be considered also.

Homejay's management needs to reassess the projected cash flows to ensure that they are achievable and realistic. In particular, the forecast cash flows need to address Electryco's pricing policy and whether it can compete effectively at the forecast prices. Furthermore, the quality problems that Electryco is currently experiencing need to be rectified. Any impact on prices and volumes and any increased production costs required to improve quality control need to be built into the forecast cash flows. Has this been done and are the forecast costs of manufacture realistic and achievable?

Another issue to be considered is that the $310 million divestment price is fairly certain, whereas the $318.1 million forecast future cash flows are rather uncertain. Additionally, Electryco seems to have a brand image and the Homejay Board should consider the risk of retaining this business unit and the possibility of the bad image from faulty goods affecting the rest of the company.

The Electryco business unit has recently undertaken a pricing review and has not made major changes to its pricing structure. Since there are a number of indications that its products are not priced competitively, this must cast some doubt on whether the forecast cash flows could be achieved.

Another consideration in the proposed divestment of Electryco is that the business unit has a forecast level of capital employed of $350 million at the end of February 2004. If the business unit were to be divested for $310 million, there would be a one-off impact on the company's EPS arising from the write off of $40 million of capital employed. However, it is likely that the capital employed for the Corporate Head Office would, in the short term, simply be reallocated to the remaining business units, with little, or no, effect on EPS.

To sum up, the uncertainty of the future profitability and reliability of the forecast cash flows should be sufficient evidence to persuade the Homejay Board to divest Electryco now. Homejay has a possible buyer and Kitbeco has expressed a firm commitment to acquire Electryco for a realistic price. If this offer is not accepted and the Electryco business were to suffer further declines in sales and profitability, it could make a divestment harder at a later date, and probably at a much reduced price.

Since Kitbeco has offered a price of $310 million for the business, which currently has capital employed of $350 million in the latest forecast, it obviously considers that it can achieve higher future cash flows than Electryco.

It should also be noted that the forecast cash flows for Electryco (and Cardco) are after their respective allocation of corporate Head Office costs. The level of allocated corporate Head Office costs charged to each business unit has not been stated. Homejay would need to put in place a process to manage divestment, so that the overall level of corporate Head Office costs should reduce with the divestment of Electryco (and Cardco). It could be that some corporate costs, such as the company secretary office, would not reduce and would simply be reallocated to the three remaining business units. However, with the divestment of two of the five business units, there should be ample scope to reduce the overall level of corporate Head Office costs. Possibly, Kitbeco has a lower level of corporate costs and can operate this business more profitably.

At the strategic level, Homejay would need to divest Electryco in order to finance the acquisition of Makeitco, which is forecast to generate $44.6 million of value for shareholders. This is larger than the possible gain of $8.1 million that could be made by retaining Electryco.

Homejay would still have to bear the burden of warranty costs for Electryco's products sold, although this could be insured against. Alternatively, Electryco could come to some arrangement for Kitbeco to undertake repairs or replacement products. Assuming a higher than normal failure rate of, say, 5% then this could possibly cost Homejay $34 million in replacement products.

It is recommended that Homejay divests Electryco and uses the sale proceeds of $310 million to be put towards the acquisition cost of Makeitco. However, it should be noted that the amount of $310 million would be insufficient to acquire Makeitco, without the additional divestment of Cardco.

6.0 Review of Homejay: Option C – divest Cardco

Cardco's forecast cash flows are expected to grow at over 10% each year for the next two years. It should be questioned whether this forecast growth in cash flows is realistic and achievable. Even if the cash flow forecasts are correct, the business is not growing in the dynamic way that Ken Kato wants to achieve for Homejay.

The discounted cash flows for Cardco produce an NPV of $120.1 million, as shown in *Appendix 3*. The possible divestment of Cardco at around $160 million, because of its valuable high-street sites, therefore looks very attractive. If this business were to be divested, then the company would gain $39.9 million over the future discounted cash flows.

The card retailing business has not been growing rapidly over recent years and it is not a core business. Homejay has retailing skills and is best known for its DIY and furniture businesses and it is recommended that this minor business be divested now for around $160 million. The material states that two companies are interested in acquiring Cardco and perhaps if they are both keen to acquire Cardco's valuable high-street sites, the actual price obtained could be even higher than the $160 million currently indicated. They must have business plans that could achieve higher cash flows than Cardco has forecast that it could produce if they are willing to pay this price.

Additionally, the $160 million selling price is $70 million in excess of the forecast capital employed for the business. This would help to contra the adverse $40 million difference in the Electryco sale price to its capital employed, should both businesses be divested.

It is recommended that the proposed divestment of Cardco should be pursued.

The $160 million raised by the sale of Cardco could be used to finance other areas of the Homejay business, such as the proposed acquisition of Makeitco, or to repay debt.

7.0 Review of Homejay: Option D – proposed acquisition of Makeitco

Barry Milo has identified a DIY chain in the USA called Makeitco, which is looking for a cash buyer and, at present, no other companies are competing to acquire it. It also would be considered a friendly acquisition and, with the absence of other buyers, it is likely that Homejay could acquire the company for around the current valuation price of $350 million.

The evaluation of the future cash flows for Makeitco is shown in *Appendix 4*. At an acquisition price of $350 million, and re-branding costs of $10 million, Homejay could achieve a positive NPV on this acquisition of $44.6 million, if it is able to achieve synergy benefits of $5 million per year (discounted at 10%). However, the acquisition has a long payback period of around 9 years (undiscounted), which is to be expected in a business of this nature.

Perhaps a small premium would be necessary to acquire the company, which would erode some of the positive NPV of $44.6 million based on cash flow forecasts supplied by Makeitco's management. Subject to these forecast cash flows being verified by Homejay's management or its advisers, this looks to be a promising acquisition.

In strategic terms, the acquisition of Makeitco makes sense, as it is an acquisition of a company in the same retail field as one of Homejay's existing businesses, that is, DIY stores. It would also give Homejay access to the growing DIY trade in the USA. At the same time, it also provides further retail outlets in the USA for Woodyco's products. The DIY industry is growing globally and this acquisition would enable Homejay to be a global leader in this industry and would allow it to gain advantage from economies of scale and other synergy benefits.

Therefore, if Homejay feels that this acquisition is a good strategic fit to its other DIY business, Fixitco, then the acquisition should be made. However, this positive NPV could be eroded by any premium that may be required to acquire Makeitco. If the premium over the current valuation is only 10%, then the premium would be $35 million and the NPV would reduce to only $9.6 million. If the premium were greater, then this would cast doubt over the financial viability of the acquisition.

Other points to consider on the financials is whether Homejay should re-brand Makeitco stores, presumably to the brand Fixitco, and whether $10 million is sufficient to do this. The calculations also include synergy benefits of $5 million per year. It needs to be established how these synergy benefits have been calculated and operational plans would need to be put in place to ensure these benefits do accrue. Often after an acquisition, synergy benefits fail to materialise as the company finds it difficult to merge the two businesses. A further cost that Homejay may incur may be the one-off cost of merging Makeitco's stores into Homejay's portfolio, or any IT-related costs required to ensure that IT systems are compatible.

Additionally, if the price of Makeitco were to rise above $350 million, which could happen if other companies are interested in acquiring Makeitco, then the maximum that should be paid is $394.4 million, which includes the identified synergy benefits.

In summary, it is recommended that Homejay does acquire Makeitco, but at a price not exceeding $390 million. However, due to funding limitations, this could not be financed by further loans and the owners of Makeitco have indicated that they do not want shares

(even though they could sell Homejay shares on the open market) and are looking for a cash buyer. Therefore, the acquisition could proceed only if both Cardco and Electryco were to be divested.

If Electryco and Cardco were to both to be divested, then these two businesses would generate $470 million ($310 million plus $160 million). This would be more than sufficient to purchase Makeitco at around $350 million. It would also allow Homejay to undertake all of the other identified capital projects, as well as repay some of Homejay's debt. This is detailed in *Appendix 5*.

8.0 Recommendations for changes

The time is right for Homejay to make a number of strategic changes. The actual process of making these changes will signal to market analysts that Homejay is tackling its problems, which have resulted in stagnant EPS and falling share prices in recent years.

The process of re-examining its portfolio of businesses and divesting two businesses which it considers to be non-core and the acquisition of a USA-based DIY company, Makeitco, would probably be greeted with enthusiasm by market analysts. This would have a positive effect on the confidence of the market in Homejay. This should result in an increase in Homejay's share price in the short term, as the market would view that its medium-term to longer-term prospects look brighter. However, until increases in the company's EPS actually appear, the market analysts may remain cautious. Continued close liaison between Maxine Gill, and also Ken Kato, and the market analysts, is recommended to build confidence and to inform the latter of its outline plans.

It is recommended that Electryco is divested for $310 million, even though this is lower than the value of forecast future discounted cash flows of $318.1 million (but there is doubt over the reliability of the future cash flows because of pricing and quality issues). The funds generated could be put to better use to generate wealth for shareholders by acquiring Makeitco.

It is recommended that Cardco be also divested for $160 million, as this is in excess of future expected cash flows for the business.

It is recommended that Homejay acquires Makeitco for a price around $350 million. Cash raised by the sales of both Electryco and Cardco could be used to fund the cash acquisition of this company.

It is also recommended that the refurbishment programme in Fixitco be undertaken during 2004/05 at a capital cost of $45 million, and *not* deferred any longer.

Appendix 5 shows a summary of the financial effects of these recommended changes for 2004/05. This table shows that the net effect for 2004/05 is a net cash inflow of $75 million, which could be used towards other capital projects or to repay debt. The acquisition of Makeitco is broadly financed by the divestment of both Electryco and Cardco, and the capital expenditure required to refurbish the 25 Fixitco stores is available with $75 million remaining. This could be used on improving the company's IT systems or indeed for expansion of sales outlets.

The $75 million remaining for capital projects does not include the costs associated with the acquisition and divestments, nor any of the operational costs of the recommended staff changes.

While all of these changes are occurring, it is considered the wrong time to undertake the proposed corporate marketing campaign. It is recommended that each business unit's marketing budget and planned marketing activities should be reviewed, so that each business continues to market its own brands to build upon its already established brand awareness.

There are a number of organisational changes recommended. The Homejay Board needs to agree on a number of senior posts. After the posts are agreed, Catherine Barnes would need to ensure that the selection and appointment of suitably-qualified and experienced personnel are made at the earliest opportunity. It is vital that these crucial new posts are filled by people with a proven track record of delivering results in their field of expertise. The organisational changes that are recommended are detailed above in section 4.0 of this report. The new posts and organisational changes that are recommended are summarised as follows:

- Business Development Director – responsible for expanding the core businesses into different geographical areas and establishing new sales outlets for existing products;
- Operations Director – responsible for monitoring on-going operations within the business units. The business unit general managers would report to the Operations Director (instead of to the Chief Executive);
- Remove the role of Chief Executive;
- Andy Mottram, the current Chief executive, should have his contract terminated;
- IT Director – responsible for all of Homejay's IT requirements;
- Procurement Director – responsible for Homejay's procurement policy and maintaining best practice across all business units;
- A more experienced planning manager should replace the current Head of Corporate Planning Department, Paul Simpson. It is also recommended that Corporate Planning should move under the direct control of the Finance Director.

With the recruitment of an IT Director, more emphasis should be placed on improving the company's IT systems. Improved communication between businesses, and also within business units, is necessary, so that there are no more surprises at each financial year end. Improved financial forecasting systems are required so that actual results are closely tracked to internal budget, and updated forecasts and reasons for variances understood in a timely manner so that corrective action can be taken to ensure that financial targets are met or exceeded.

While much change is occurring within Homejay, it is not recommended that the company should relocate its Head Office. However, as part of the review of Corporate Head Office functions, perhaps as departments are thinned down, a logical time to move may be when the two business units (Electryco and Cardco) have been divested and Makeitco has been acquired. This move should be deferred by about two years and it would be logical to minimise the number of geographical locations that the company is operating in. Therefore, if the Head Office is to relocate, it is recommended that this could be to one of the US cities in which Homejay already operates (that is, to one of the cities where Woodyco, Cosmetco or Makeitco already has offices).

It is recommended that Homejay changes the criteria used for managers' performance-related bonus scheme, so that it is aligned with shareholders' interests. Of the two proposals made by Catherine Barnes to link it to either the company's share price or to the company's EPS, the latter is recommended. This should encourage all managers to work towards one goal, which would be to improve the company's EPS. This should, in turn, lead to increases in its share price.

It is also recommended that Head Office costs are thoroughly reviewed and that many Head Office functions are cut back or put under the direct control of each of the respective business unit general managers. The Homejay Head Office costs appear far too large

for an organisation such as this with highly devolved business units. These costs need radical trimming. Targets for cost reduction should be set for the next few years.

As part of the recommendation to move Corporate Planning under the direct control of the Finance Director, there is a need to improve the control of Homejay's planning process. The current planning process appears not to link with what is actually happening within each business. Improved communication and modelling based on historical trends is required so that plans prepared are more realistic. It is also recommended that the Head of Business Planning be replaced with a more able manager. The current Head of Business Planning, Paul Simpson, has a poor track record of producing achievable forecasts. These poor forecasts that have been communicated to market analysts have led to a lack of confidence in Homejay's ability to deliver results. As recommended above, Business Planning should move to be under the control of the Finance Director, Maxine Gill.

Once all of these recommendations have been actioned, and the two business units have been divested and Makeitco has been acquired, Homejay will become a much stronger player in its chosen markets. It will be able to start to reap the rewards of becoming a global player and could expand its furniture, DIY and cosmetics businesses into new geographical areas to improve its growth prospects.

Appendix 1

SWOT analysis for Homejay

Strengths

- Profitable business units
- Established sales channels
- Established brand names
- Repeat business from customers
- Good quality record generally (except some recent problems with some Electryco products)
- Experienced staff
- Valuable High Street sites of Cardco retail outlets
- New Chairman, Ken Kato, and his retail experience
- Control of its own manufacturing plants for the Woodyco business
- Cosmetco's profitability is growing fast

Weaknesses

- Weak management
- Slow to innovate
- Market led, rather than driving the market
- Poor planning and control systems
- Poor cost control
- Slow to react to changes in demand
- Organisation slow to change to meet the changing tastes of consumers
- Head Office corporate costs very high
- High fault level in new Electryco products
- Homejay management performance bonus scheme not aligned with shareholders' interests
- Some Electryco products not competitively priced

Opportunities

- Expansion through new sales outlets of existing brands
- Expansion geographically
- Improved IT systems should improve cost control
- Improved IT systems should identify fast-moving stock more quickly to maximise sales
- Opportunity to acquire Makeitco to enable Homejay to own retail DIY stores in USA
- Opportunity for new sales outlets for Woodyco products if Makeitco is acquired
- Opportunities to divest Electryco and Cardco
- Opportunity to rationalise Woodyco manufacturing plants

Threats

- Existing competitors (and new competitors) gaining market share from Homejay, resulting in falling sales
- Competitors with lower prices (particularly in Electryco's business)
- Competitors introducing new products more quickly than Homejay
- Electryco's quality problems could affect entire businesses if not managed promptly, which could lead to major loss of market share
- Loss of confidence in Homejay by shareholders and market analysts if Homejay is unable to increase EPS, which could lead to a downward spiral in its share price
- Could be the subject of a takeover
- Proposed corporate marketing campaign may not be a success, and high cost of campaign could erode Homejay's profitability

Appendix 2

Homejay draft budget for 2004/05 and EPS calculations

	Actual 2002/03 *\$ million*	*Latest forecast* 2003/04 *\$ million*	*Budget changes*	*Draft budget* 2004/05 *\$ million*	*Less:Head Office savings* 10% × \$330 *\$ million*	*Revised budget* 2004/05 *\$ million*
Turnover	4,290	4,510	17%	5,277		5,277
Operating costs	4,076	4,287		5,012	(33)	4,979
NPBIT	214	223	19%	265		298
Interest	64	64		64		64
Net profit after interest	150	159		201		234
Tax at 30%	45	48		60		70
Net profit after tax	**105**	**111**		**141**		**164**
Number of shares	480	480		480		480
EPS	**0.22**	**0.23**		**0.29**		**0.34**

Notes:
1. This assumes that all five business units continue.
2. Assumes that loan interest remains at \$64 million per year.
3. Assumes that the corporate marketing campaign does not proceed and that Head Office is not relocated but that savings of 10% on Head Office costs could be achieved.
4. This assumes that Homejay is capable of producing growth of 17% in its turnover and 19% growth in its net margin and that the latest forecast for 2003/04 is accurate.

Overall, the resultant EPS of \$0.34 looks very optimistic and a more reasonable EPS for release to market analysts would be between the current actual of \$0.22 and this optimistic budget of \$0.34, that is, around \$0.28. Even EPS of \$0.28 would be challenging to deliver.

Appendix 3

Evaluation of the proposed divestment of the Electryco and Cardco business units

	Year 1 *2004/05* *$ million*	*Year 2* *2005/06* *$ million*	*Year 3* *2006/07* *$ million*	*Year 4 onwards* *2007 onwards* *$ million*
Electryco				
Net cash flows	39.0	40.0	41.0	42.0
Year 4 cash flows in perpetuity				42.0/0.13
Year 4 cash flows in perpetuity				323.1
Discount rate @ 13%	0.885	0.783	0.693	0.693
DCF	34.5	31.3	28.4	223.9
Cumulative DCF	34.5	65.8	94.2	318.1
Total NPV				318.1
Potential divestment price for Electryco				310.0
Decrease over future expected cash flows				(8.1)
Cardco				
Net cash flows	16.0	18.0	20.0	20.0
Year 4 cash flows in perpetuity				20.0/0.16
Year 4 cash flows in perpetuity				125.0
Discount rate @ 16%	0.862	0.743	0.641	0.641
DCF	13.8	13.4	12.8	80.1
Cumulative DCF	13.8	27.2	40.0	120.1
Total NPV				120.1
Potential divestment price for Cardco				160.0
Increase over future expected cash flows				39.9

Appendix 4

Evaluation of forecast cash flows for the proposed acquisition of Makeitco

	Year 0 *2003/04* *$ million*	*Year 1* *2004/05* *$ million*	*Year 2* *2005/06* *$ million*	*Year 3* *2006/07* *$ million $*	*Year 4 and annually thereafter* *$ million*
Makeitco					
Net cash flows	(350.0)	33.0	34.0	35.0	36.0
Synergy benefits		5.0	5.0	5.0	5.0
Year 4 cash flows in perpetuity					41.0/0.10
Year 4 cash flows in perpetuity					410.0
Rebranding costs	(10.0)				
Total cash flows	(360.0)	38.0	39.0	40.0	410.0
Discount rate @ 10%	1	0.909	0.826	0.751	0.751
DCF	(360.0)	34.5	32.2	30.0	307.9
Cumulative DCF	(360.0)	(325.5)	(293.3)	(263.3)	44.6
Total NPV	44.6				
Payback (undiscounted)	9 years				

Appendix 5

Summary of the financial effects of the recommended changes for 2004/05

	Financial effect of changes in 2004/05 $ million
Refurbishment of 25 Fixitco stores	(45)
Divestment of Electryco	310
Divestment of Cardco	160
Acquisition of Makeitco	(350)
Net cash inflow for 2004/05 towards other capital projects or to repay debt	75

Notes:

1. The cost of the acquisition of Makeitco could be greater than $350 million if a bid premium is paid, which would reduce the net cash inflow for 2004/05.
2. This does not include the costs associated with the acquisition and divestments, nor any of the operational costs of the recommended staff changes.

Appendices

Summary of the Appendices:

Appendix 1 – IRS Ltd. (November 2001)
Appendix 2 – Ofood4U (May 2004)
Appendix 3 – Mayah Group of Hospitals (November 2004)
Appendix 4 – ReuseR and NOW (the first TOPCIMA exam in May 2005)

Appendix 1 – IRS Ltd (November 2001)

IRS Ltd – Pre-seen material

Historical overview: IRS Ltd as a sideline

Intelligent Refrigeration Systems (IRS Ltd)[1] was founded in 1992 by three friends, Charan Dill, David Thomas and Alex Watt, all of whom had worked with the same family-owned electronics company based in Glasgow – CE Ltd. This company was beginning to show signs of running into difficulties, and David had recently been made redundant from CE Ltd. Charan and Alex also saw that their future employment was in jeopardy. IRS Ltd was set up initially to provide an additional source of income and potential security for the three friends, and operated from Alex Watt's home.

At the outset, work was sourced from a family contact that Charan had in Malaysia, Mohammed Khan. IRS Ltd designed and manufactured (through a sub-contractor) burglar alarm systems and energy-saving devices for hotels, on behalf of Khan. The income from this business quickly became sufficient to support the founders. Charan and Alex then left CE Ltd to work full-time at IRS Ltd. David resigned from his post with a local engineering company to join them full-time.

IRS Ltd takes off

Charan saw an opportunity to take advantage of the problems that their former employer was having and to pick up work from its existing customer base. IRS Ltd concentrated its efforts in this area and on one sector: temperature controls for most of the major refrigeration Original Equipment Manufacturers (OEMs). The approach that Charan took was to work at developing a strong relationship with potential customers, so that IRS Ltd was seen, not merely as a supplier, but also as a partner who was able to work on joint developments and act as a solution provider. However, it took until 1994 to get the first order from one of the large OEMs, which was then followed by orders from many of the other OEMs, who were customers of CE Ltd.

At the stage where this new business began to take off, the founders decided to withdraw from the sub-contract work for Khan. Nevertheless, Khan continued his support for IRS Ltd, maintaining his investment in the company and continuing to guarantee the bank facilities. By 1995, IRS Ltd was achieving sales of just over £1 million from the refrigeration case OEMs that supplied UK supermarkets. In essence, what IRS Ltd had achieved was the replacement of traditional electromechanical temperature controls in refrigeration cases, with electronic temperature controls. However, IRS Ltd was not alone, as four competitor companies were also operating in the UK market.

The birth of Innate

Charan, however, saw that there was scope for developing more sophisticated control mechanisms because of the electronic content of the new generation of temperature controllers. He foresaw an ability to link each refrigerated case electronically to provide a centralised monitoring function, but to do this IRS Ltd would need to be independent of the OEM case manufacturers. IRS Ltd would still supply the temperature controllers to the case manufacturers, but could potentially benefit from developing a relationship with the end user – the supermarket.

Charan Dill was introduced to the technical manager of one of the large supermarket groups by a contact within a major US supplier to that supermarket. In the course of a discussion with the technical manager, Charan was made keenly aware of the extent of market dominance achieved by one of his main competitors, CML, the established leader for control systems – "it was the

[1] The company was originally registered as Intelligent Systems (IS) and changed its name to Intelligent Refrigeration Systems (IRS Ltd) at the end of 1993.

brand leader of control systems". However, the control systems were supplementary to the controllers built into the original cases. IRS Ltd began to develop an alternative alarm and control system using existing controllers, which the supermarkets had already bought and installed. A similar concept had been tried successfully by another rival, JKL, but was specific to another large supermarket group.

Charan saw an opportunity to create for IRS Ltd, as a specific branded product, a system capable of being used by any supermarket, and so the IRS Ltd Innate system was born. He chose the name "Innate" to signify the nature of the electronic alarm and control system. The system would be dormant until it detected a fault and would then activate itself only to warn of a temperature problem.

IRS Ltd would design and manufacture its own alarm and control system capable of working with the existing controllers installed by supermarkets. To do this, Charan entered into an agreement with the supermarkets so that IRS Ltd could be provided with sample controllers, around which IRS Ltd could design a system for each customer. This meant a great deal of varied development and engineering work to suit each supermarket group but it gave IRS Ltd the opportunity to sell to the whole supermarket business sector rather than to a single supermarket group. The first Innate sale was made in 1997 and over the next two years, IRS Ltd successfully sold Innate to almost all of the major supermarket groups in the UK, resulting in rapid growth for IRS Ltd.

Rapid growth through product development

The Innate system rapidly became the main part of the business of IRS Ltd although the manufacture of controllers for OEMs still continued. Its major competitor JKL was taken by surprise as it had held its dominant position for so long. However, JKL could not respond quickly because of the significant investment in its client-specific control system. Charan's obsession with customer service led to the creation of separate account managers for each customer. He explained to customers that *"every time you fall there will be an IRS Ltd person to catch you"*.

Each supermarket group supplied IRS Ltd with one of its cabinets fitted with temperature controllers. IRS Ltd project teams then developed a specific Innate alarm and control system for that cabinet system, which could then be fitted to all of the cabinets used by that supermarket. This process, while giving IRS Ltd its principal competitive advantage, did mean that a number of production issues arose. Each project team had to source the components needed for the Innate system it was developing to match the controllers used by the various supermarkets. Sourcing of components by the purchasers within the production department took place, not only in the UK, but also in Malaysia and Japan, helped by the contacts of Mr Khan.

Quality issues emerged, based on the continued prototyping of systems and parts for the various cabinet systems used by supermarkets. Forward buying of parts was difficult, as prototypes had to be tested on site before any major order was placed by the supermarket. In addition, specifications were always being changed, as the supermarkets sought ever more sophisticated monitoring of their cabinets. Each Innate system comprised a wide range of bought-in components complemented by specific alarm and circuit designs developed by IRS Ltd engineers. Once the client had approved the prototype Innate system, it would then be moved into the production area for large volume assembly. This assembled equipment then became the Innate system "box" which would then be connected on site, by IRS Ltd engineers, to the refrigerated cabinet.

The activities that related to selling the Innate system (which generated the need for very detailed specifications) coincided with the decisions taken by supermarkets to downsize their engineering functions – even though supermarkets were becoming more complex. Through the use of account managers, IRS Ltd was in continuous contact with the end user and able to determine customers' changing needs.

In order to demonstrate its commitment to developing Innate with its customers, IRS Ltd set up its own engineering development and support function, with both hardware and software engineers. This commitment, while relatively expensive (4% to 5% of turnover) enabled IRS Ltd to work so closely with its customers that it became an integral part of the store design and refit

planning teams. This resulted in IRS Ltd products being specified by the supermarkets. The main refrigeration contractors were forced to come straight to IRS Ltd at the outset of any new-build or refit and the company's growth continued apace.

The company's product range has successfully grown to comprise:

- Innate – the supermarket control system;
- GDS – a gas detection system – an add-on to Innate to detect leaks in refrigeration systems;
- "Plastic chicken" – an add-on to Innate used to monitor conditions in chiller cabinets;
- OEM controllers – individual controllers and panels for case manufacturers.

As indicated, the Innate system had quickly become the mainstay of the revenues of IRS Ltd. Sales of Innate systems now represented approximately 80% of IRS Ltd total sales. Each Innate system fitted in a store would cost a supermarket between £40,000 and £50,000 depending on whether any additional systems were fitted such as the gas detection system (GDS) or the "plastic chicken".

A failed opportunity

However, not all new product developments have been successful. In 1997, IRS Ltd invested in the Sato Corporation, to develop and market stand-alone thermometers for the consumer and gift markets in Japan. This was based on a modification to existing thermometers used in refrigeration cases. Charan was a keen traveller to Malaysia for meetings with Mr Khan and to Japan where Khan had many business interests. The Japanese are very conscious of quality and innovation and like all kinds of "electronic gadgets". Charan thought he could use his recently-developed technology in a synergistic way and gain, not only additional business, but also a foothold in this major market. However, it quickly became apparent that the company had no experience of selling in consumer markets, local management was ineffective and not controlled to any extent from Glasgow. The business was abandoned in late 1998. IRS Ltd lost the original investment of £120,000 and a further £135,000 owing for products supplied for this unsuccessful venture.

Moving on

Charan continued to have plans for IRS Ltd. He envisaged IRS Ltd developing in the direction, not just of energy-efficient refrigerator cabinets, but also towards "intelligent systems" of all kinds, that involved the operation and monitoring of electric motors.

The Founders

Charan Selvarai Dill

Charan helped found IRS Ltd when he was 31. Born in Malaysia, he followed a well-trodden educational path, coming to the UK to attend university after leaving school. Charan graduated with an Electrical Engineering degree from Glasgow University in 1984. During summer vacations, he worked for a family business in Largs, on the West Coast of Scotland, servicing and repairing refrigeration equipment. After graduating, he was offered a place at university to study for a MSc in Refrigeration. He did not take up this place, joining instead a Glasgow-based family-owned electronics company, CE Ltd. Here he met his co-founders David Thomas and Alex Watt.

Charan "always had ambition for achievement", although not necessarily to have his own business. His father had moved from India to Malaysia and, as well as pursuing a career in the Civil Service, had created significant wealth as a property developer. The influence and support of Khan, a family friend in Malaysia and a very wealthy businessman, has also been significant. Charan is married with two children and his wife accepted the long hours that he had to work as

IRS Ltd became established. For Charan, the business is twenty-four hours a day, seven days a week. In the early days of IRS Ltd, Charan drove between 70,000 and 100,000 miles a year developing relationships with clientele.

As the sales force became established, this reduced to 30,000 miles and subsequently to an average annual mileage of 12,000. However, he now flies some 250,000 miles a year: twice a week to London to see customers and once a month to the Far East to develop new business ideas. *"I don't waste time on the road any more"*. Charan says that he has never had a sleepless night and *"can switch off from IRS Ltd at will"*. However, as soon as he gets up in the morning he is thinking about IRS Ltd, using his "showertime", which can be anything up to an hour, to plan out his day in response to the previous day's events.

Alex Watt

Alex Watt was 38 when IRS Ltd was established. Son of a Glasgow bank manager, Alex was educated at Grammar School, and he too obtained an Electrical Engineering degree. He entered the Scottish Electrical Training Scheme and joined EP Group Ltd as a designer. After a year, he went to South Africa with an EP Group company where he worked for four years as an electrical engineer. After getting married, he returned to Glasgow in 1984 to work for CE Ltd as a designer. Over the next few years, Alex was involved in the design of a very wide range of electronic devices and also trained Charan, who had subsequently joined CE Ltd.

In contrast to Charan's desire for achievement, Alex had no such ambitions. *"I would have been happy to retire at CE"*, Alex reported to David Thomas at the time that the three founders were thinking about starting IRS Ltd. When David was made redundant, Alex began to worry about his own position and agreed to set up IRS Ltd. Early operations were based in his son's bedroom, to carry out work for Khan, while he and Charan were still employees of CE Ltd. Both Alex and Charan could see the problems growing with their employer and Charan persuaded Alex that they should take IRS Ltd seriously.

Alex finally had a major disagreement with CE Ltd's family board members about the way the company was run, and resigned. Alex decided to pursue the IRS Ltd opportunity, as it was *"easier to do than to hawk myself round the marketplace"*.

He also believed that having his own business could make him rich.

David Thomas

An engineering and economics graduate of Cambridge in 1978, David Thomas joined Siemens AG in Germany as Project Engineer, where he was involved in the design of electrical equipment including motors, drive control systems, and switchgear. David was seconded to Siemens (India) in 1987, to manage a contract with a state-owned electrical company. His role became less technical and more commercial and he became responsible for customer liaison and commercial negotiation, as well as technical support and training. In 1989, he returned to the UK and joined CE Ltd as a senior hardware design engineer.

His role developed to include responsibility for all new product design, and management of the design team, which included Alex Watt and Charan Dill.

David was made redundant by CE Ltd prior to the formation of IRS Ltd, and worked as a design engineer for another small electrical engineering company before agreeing to join Alex and Charan at IRS Ltd. He was then 36.

Development of IRS Ltd

At the start of IRS Ltd, the three founders were equal partners and shared in the management of the company. They naturally tended towards their areas of experience and interest: Charan took on the sales and customer service role; Alex the technical design role; and David the production and administration role. This very democratic management process lasted until 1998 when,

following a review by a national firm of management consultants, Charan was formally appointed Managing Director, with David as his key lieutenant and Production Director.

With the growth of the company, Charan had moved from being involved in almost everything and doing a lot of detailed work, to being more of a strategist: *"I do the thinking and someone else will do the work"*. Within a year, Charan was thinking on a grander scale, and his more immediate plans now covered a two-year period rather than a two-week period. However, he felt that as the company was successful and growing at a faster and faster rate, the rest of the team was not keeping pace with him. He was inevitably becoming more dictatorial in style – *"there was no time to bring everyone along"*. Alex and David seemed to accept this change in Charan – *"we trusted him"*.

Management structure

Gradually, key managers were appointed and made directors of the company. The board now comprises:

Charan Dill	*(Chairman and Managing Director)*
David Thomas	*(Production Director)*
Alex Watt	*(Projects Director – no functional responsibility)*
Andrew Wilson	*(Technical Director)*
Paul Hunter	*(Marketing (Sales) and Customer Services Director)*
M H Khan	*(Director – Non-executive)*

There is also Ian McCallum, Customer Service Manager, who reports to Paul Hunter, and a non-executive Financial Consultant, Joe Halley, who helps to advise on financial matters, although Khan, who is himself an accountant by training, provides most of the advice on finance. Indeed, from the very start of IRS Ltd, he has insisted on proper management accounts as part of a formal management process within the company. The management structure is shown as Exhibit 4 *(on page 12)*.

The organisational structure at IRS Ltd is based on a combination of a functional structure with an enabling framework which allows staff to move across functions into project teams. Teams were essentially created in a matrix format across functional lines, with individuals free to move within and across teams and functions, based on project requirements. Basically, a project team is formed to deal with the development of an Innate system for a supermarket client. The majority of the members of a project team will come from engineering led by Andrew Wilson, and production led by David Thomas, with direct involvement from the Marketing and Customer Service department led by Paul Hunter. In this system, Alex Watt has responsibility for the "critical path" management of each project. Charan worked within the marketing element of the project as required, helping to motivate the project teams towards completion.

Charan was proud of this system. For him, it was the modern way of doing things. He wanted the workforce to have a flexible attitude to tasks. He did not want them to see themselves as engineers or production people solely, but as members of a team working to give clients the solutions they paid for. This approach was in line with Charan's anti-union views and in the way he rewarded his employees. Although his hourly rates were not as high as those offered by some of his competitors, many of his workers, who had left for a higher hourly rate, returned to IRS Ltd on the basis of higher level of pay determined by bonus and overtime payments. Charan was happy to welcome back these employees.

Financial profile

The financial profile for IRS Ltd for the period 1996 to 2000 is provided as Exhibits 1, 2 and 3 *(on pages 8 to 11)*.

IT systems

IT systems in place included:

- a financial accounting system, incorporating integrated sales and purchase ledgers, running in DOS and storing data in a non-relational database;
- relatively new computer-aided management (CAM) systems to help control the production of Innate products;
- basic human resource/personnel database management systems running in Windows;
- customer contact database accessible from head office providing dial-in access.

The focus by IRS Ltd on customer service tailored specifically to each supermarket's requirements meant that each project team tended to purchase and install hardware and software specific to the requirements of that project.

By the end of 1999, many of the IT systems were relatively old and in need of replacement.

The next stage of development

Charan was excited about the prospects for IRS Ltd and he was eager to tell David and Alex and other members of the management team about these during their next scheduled meeting.

IRS Ltd – Exhibit 1

Profit and loss account information (unpublished) for year ended 31 December

	2002 Draft budget UK only	2001 Latest estimate	2000	1999	1998	1997	1996
	£000	£000	£000	£000	£000	£000	£000
Turnover	15,200	13,100	10,343	7,000	5,965	4,408	2,767
Cost of sales	11,250	9,850	8,004	5,223	4,351	3,287	2,004
Gross profit	3,950	3,250	2,339	1,777	1,614	1,121	763
Administrative expenses	3,100	2,800	1,952	1,340	1,147	765	675
Other operating income	30	30	30	27	12	28	19
Operating profit	880	480	417	464	479	384	107
Exceptional items *(Note 1)*	Nil	100	48	149	255	Nil	Nil
Interest payable	250	230	150	128	156	77	29
Profit before taxation	630	150	219	187	68	307	78
Taxation	200	50	84	74	24	96	38
Profit after taxation	430	100	135	113	44	211	40
Dividends	Nil	Nil	Nil	Nil	Nil	Nil	Nil
Retained profit	430	100	135	113	44	211	40
Number of employees	*200*	*182*	*130*	*102*	*87*	*67*	*42*

Notes to Exhibit 1

1. Exceptional items in 2001, 2000 and 1999 relate to obsolete stock being written off.
The exceptional item in 1998 is the cost of the failed investment in Sato Corporation.

2. New data for 2001 and 2002 has been added in the shaded columns. The information for 1996 to 2000 is unchanged.

IRS Ltd – Exhibit 2

Balance sheet information (unpublished) at 31 December

	2002 Draft budget UK only	*2001 Latest estimate*	*2000*	*1999*	*1998*	*1997*	*1996*
	£000	*£000*	*£000*	*£000*	*£000*	*£000*	*£000*
Fixed assets:							
Tangible assets	1,745	1,545	1,363	886	840	305	153
Investments	5	5	5	Nil	Nil	120	Nil
	1,750	1,550	1,368	886	840	425	153
Current assets:							
Stocks	1,800	2,000	1,341	989	964	608	348
Debtors	2,800	2,750	1,999	1,508	629	1,149	461
Investments	Nil	Nil	70	46	23	Nil	Nil
Cash	Nil	Nil	38	1	41	Nil	11
	4,600	4,750	3,448	2,544	1,657	1,757	820
Creditors: amounts falling due within one year	(4,068)	(4,448)	(3,288)	(1,983)	(1,295)	(1,487)	(651)
Net current assets	532	302	160	561	362	270	169
Total assets less current liabilities	2,282	1,852	1,528	1,447	1,202	695	322
Creditors: amounts falling due after more than one year	(1,000)	(1,000)	(764)	(818)	(698)	(230)	(70)
Provision for deferred taxation	Nil	Nil	(12)	(12)	Nil	(5)	(3)
	1,282	852	752	617	504	460	249
Capital and reserves:							
Share capital	50	50	50	50	50	50	50
Profit and loss account	1,232	802	702	567	454	410	199
	1,282	852	752	617	504	460	249

Note: New data for 2001 and 2002 has been added in the shaded columns. The information for 1996 to 2000 is unchanged.

Exhibit 2 (continued)

Notes to balance sheet information

1. There were significant fixed asset additions during 1998, principally new premises at a cost of approximately £570,000. Total tangible assets in 2000 are now £1·36 million and include the value of premises, plant and equipment owned by the company and all finance leases.

2. Shareholding in 1996 reflects changes in 1995 when a further 20,001 shares were allotted as fully paid as a bonus issue out of reserves.

	1996	*1995*
Charan Selvarai Dill	11,667	7,000
Alex Watt	11,667	7,000
David Thomas	11,667	7,000
M H Khan	15,000	9,000
	50,001	30,000

IRS Ltd – Exhibit 3

Financing information (unpublished) at 31 December

	2002 Draft budget UK only	2001 Latest estimate	2000	1999	1998	1997	1996
	£000	£000	£000	£000	£000	£000	£000
Bank overdraft	1,268	1,998	1,156	542	518	393	Nil
Bank loans	1,000	1,000	635	737	665	163	Nil
Other loans	Nil	Nil	Nil	Nil	Nil	150	41
Finance leases are included in bank loans in 2001 and 2002	–	–	291	154	61	100	55
	2,268	2,998	2,082	1,433	1,244	806	96
Less cash	0	0	38	1	41	Nil	11
Net external finance	2,268	2,998	2,044	1,432	1,203	806	85

Notes:

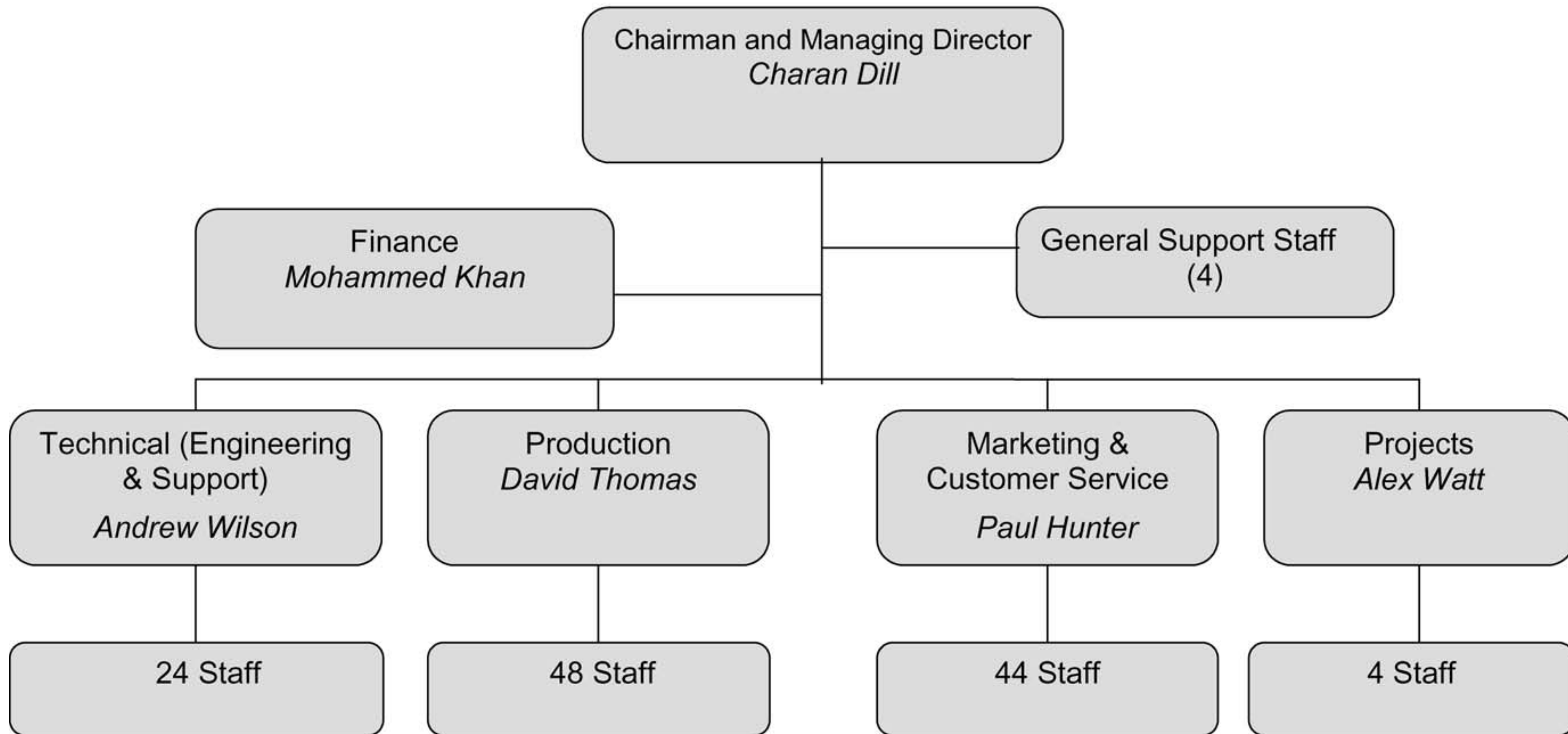
1. **The split between bank overdraft and bank loans in 2001 and 2002 is an estimate.**

2. **New data for 2001 and 2002 has been added in the shaded columns. The information for 1996 to 2000 is unchanged.**

IRS Ltd – Exhibit 4

UPDATED BY EXHIBIT 5 ON PAGE 19

IRS Ltd Management Chart



IRS Ltd – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 14– 19.

Exhibits 1, 2 and 3 on pages 8 – 11 have data for the years 2001 and 2002 added to the pre-seen material, but the pre-seen material on these Exhibits is unchanged.

Exhibit 5 provides a revised board and management structure and is given on page 19.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are a management consultant retained to advise the board of IRS Ltd on the Managing Director's 2009 vision. The board of IRS Ltd requires a report which includes the identification of key issues, feasibility (including financial viability), and recommendations for appropriate management actions. Within the overall context of the report on the 2009 vision, the board is particularly concerned that the issues relating to the earlier years 2002 to 2004 are addressed.

IRS Ltd – Unseen material provided on examination day

The next management meeting

Charan Dill switched the overhead projector off and asked for comments. He looked around the room. There was a stunned silence. Not one of the directors wanted to make the first move. Charan had just presented his vision: *"to grow IRS Ltd into a £100 million turnover company by the end of 2009"*. My *"end of decade blockbuster"*, he called it. Charan had outlined the targets for the growth of Innate and the OEM (Original Equipment Manufacturer) business, and had talked excitedly about new developments. Paul, Andrew and Ian looked excited; David and Alex, however, had seen this all before with the failed Sato venture.

Alex and David are becoming increasingly concerned about the general management of the company. It is growing too quickly. David feels that he does not have the experience of running anything but a small company. Everyone seems to be fire-fighting and dealing with an increasing number of quality problems. *"No-one is in control"*, was David's frequent remark. Alex is also concerned about the issue of signing yet another bank guarantee.

Neither Alex nor David wants to dampen Charan's enthusiasm; after all they would not be there now were it not for his drive and determination. Nevertheless, they feel that they need to sit down with Charan and Khan (the company's external Malaysian investor), talk frankly about their

fears and set out formal action plans to ensure that IRS Ltd makes progress towards the £100 million objective.

The new strategy

Charan outlined that the growth of IRS Ltd to a £100 million company by 2009 was based on product and new market development. *"Already IRS Ltd would reach £13 million of sales in the current year in the UK. However, because of the strong penetration rate of IRS Ltd products in the UK supermarkets, it is not going to be easy to build the UK market sales significantly higher on the basis of the existing product range."* Charan continued with his strategy outline, spelling out the move of IRS Ltd into the heating and ventilation controls business so as to offer what he termed *"total building management control – or TBMC"*.

"The major UK supermarkets want the ability to save costs as well as giving their customers a better shopping environment. Even a small change in overall store temperature involves the cabinets using additional electricity to regulate temperature. This can cost a lot of money when multiplied across the stores. We can get a contract of £130,000 to £150,000 per store for the TBMC as opposed to just £40,000 to £50,000 for the Innate system. The present technology is boring technology. Food loss still occurs and costs the big supermarket groups many millions a year in perished goods. Maintenance and alarm calls also cost substantial sums."

Charan continued: *"As you all know, we are just about the biggest refrigeration control systems company in the UK. We cannot get much in the way of real growth from an acquisition strategy in the UK and any acquisition would just not be worth the trouble. I am therefore proposing a growth strategy based on global expansion. We are going to move into the US and European markets with our building control range of products. This will take us to the next level of technology with freezer controllers and other devices that talk to each other. I believe that the US market offers us the potential to reach sales of at least £40 million to £50 million by the end of the decade. The European market offers sales potential of just around half of the US market. If we can grow the European market to around £25 million and increase the UK sales from £13 million to £25 million, we will be a £100 million company by the end of the decade."*

The US market

IRS Ltd already had an informal alliance with a major US-owned OEM which operates in the UK. Charan indicated that with its recommendation, a provisional agreement had been made with a major US supermarket group, Atlantic and Pacific (A&P), to install Innate systems in a number of its stores. Once the Innate system proved itself to A&P management, the aim was to sell the TBMC to A&P and to other large supermarket groups.

A&P had a major presence in both the east and west coast states of the United States. IRS Ltd would therefore need to open support offices in both California and New England to support this new client. *"We need to be able to offer the same overnight support and maintenance service to A&P that we currently offer to our UK customers. If this works well, we will have a number of these support office facilities located near major hub airports in the US. There is a lot to learn about this market, and the experience we get with A&P will tell us a great deal about the logistics of selling into, and supporting, the US market. Too many British companies have failed to make the grade in the US for us to take this lightly."*

The European market

The European market was then covered by Charan in his presentation. He outlined the nature of the contacts developed by Paul Hunter. Again, the strategy was to make a breakthrough with one major European supermarket group, and from that to demonstrate to the others the quality of service that IRS Ltd could provide. However, Charan did not feel that IRS Ltd could, at least initially, cope with an expansion into both the US and Europe at the same time. *"We will open the formal dialogue with our European contact some time in 2002, once we see how the US strategy is developing."*

The UK market

Charan repeated his view of the UK market as one which offered limited growth compared to the US. *"It is, however, our core business"*, he said. Charan outlined the aim to double sales in value terms over the period of the 2009 strategy. This would involve selling the existing range of products, with the gradual introduction of TBMC to the UK supermarkets. *"It is likely that the supermarkets will only see the value of installing the TBMC in their larger stores. However, by 2005 we aim to have annual sales of 30 systems, accounting for approximately 25% of the total sales in the UK and for this to gradually increase over the period of the 2009 strategy to 40% of the total UK sales of IRS Ltd."*

Charan then provided a review of the projected outcome for 2001 and the estimated sales for 2002 for the UK. **[These are shown in the additional (shaded) columns in Exhibits 1, 2 and 3 *(see pages 8 – 11)*.]** *"As you can all see, we are on course for a good year despite some difficulties in the general economy. Thankfully we are in a strong sector of the economy and that should see us in good heart for the exciting period to come."*

The financial strategy

Charan then asked Joe Halley to take over. Halley had been brought in to the business in 1999 as a consultant. He had an accounting background, had worked for a number of major international consultancies in the financial systems area and had a good reputation in the investment banking business. In his short time at IRS Ltd, he had so impressed Mr Khan and Charan that they had recently hired him as the new Financial Controller. Charan indicated that Halley would also have responsibility for the implementation of a new IT strategy.

Halley indicated that the initial cost of the IRS Ltd 2009 strategy, for the first two years of operation in the US market, was estimated at £2 million. These costs were additional to the normal sales support and engineering costs associated with every order. The greater part, £1·4 million, would be incurred in 2002, and the balance of £0·6 million in 2003.

The US presence would involve a small team of engineers, six in total, moving to the US to support the IRS Ltd equipment installed in A&P stores. These engineers would travel to any store as required and deal with any problem in the same speedy way that alarm and control problems are dealt with in the UK. This would mean IRS Ltd maintaining a stock of parts and accessories in each of their support locations. The marketing arm of IRS Ltd would involve two people initially, one servicing the east coast states and the other in the west. They would be supported directly from the UK.

The £2 million would be funded through the issue of equity to the venture capital arm of a bank. The bank would then hold a minority shareholding in the company. The venture capitalist had indicated agreement to provide further funding in 2005, assuming satisfactory performance.

Joe Halley continued: *"We are seeking sales in the US of £2 million from 40 Innate systems in 2002. In 2003, a further 40 Innate systems would be sold to A&P, again at £50,000 each, plus 24 TBMCs at £150,000 each. Once A&P see the benefits of the TBMC package, then the sales of Innate systems would gradually be phased out with A&P. With the TBMC proving itself to A&P, we can build sales in the US of the larger system with other supermarket groups. The Innate system will really only come into play as a starter package for some stores or as a more economic option in the small outlets whose selling space does not warrant the larger system."*

Joe Halley presented a slide of the total sales forecast for the years 2002 – 2004:

Year	*UK Innate*	*USA Innate*	*USA TBMC*	*Total*
	£000	*£000*	*£000*	*£000*
2002	15,200	2,000	Nil	17,200
2003	16,300	2,000	3,600	21,900
2004	17,400	2,000	9,000	28,400

He commented that the draft UK budget details for 2002 [shown in the Exhibits] had been prepared by the various individual managers and had not yet been reviewed. However, the sales shown in the draft UK budget and all of the other sales forecasts shown in this slide were fully in line with the overall strategic vision.

For simplicity, all UK sales have been assumed to be of Innate systems – sales of all other products will be relatively minor. Pilot sales of TBMC in the UK in 2003 and 2004 have been ignored.

Halley followed this with a slide comparing margins and operating profits **per unit of product, based on his assessment of current and planned performance:**

Effect on profit of manufacturing and selling 1 additional unit:

		UK Innate		*USA Innate*		*USA TBMC*
	% of selling price	£	*% of selling price*	£	*% of selling price*	£
Selling price		50,000		50,000		150,000
Cost of sales	75	37,500	75	37,500	50	75,000
Gross profit	25	12,500	25	12,500	50	75,000
Administration	20	10,000	20	10,000	20	30,000
Operating profit per additional unit		**2,500**		**2,500**		**45,000**

Halley continued by saying that *"debtor behaviour in the US is much better than that in the UK. In the US, the pattern is for prompt payment with debtors paying in half the time taken by UK supermarkets. This outweighs the extra stocks needed."* He illustrated this:

Effect on working capital of manufacturing and selling 1 additional unit:

		UK Innate		USA Innate		USA TBMC
	Days	*£*	*Days*	*£*	*Days*	*£*
Debtors	65	8,904	33	4,521	33	13,562
Stock	72	7,397	102	10,479	102	20,959
		16,301		15,000		34,521
Less creditors	91	9,349	91	9,349	91	18,698
Extra working capital required per additional unit		**6,952**		**5,651**		**15,823**

The effect on working capital can be summarised as:

Effect on working capital of additional sales:

	UK Innate	USA Innate	USA TBMC
Extra working capital required, as a % of sales	**13·9%**	**11·3%**	**10·5%**

Halley continued: *"IRS Ltd will need to make further major investments in 2005, but we expect the venture capital arm of the bank to help us to fund £2 million to £3 million of investment then. Half of this investment will be used to double our factory capacity to service the growth in sales, and the other part of the investment will go in further support measures, including additional bases.*

In each of the years 2002, 2003 and 2004, the increase in fixed assets will be £200,000."

IT issues

Charan then took over the presentation by describing his concept of the IT support system for the enlarged company. *"We have to be able to support our engineers in the field wherever they are. They need direct dial-in access to be able to order parts and equipment from on site straight through to us. We also need to be able to monitor the performance of our equipment on a twenty-four hour basis. Our client supermarkets need the same facility."*

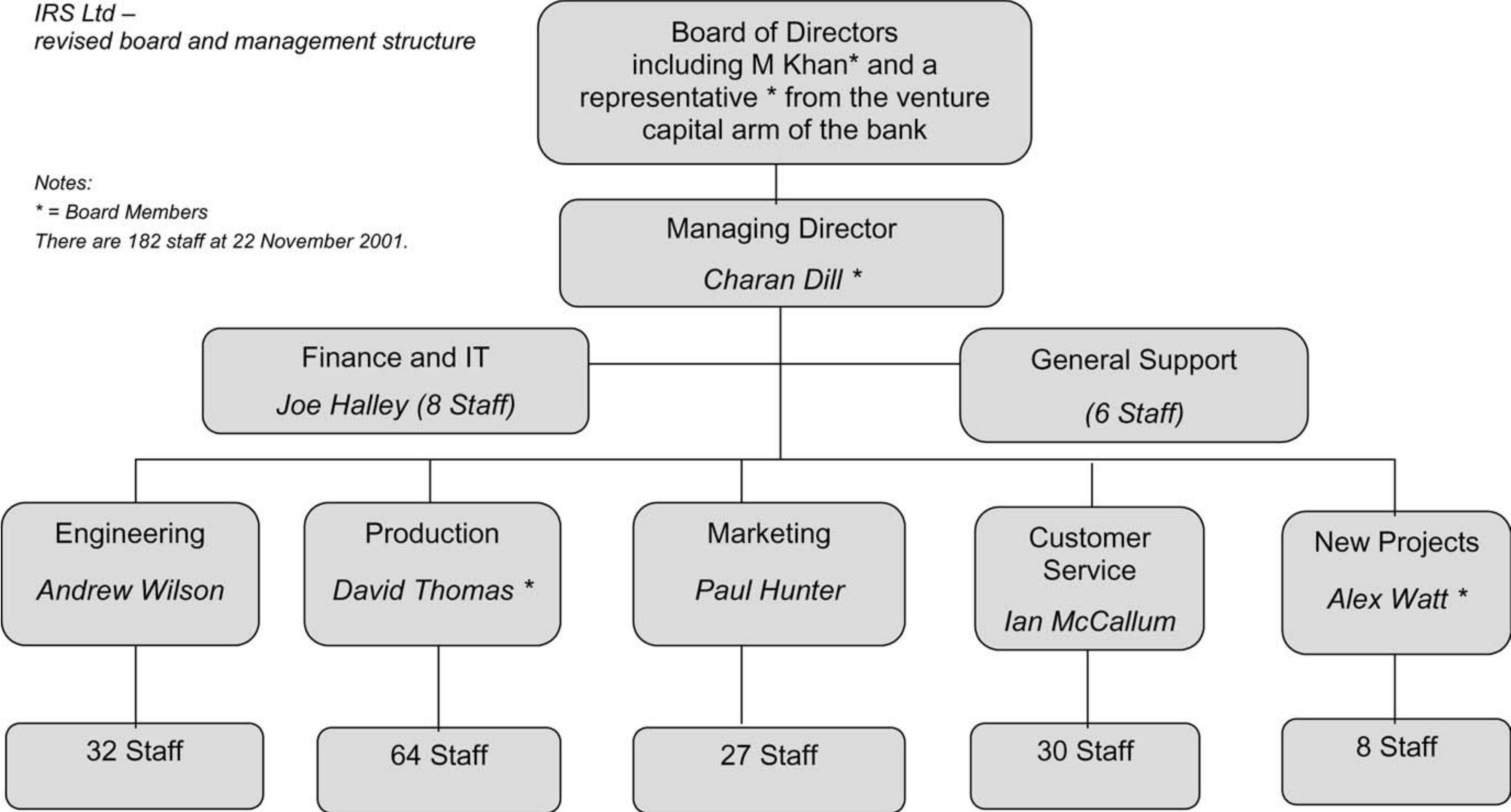
Joe Halley commented: *"This is one element of the IT provision for the company. What is needed is a clear IT strategy for the future that accommodates our development plans."*

Management structure

Charan then moved on to outline his ideas on the structure for the business.

"In order to implement the 2009 strategy, we need to build on our existing structures which have served us well. Over the last few weeks, I have discussed the operation of the individual

IRS Ltd – Exhibit 5



functional areas with each of you and this is how I see the structure that will take IRS Ltd forward."

Charan then displayed a slide of the chart shown on page 19 as Exhibit 5 and stated: *"With this new structure I want to introduce a clearer role for the board, which will involve changes. The board will comprise Mr Khan, David, Alex and myself with someone from the venture capital company. It will be tasked with making sure we keep IRS Ltd sound both strategically and financially throughout the course of implementing the new 2009 vision."*

The Facilitator's Answers for Management Accounting – Case Study

Initial Notes

This answer is substantially longer than would be expected from a good candidate in the time available. It has been prepared to show the range of possible comment that could be made on the various issues in the case, and to provide a guide for candidates and for future teaching purposes.

Objectives of the case

The basic theme of this case is to illustrate how an individual with specific market knowledge can, by hard work and the force of personality, quickly build up a sizeable manufacturing business from a zero base. Once that business has stabilised and development opportunities exist, the skills required, and the role of the main driving force of the business may need to alter. New problems will also emerge as markets mature.

The case identifies the problem of a business leader with strong ideas for growth contrasted with the problems of funding the significant development envisaged, linked to the need to both delegate and develop a management team to take the business forward.

Synopsis

IRS Limited was started by three friends who worked in a family-owned electronics company. The company got into difficulties and the three were faced with redundancy and decided to act. As a result of strong leadership from one of them, Charan Dill, opportunities were spotted to obtain business from large organisations. The three friends had very little in the way of personal resources and were fortunate that Charan had a close family friend, Mr Khan, based in Malaysia who was a successful businessman in his own right. Mr Khan both provided work for the new business and the necessary bank guarantees to develop it.

By virtue of hard work by all three partners, the influence of Mr Khan, and the customer relations which Charan Dill developed, IRS quickly grew to £10.3 million turnover in 2000.

In common with many other fast growing businesses, such growth brings with it new problems. This was the case with IRS. The pace at which Charan Dill wished to go in the future alarmed the other two partners. At the same time, the need to bring in professional management to the business was identified as the complexity of the business grew. The role of Charan Dill, and his possible relationship with his existing and expanded management

team, coupled with the additional involvement of the external investor Mr Khan, added to the complexity of the situation. The company had developed, but had also made a number of major errors.

The future of IRS may not be as assured as first impressions would suggest. The financial performance of the business also gives cause for concern.

Case focus

The basic focus of the case is the study of the development of the business and the role played by Charan Dill as the driving force in this business. Charan is totally dedicated to developing the business with a vision for the business that is considered by many to be too dramatic and perhaps too risky. By analysing the role played by Charan from the start of the business, a study of the traits and characteristics of entrepreneurs can be undertaken.

Other opportunities exist to look at the long-term issues in the company, particularly in terms of the development of the management capability in the business as a counterpoint to Charan Dill. There are also the strategic management issues of the business life cycle, and the practical problems for a small firm in selling to a small number of very large customers, and the financial management issue of financing the growth of a small firm.

The requirement

You are a management consultant retained to advise the board of IRS Limited on the Managing Director's 2009 vision. The board of IRS Limited requires a report which includes the identification of key issues, feasibility [including financial viability], and recommendations for appropriate management actions. Within the overall context of the report on the 2009 vision, the board is particularly concerned that the issues relating to the earlier years 2002 to 2004 are addressed.

Notes: Analysing the requirement

The requirement indicates the broad shape of the report required, though there is still some scope to vary the way in which certain issues are dealt with. The key to producing an effective report is in the analysis of the requirement and the identification of issues that require comment.

1 – the identification of key issues

This clearly indicates the need for an overview, prioritising issues, rather than a listing of all problems regardless of relative significance. This will include an overview of problems discussed in detail subsequently.

*A useful working paper that could contribute to the identification of the relevant issues could be the preparation of a simple SWOT analysis – **Appendix 1** – reflecting the content of the unseen material, as well as the pre-seen. This is useful as an appendix to the report. The key test is that it should reflect new information as well as the pre-seen.*

2 – feasibility

This requires discussion of whether IRS can meet the demanding targets being set by the vision. There is obviously scope for discussing some aspects such as the realism of the marketing plans either here, or under financial viability. It may be better to discuss these here, along with the issues of organisational capability, and leave the financial viability heading primarily to review the working capital and financing issues.

3 – financial viability

This requires discussion of the realism of the financing requirements and the plan. It is limited to the years 2002 to 2004, after which further major investment is required.

4 – recommendations for appropriate management actions

There is scope for a wide range of possible recommendations, but these must be feasible and broadly sensible and related to the main problems identified.

REPORT
To: Members of the Board of IRS Limited
From: Management Consultant
Report on the Managing Director's 'Vision 2009'

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2. **Review of operating ratios**
3. **Review of proposed UK budget**
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Report

Section 1: Identification of Key Issues

A. Broad Strategic Issues, Including Issues Concerning the Aims of the Shareholders

[i] Possible alternative strategies

It can be argued that IRS, as it is presently constituted, is at a crossroads. The management team are divided in their aims and objectives for the business and for themselves. The initial basic premise of the business, that has served the company so well in the past, is likely to change dramatically if the Vision 2009 strategy goes ahead.

One view is to say that the business has reached a position where consolidation and not hectic expansion is needed. From this, at a later date, the decision to expand could be taken when the management and resources are in place to move forward in a measured way. The Sato venture mentioned in the case was a near disaster, caused by the assumption that IRS could enter an unknown market albeit with known technology. The distinct possibility exists that this business may not learn from previous mistakes. However, with the Sato adventure, IRS was not selling to industrial customers, but to Japanese consumers. Selling business to business is very different from selling business to consumer. The nature of the relationship and the expectations and resources for each element of the transaction is different.

Note: Candidates could show knowledge of this and refer to marketing theory on the difference between consumer marketing and industrial marketing.

The opposite view could also be taken. The drive shown by Charan Dill needs to be harnessed and extended through additional management and related resources, especially finance. What is needed is the drive to expand IRS to be a £100 m business. Whether a real opportunity exists, which needs to be seized now, to make this small-medium company into a big business will be discussed later. To reach £100 million turnover, an annual

sales growth rate of 28.5% is required. IRS growth rates in the past suggest this is entirely possible.

There are also significant risks in standing still and consolidating. UK growth is forecast to taper off, and, after the budget year, will be no more than 7% per year. Supermarkets can be very demanding customers, and prices could be squeezed.

[ii] Shareholder motivation, risk and growth

Not every business grows. Not every chief executive wants to grow his or her business in a dramatic way. However, there are a lot of pressures to grow. IRS is not a quoted company and does not have shareholder pressures from big city institutions that often push management into growth when they maybe should consolidate. But, any future outside investor could push for growth to deliver a significant capital gain over a 3–5 year period. Flat, steady profits do not do much for share prices.

It is clear from conversations that David and Alex are not interested in the challenge of growth, but, sooner or later, a big pay-off and retirement. There is a limit to the amount of risk they wish to accept, and the amount of effort they can make towards achieving very demanding goals. This does mean that they necessarily wish to sell and go now; the value of their shares may not be enough to fund adequate early retirement incomes. But they may well wish to see a clear possible exit before 2009.

Mr Khan's motivation as an outside investor is not clear, though there are family connections to consider, as well as normal investment criteria. He has been an investor from the start, which is already a long time for an individual investor, with changing priorities; it is unlikely that he will wish to invest forever.

A growth strategy could very well be based on a plan for harvesting the business. This would imply perhaps some recognition that harvesting might come sooner rather than later. David, Alex and Mr Khan really might be more interested in early harvesting – 2003/04, rather than waiting to 2009. Vision 2009 is inherently risky because of its ten-year time horizon. Anything could happen in a period of this duration.

Small businesses such as IRS can rarely self-fund a period of growth such as that envisaged. It is very likely that a strategic partner with far more financial resources would be needed and this would usually involve a take-over. Therefore, financial issues might be different and the venture capital arm of the bank might also be seeking a five-year maximum involvement.

[iii] The Managing Director's motivation

It seems clear that Charan Dill exhibits very many distinctive entrepreneurial traits, especially the need for achievement. The pre-seen case indicates Charan has a father who has been successful in business. Charan is likely to feel he 'has to' succeed to match his father's success. This may push him on to be less risk averse than he should be.

[iv] The Life Cycle Model: describing the stage that IRS has reached

In the same way as products have a life cycle, so do businesses. IRS is a business which essentially has moved quickly from survival, to existence, to growth and to the take-off

stage and may be approaching the final stage, maturity when the business is set for the long term. It could be argued that the Vision 2009 is a natural and feasible way forward, and one which a business such as IRS needs to take.

Notes:

There are several acceptable organisational growth models: Churchill and Lewis have outlined a model which covers the five stages of Business Growth.

IRS has gone through Stage I, Existence, to Stage II, Survival, and just as quickly on to one aspect of Stage III, Success-Growth. The business has now moved on to questions related to Stage IV, Take-off where the business needs to:

- *develop a management style along structural lines;*
- *introduce a considerable amount of formal systems;*
- *devise a viable means of financing growth.*

Essential factors are the quality of the people in the business and their diversity in terms of skills, strategic planning, systems and control, and the owner/entrepreneur's ability to delegate. In the case of IRS, the ability to delegate and manage by consensus is crucial to the further development of IRS.

[v] Whether IRS is a sufficiently entrepreneurial organisation to succeed

IRS can be analysed from the point of view of whether or not it is an entrepreneurial organisation. To grow as rapidly as projected, it really needs to be entrepreneurial if it is going to be successful in the US market.

The analysis shown below actually works very well for IRS, particularly in terms of innovation, opportunity, niche markets and the flexible organisation. The five main elements of analysis are detailed below:

1) There must be a focus on innovation, change and opportunity. Charan has been good at devising a new approach to the supermarkets' problems.
2) There must be a change of focus from massed markets to niche markets. The focus has been largely on a very specialised market.
3) There must be a strong entrepreneurial spirit throughout the organisation. Charan has been extremely entrepreneurial; it is open to question whether he has successfully encouraged other to show such initiative, though contacts have been developed for the future in Europe.
4) The organisation must be sufficiently flexible to react fast to complex threats and opportunities. A flexible matrix structure of project teams is used, but its success is not proven and complete.
5) Empowerment. In theory, the project teams are empowered – but the extent to which this is effective is not clear.

Smaller and flatter entrepreneurial systems ultimately require a considerable degree of delegation of authority to sub-ordinates. Quite simply, there is often not enough time for key decisions to be taken by the senior management when creative employees are confronted with new opportunities and threats.

B. Practical, Performance Related, Issues

[i] Mixed financial performance

The analysis of performance to date, included in **Appendix 2,** shows mixed results, but can be summarised:

- impressive rate of sales growth;
- erratic profits with falling margins, and major write-offs;
- a continuing need for more working capital and funding.

It is notable that the company has never paid any dividends. All earnings have been reinvested in the company – but required borrowings continue to increase. Margins are insufficient to fund working capital growth.

The latest estimate for the current year and the budget show awareness of the problem of margins, and some effort to increase margins. The plan data shows awareness of the working capital problem, if only limited attempts to solve the problem. The UK debtor problem may be insoluble – part of dealing with supermarkets is helping to finance their businesses.

[ii] Limited financial resources

Available resources are clearly limited, even though there are no explicit statements of what these limits are. The amounts that can be borrowed are limited by the view taken by the bankers, who may relate these to:

- the proportion of total requirements to be funded by debt, other than equity;
- the potential value of Mr Khan's guarantee, and the lesser value of the three shareholder executive directors' guarantees. The bankers' problem, in relation to Mr Khan's guarantee, is that they may only be interested in his UK assets, as there could be severe difficulties in enforcing claims under his guarantee on overseas assets;
- the value of the tangible assets, especially property, owned by the business.

The basic growth problem is that additional sales, to date, have not funded the additional working capital required. The new product is forecast to change this.

[iii] Flexibility, management style and business growth

The company has been profitable, and successful in the past, as a partner and not merely as a supplier to its major customers. It can be argued that this will be more difficult as the company grows and more and more of the day to day work has to be delegated. Indeed, this has already, to some extent, started as Charan Dill has already moved to being more of a strategist. The company has depended on staff flexibility, and operated complex matrix systems for project management; these become more complicated as size increases. The company will need to take these changing circumstances on board and to decide explicitly how it is going to address the problem. A consolidation strategy could well go for a more conventional structure, with the appointment of a general manager, and the imposition of a clear set of structured responsibilities – but this would be far from ideal for rapid growth.

[iv] Standardisation of components, stock control, write-offs

There is little standardisation of components and this has, in the past, meant that there have been relatively high write offs of obsolete stock, although it is noted that there is no provision for this in 2002. If management is to become more remote there is potentially a very serious problem here and a very definite and specific system must be in force to see that this does not get out of hand. There are the related problems of:

- apparently no system of a 'design guide' to use common components for disparate systems;
- poor IT systems in need of renewal – if the costs, financial and management time, can be afforded;
- no central purchasing system.

Section 2: Feasibility

A. The Forecasts

[i] Factors that counter the identifiable risks of expansion

The problem is balancing the obvious high risk factors in the forecasts, with the already proven ability of Charan to identify a new opportunity and achieve a high rate of growth. The plus factors are worth stating, and may outweigh the very obvious problems:

- the high rate of growth achieved in the past;
- the ability to do things differently from the competitors, effectively outflanking them;
- the company, and Charan, may have learnt from experience. With the new product, they may be more conscious of margins and working capital, even though this may slow growth and encourage competition.

[ii] The high risk of dependence on developments in the USA

One point to take into consideration is the lack of experience in trading abroad, as is indicated in the Sato experience. With the proposed investment in the USA being such a large percentage of its future business, it will be necessary to appoint someone to oversee the day to day running of the USA "section" of the business. If none of the directors have the necessary experience and/or time, this will need to be bought in.

The company will have only one customer in the USA at the beginning, and the whole company is heavily dependent on this customer. Should anything go wrong, the company would face very major problems.

There is no mention of competition in the USA and this must be assessed before any decision is made. At the same time, the likelihood of future competition should be assessed. Is it likely that local companies will not attempt to provide these services?

There may be customer prejudices in favour of having a 'local' supplier. The customers will certainly wish to be re-assured by a highly visible 'footprint' in the USA in terms of premises, facilities and senior management.

Cultural and geographical problems must also be examined to see that any differences have been provided for in the estimates as these could affect the feasibility of the proposals. There is also the risk of currency fluctuations affecting margins.

[iii] Forecasting new product sales, selling prices, and margins

The sales forecast in the USA depend on the extent to which the product is genuinely innovative. If this is accepted, the volumes look small compared with the scale of the potential market. The overall growth rate implied for IRS is comparable with the rate of growth achieved to date. However, the scale of the market implies scope for competition to develop.

Selling prices and margins are more difficult to forecast. Clearly, the old product was underpriced, and the new product is being priced to provide a radically better margin. However, while prices for TMBC were mentioned by Charan of £130,000 to £150,000, the calculations were only made on the higher figure. The higher price may be obtainable initially, but pressure on selling prices may force these down after a few years.

Note:
It would be feasible to prepare fairly simple 'what if' calculations to show the effects of changed assumptions re volumes and selling prices, and include these as an appendix. Fairly minor changes in volume assumptions produce quite significant effects.

B. Management Capability

[i] Managing development

There is a general issue of whether the management of IRS has developed in line with the explosive growth of the company, and whether they can cope with the forecast growth, and the changes needed to achieve the growth.

[ii] Management in the USA

There are obvious difficulties in maintaining flexibility and a rapid response to customer needs as the company grows. The problem will become more difficult with a significant level of trading in the USA. The preliminary outline of arrangements in the USA is not promising:

- two locations holding stocks;
- engineers from the UK;
- two separate marketing staff supported directly from the UK.

There is no mention of any form of local general manager to co-ordinate operations. Looking further ahead, if volumes in the USA develop as planned, it would be sensible, in due course, to consider

- the recruitment and training of local engineers;
- local assembly, rather than taking components and assemblies to Scotland for assembly, and then to the USA;
- the recruitment and training of local sales and marketing staff;
- the appointment of a general manager, responsible for USA operations.

[iii] Financial management and management co-ordination

It is clear that resources will be stretched on any assessment of financial feasibility. The forecasts suggest

- continued strong growth in the budget year 2002 in the UK, slowing thereafter;
- growth in the USA;
- subsequent growth, after the initial period of 2002–2004, in Europe;
- a major investment needed now, and a further investment needed after 2004.

Strong financial management will be needed. Joe Halley was recruited in 1999, but there is no evidence to date on his effectiveness. He has not been appointed to the Board.

There is no clear indication that the new management structure deals with David's criticism that 'No-one is in control'. The new structure appears to retain a framework for a set of project teams.

[iv] Information systems and production and working capital management

There are clear indications of past problems, and no indication that these problems will not recur. The commentary on the information systems suggests that, at some point, new systems will be required. There are obvious difficulties:

- the time and cost involved in specifying, developing and installing the new systems required. There are severe limits to the scale of effort that can be afforded by a firm of the size of IRS;
- difficulty in forecasting the system requirements for USA operations in sufficient detail to permit useful system specification and development;
- the need for some immediate improvement in control, rather than waiting for 1–2 years, or more, for a new system.
- It is possible that the best short-term solution is to price new business to allow for potential inefficiencies.

Section 3: Financial Viability

Notes:

Candidates could be expected to provide three forms of financial analysis in appendices to support this discussion, and the general review of issues:

- *some basic ratio analysis to help understand the business and its problems. This could in particular inform discussion on the realism of the budget and the forecast ratios*;
- *candidates may provide some 'what if' analysis. This is not essential, but could be helpful*;
- *some calculations of future cash flows and financing needs.*

Calculations of future financing can be done in a variety of ways, and will vary according to the simplifying assumptions made.

Calculation of the need for funds is fairly simple – multiplying up the working capital needed, and adding in investments needed. Possible variations include re-stating the budget, which is clearly optimistic compared with recent performance, and possibly making more pessimistic assumptions than those made by Joe Halley.

Calculation of the sources of funds is also simple, if the necessary assumptions to be made are clear:

- *it makes little difference whether the venture capital investment is shown as being made in one tranche or two;*
- *it is simpler to assume that no dividend is paid, and that all profits after tax are re-invested in the business;*
- *the balance [needs – venture capital – profits re-invested] equals borrowings;*
- *the borrowing limits are not known, but if borrowings do not increase, or do not increase as a proportion of equity, it could be argued that the financing is feasible.*

[i] Past and current performance

Some key ratios are provided in **Appendix 2.** The overall picture gathered from this analysis shows for trading:

- impressive sales growth rates;
- falling gross margins, but this trend reversed in the current year;
- continually increasing overheads, which appear variable upwards in line with sales, though they probably will not vary downwards in the case of possible problems;
- repeated 'exceptional' stock write offs;
- very erratic net profits.

The most notable feature of the P&L is the continued increase in interest payable, and the lack of dividends. This is an excellent business – for the bank. The balance sheets explain the problem:

- high working capital requirements, especially debtors. This is a matter of helping supermarkets to finance their business;
- owned, rather than rented, premises. These may represent a potential source of funds [by sale and leaseback], but are probably regarded by the bank as essential security for the loan and overdraft;
- insufficient retained profit, despite the lack of dividends, to finance the additional working capital.

The key requirement is higher retained profits to finance growth. While working capital management can be improved, the real problem is the lack of retained profits providing extra capital.

[ii] Forecast working capital requirements and financing

The table below starts from the latest estimate for the current year in a much simplified form. Working capital and profit are calculated from data supplied by Joe Halley. Details are shown in **Appendices 3 and 4.** External finance [borrowings] are the balancing figures each year.

Simplified summary balance sheets and movements, starting from 2001 (latest estimate)

		End 2001	*In 2002*	*End 2002*	*In 2003*	*End 2003*	*In 2004*	*End 2004*
		£000	*£000*	*£000*	*£000*	*£000*	*£000*	*£000*
Fixed assets:	UK	1,550	200	1,750	200	1,950	200	2,150
	USA	–	1,400	1,400	600	2,000	–	2,000
Working capital		2,300	126	2,426	446	2,872	722	3,594
		3,850	1,726	5,576	1,246	6,822	922	7,744

Financed by:							
Equity	852	435	1,287	1,214	2,501	2,400	4,901
Venture capital	–	2,000	2,000	–	2,000	–	2,000
External finance	2,998	(709)	2,289	32	2,321	(1,478)	843
	3,850	1,726	5,576	1,246	6,822	922	7,744

The key assumptions in these estimates are that they take on trust Charan's sales estimates, Joe Halley's unit cost and contribution calculations, and his working capital calculations. Any shortfall would have very noticeable effects, as could be shown by normal 'what if' analysis. These are 'best case' assumptions; normal financial prudence would indicate the need for some form of contingency or safety margin.

Assuming that the bank tolerates the present level of borrowings, and that the borrowings during the year are at no point significantly higher than the year end figures, the following comments can be made:

- true borrowing requirements will remain at the present, very high, level for another year. The reduction shown above is almost completely due to getting the full venture capital investment of £2 million in 2002, but only investing £1.4 million in 2002;
- subsequently, there are significant reductions in financing needed, as sales of TBMC at much higher profit margins than the old product, outweigh the additional working capital requirement.

The position can be summarised as feasible – with considerable improvement in management control.

Section 4: Recommendations

Notes:

Recommendations are essential, but will vary according to the analysis already made, and the extent to which the broad issues have been appreciated. The key tests are that:

- *recommendations should be relevant to the main problems analysed. If working capital management is seen to be the main problem, the recommendations should include relevant and commensurate action.*
- *recommendations should be feasible and reasonable.*

A. Strategic decisions

[i] Resolve the strategic choices

There is a clear choice between consolidation, and a future as a UK supermarket supplier being squeezed by powerful customers, and risky expansion. The shareholders must:

- recognise the nature of this choice;
- discuss the viability of both options;
- decide which they consider to be the best organisational choice and, as far as possible, separate feasibility from the fit to personal preferences.

On balance, it can be argued that expansion is the best option, even if expansion may need to be somewhat more cautious than that envisaged by the Managing Director. However, the pace of the expansion may be determined by the need to satisfy the prospective customers

in the USA, and to discourage them from seeking an alternative supplier. Prospects in the medium term in the UK may be unappealing, and lead to a permanent fall in the value of the company as profits are squeezed.

[ii] Resolve the position of the four original partners

The four original directors – Charan, David, Alex and Mr Khan – need to discuss their attitudes to the future. Charan may see himself running a £1,000 million company – in X years time, and subsequently a £1,000 million company – but this vision is not necessarily shared by all. It is probable that all the others want to exit at some uncertain future time, certainly before 2009.

Very approximate calculations suggest that the growth of the company, as envisaged, requires additional shareholders:

- the £2 million venture capital now envisaged may represent (though this is not stated in the case) a shareholding around 20% – but this could vary considerably;
- the additional investment required post-2004 could represent another 20% or so of the company;
- as soon thereafter as anyone wished to sell, the original partners could lose overall control, though they would still have management control.

The risk is that any sale by an original partner, even now, but certainly in a few years time, could jeopardise overall control.

[iii] Agree the financing plan

Rational planning would suggest, subject to the resolution of the shareholders' positions:

- the additional £2 million equity must be firmly committed, and agreement must be made on what proportion of the equity it represents, before commencing action on the plan;
- bank overdraft and loan facilities must be agreed for the three year period;
- ***either*** all the shareholders agree that all will hold their shares to end-2004, and trust that the first phase of the vision will be successfully implemented, and the company will be worth far more than at present;
- ***or,*** if any shareholder wished to sell now, resolve this sale and the additional equity required for the expansion, and the future financial structure of the company, before commencing action on the plan.

[iv] Risk assessment and detailed review of plans

Assuming that there is broad acceptance of the vision for at least the first phase, a detailed critical review is required to identify the key risks, and any action that can be taken to minimise risk. Possible suggestions include:

- phasing the American development, doing either the East or West Coast X months ahead of the other;
- employing and training say two American engineers immediately, to learn from them any distinctive local problems that may need to be met;
- reviewing the amount of effort being expended on other developments, such as Europe, and the amount of distraction of management time it represents;

- carrying out a very careful analysis of the key contributors to profit in the expansion plan and ensuring that Charan is adequately briefed on what he can and cannot concede in negotiations. In particular, he must be briefed on the importance of the new product, and on how little the old product sales in the USA contribute. It may be feasible to introduce the new product at a higher price, but the important issue is the mix of old and new products sold.

[v] Succession planning

A review should be carried out of possible management succession. It may be that some of the relatively new senior managers can be seen as medium-term potential successors to David and Alex. The problem that must be faced is that there does not appear to be any potential successor to Charan. A contingency plan should be discussed in case Charan is, for whatever reason, incapacitated.

B. Short Term Recommendations

[i] Management structure

The proposed management structure should be critically reviewed, with a view to ensuring clarity of responsibility for certain issues:

- responsibility for the USA must be clarified. It may be appropriate for Alex to be moved short-term to the USA, so as to have a visibly senior manager on the ground, prior to appointing a local national as general manager;
- responsibility for stock control must be clarified;
- financial management will be very important for the foreseeable future. It may be appropriate to emphasise this by making Joe Halley the Finance Director;
- the appointment of a General Manager to support Charan should be considered.

[ii] Stock control

Stock control must be improved. This may be attempted in a variety of ways, including some centralisation of purchasing, some design co-ordination to ensure the use as far as possible of common components, and some better information systems, if these can be achieved in a reasonable time. Regular ‘exceptional’ stock write-offs are not acceptable.

[iii] Old product margins

There is clear evidence from the slight upward trend in gross margins shown in the latest estimate and the budget that management is aware of the problem. Efforts must be made to increase margins on sales of the old product:

- reviewing the charge made to supermarkets for what is, in effect, a premium support service, and trying to devise ways of obtaining higher rates for this service.
- reviewing costs and looking for scope to develop better purchasing systems and for management to reduce costs.

[iv] Overhead costs

Overhead costs have risen year by year in line with turnover, and appear to have been completely flexible upwards with volume. Normally some part at least is fixed. Detailed analysis is required, leading to procedures to restrict additional hiring of staff. When, after the budget year, UK growth falls to 7% per year, it will not be possible to afford any more UK staff.

[v] Staff motivation

While the four original partners have the 'jam tomorrow' motivator that their shares will some day be worth a lot of money, no one else has any specific incentive, other than the excitement of working for a fast growing firm. Some sort of incentive scheme linked preferably, to annual profits, rather than a complex shadow share option scheme, is needed. However:

- this must apply to the senior managers who were shown as directors in the original organisation chart (pre-seen material), but who appear not to be directors in the revised chart;
- this should also apply to other senior managers;
- consideration should be given to the costs and benefits of a more general scheme for all employees. The consideration should include the possible reduction in the amount of overtime being worked, and the risk of unionisation.

[vi] Systems and information technology

There are clear indications that present systems are not satisfactory. Review should concentrate on short-term improvements possible, possibly using standard packages, rather than designing and building an ideal system at great expense.

Appendices

Appendix 1 – SWOT analysis

Strengths

The leadership of Charan Dill
The experience and competence of David, Thomas and Alex Watt
The team at IRS and their 'can do' attitude
The technical competencies which have been built up over time and a willingness to innovate
The involvement of Mr Khan
The range of products
Strong internal ethos to support customers using account executives dedicated to specific supermarket clients

Weaknesses

The drive and ambition of Charan Dill
The reliance on Charan Dill
The lack of ambition by David Thomas and Alex Watt
The absence of a management team culture

The involvement of, and the financial dependence on, Mr Khan
Lack of internal financial resources
Increasing number of quality problems
Wide range of products all requiring continued development funding

Opportunities

The growth of supermarkets worldwide
Size of the US market
The strong personal relationships of IRS and Charan Dill with major supermarkets
The products of IRS
The strategic alliance with the US company
Fragmented nature of the competition with no major competitor in the UK at least
Innovation and cost cutting a feature of the supermarket business

Threats

Over-expansion by IRS
Technical change might render IRS products technically uncompetitive
Financial costs of US development
External investor involvement might not be willing to take the longer view should results not be as expected
PEST issues in the US are probably very different from the UK; understanding is probably very limited
One or more of the original shareholders may wish to sell their shares

Appendix 2 – Review of operating ratios

Note:
There is scope to compute a wide range of ratios – but there can easily be far too much detail provided for the time available in the examination. A full analysis will have been made of the pre-seen information, but this does not need to be reproduced during the examination. The following is suggested as a reasonable compromise.

Comment on these ratios is made in the main report; these figures are for support and reference.

	2002	*2001*	*2000*	*1999*	*1998*	*1997*	*1996*
Sales growth	16.0%	26.7%	47.8%	17.4%	35.3%	59.3%	–
Gross profit	26.0%	24.8%	22.6%	25.4%	27.1%	25.4%	27.6%
Admin as % of sales	20.4%	21.4%	18.9%	19.1%	19.2%	17.3%	24.4%
Turnover per employee	£76,000	£71,978	£79,562	£68,627	£68,563	£65,791	£65,881
Debtor days	67.2	76.6	70.5	78.6	38.5	95.1	60.8
Stock days	58.4	74.1	61.2	69.1	80.9	67.5	63.4

Appendix 3 – Review of proposed UK budget

Note:
This is desirable, but not essential. If this is omitted, candidates should arrive at substantially the same position at the end of the three-year period, but will have underestimated the difficulty in the earlier part of the period. There is scope for a range of variations in the answers – provided that there is some recognition that the budget is optimistic, and that the greatest problem is understating the financing requirements.

Interest has been calculated using a rate of 9.5%. This has been estimated by using the average of the year end net external finance amounts for 2001 and 2002.

The budget for 2002 for the UK sales, as provided in the schedules, requires some amendment before the addition of the USA sales, as the budget is clearly optimistic compared with 2000 and the latest estimate for 2001.

	2002 Budget UK	*2002 Budget ratio*	*2001 Ratio*	*2002 Revised Ratio*	*Revised Budget*	*2002*
Sales	15,200				15,200	given; agreed
GP	3,950	26.0%	24.8%	25.0%	3,800	
Admin	3,100	20.4%	21.4%	20.0%	3,040	compared previous years
Other income	30				30	
Operating profit	880	5.8%	3.7%	5.1%	790	
Interest	250				270	
Profit before tax	630				520	
Tax	200				166	
Profit after tax	430				354	
Stocks	1,800	58 days	74 days	65 days	2,000	
Debtors	2,800	67 days	76 days	72 days	3,000	
	4,600				5,000	
Trade creditors	2,800	91 days	91 days	91 days	2,800	
Working capital	1,800				2,200	
+Fixed capital	1,750			1,750	given	
Total capital employed	3,550				3,950	
Equity	1,282				1,206	
External finance	2,268				2,744	

An additional £476,000 will need to be financed on what are still reasonably optimistic assumptions. Working capital management will need to improve over current performance to restrict external financing to £2.75 million. The bank must be consulted to ensure that they accept this situation, and are willing to allow this as loans and overdraft.

Note:
There is clearly a range of varying assumptions that could be made. Calculation of interest is approximate as it is not known until closing borrowings, as well as opening borrowings, are known. This will not be clear until the retained profit for the year has been calculated.

Appendix 4 – Future cash flows

Future Planning:

Note:
This could be done in a number of ways, but trying to build up fully detailed plans in the same detail as the schedules provided would be tedious. Some simplifications are obvious, such as netting off cash and borrowings; others are optional. The simple approach is to work out the impact of the additional units, and then multiply up as required. This also provides a better basis for commentary.

Effect of manufacturing and selling 1 additional unit

		Innate UK		*Innate USA*		*TBC USA*
		£		£		£
Selling price		50,000		50,000		150,000
Cost of sales		37,500		37,500		75,000
Gross profit	25%	12,500	25%	12,500	50%	75,000
Administration	20%	10,000		10,000		30,000
Operating profit		2,500		2,500		45,000
Extra working capital:						
Debtors	65 days	8,904	33 days	4,521	33 days	13,562
Stock	72 days	7,397	102 days	10,479	102 days	20,959
		16,301		15,000		34,521
Less: Creditors	91 days	9,349		9,349		18,698
Extra funding needed		6,952		5,651		15,823
Operating profit		2,500		2,500		45,000
Interest (c 9%)		500		380		–*
Profit before tax		2,000		2,120		45,000
Tax 32%		640		678		14,400
Profit after tax = retained profit		1,360		1,442		30,600
Retained profit		1,360		1,442		30,600
Working capital required		6,592		5,651		–
Additional/(reduced) borrowing		5,952		4,209		(14,777)

* There is a good case for showing a negative interest figure here, as every TBMC sold reduces total borrowings. The main points for management are clear, whether or not such a negative interest figure is computed:

- further sales of Innate, whether in the UK or the USA, lead to further problems in financing working capital;
- sales of TBMC, at the margins envisaged, lead to retained profits greater than the additional working capital.

The revised 2002 budget

Note:

The UK budget is the revision already done, increasing the investment required. The US budget is calculated by multiplying up the per unit calculation.

	Innate UK	*Units*	*Innate USA*	*TBMC*	
2002	*£000*		*£000*	*£000*	*£000*
Operating profit	790	40	100	–	890
Interest					250
Profit before tax					640
Tax					205
Retained profit					435
Working capital	2,200		226	–	2,426
Fixed assets	1,750		–	–	1,750
Initial USA investment	–		1,400	–	1,400
Total capital employed	3,950		1,626	–	5,576
Funded by:					
New equity					2,000
Retained profit					435
Equity and retained					
Profit b/fwd					852
					3,287
External finance			-		2,289
					5,576

Note:

Interest has been estimate at 9·5%.

The borrowings reduce because the assumption has been made that the full £2 million new equity investment has been received, although only £1·4 million has been spent in the USA.

2003

Calculations are made by multiplying up from the per unit calculations already made. The UK budget is taken as £16.3 m/£50,000 = 326 units for 2003. Interest is calculated at 9% on an average of opening and closing net external finance. The slightly lower rate of 9% interest derives from the estimate of the effect of manufacturing and selling one additional unit.

	Units	*UK*	*Units*	*Innate USA*	*Units*	*TBMC USA*	*Total*
2003		*£000*		*£000*		*£000*	*£000*
Operating profit	326	815	40	100	24	1,080	1,995
Interest							210
Profit before tax							1,785
Tax							571
Profit after tax							1,214
Working capital		2,266		226		380	2,872
Fixed assets (+ 200)		1,950		–		–	1,950
Initial USA investment		–		2,000			2,000
Total capital employed		4,216		2,226		380	6,822
Funded by:							
New equity							2,000
Retained profit							1,214
Retained profit and							1,287
Share capital b/fwd							
							4,501
External finance							2,321
							6,822

There is a continued need for external finance, as well as the new equity.

2004

The UK budget is taken as £17.4 m/£50,000 = 348 units

	Units	*UK*	*Units*	*Innate USA*	*Units*	*TBMC USA*	*Total*
2004		£000		£000		£000	£000
Operating profit	348	870	40	100	60	2,700	3,670
Interest							140
Profit before tax							3,530
Tax							1,130
Profit after tax							2,400
Working capital		2,419		226		949	3,594
Fixed assets (+ 200)		2,150		–		–	2,150
Initial USA investment		–		2,000		–	2,000
Total capital employed		4,569		2,226		949	7,744
Funded by:							
New equity							2,000
Retained profit							2,400
Retained profit and share capital b/fwd							2,501
							6,901
External finance							843
							7,744

There is a continued need for external finance. However, if IRS's plans work out, a lower level of external finance will be required compared with 2002. Further investment is required in 2005 for a major expansion of factory capacity, but the venture capital arm of the bank may consider further investment. However, the reduced need for external finance suggests that some of the additional funding could be by way of borrowings, rather than further equity. The only way to reduce the dependence on external finance is to accelerate the switch to the new TBMC product.

Appendix 2 – Ofood4U (May 2004)

Ofood4U

Background

A rapidly-expanding new industry is the production and retailing of organic foods. Under European Community (EC) law, an authorised body must inspect the production of food that is to be sold as organic. There are a number of authorised bodies within the EC, and they strictly enforce their rigorous standards before foods using their symbols of authenticity are allowed to be marketed.

The demand for organic food increased in the United Kingdom by over 55% between 1999 and 2000, reflecting the UK population's concerns over genetically-modified (GM) foods and other scares over food safety. Demand has been growing at over 30% per annum since 2000. One of the leading UK supermarket chains now stocks over 1,300 different organic products. There are around 4,000 organic farmers in the UK at present, and almost 2,000 organic processing facilities. There is also a wide variety of produce that is grown organically in overseas countries and imported into the EC to meet the demand by consumers. Of the organic products on sale in the UK in 2002, around 70% were imported products with the remaining 30% being produced in the UK. In 2003, the level of UK-produced organic products increased to 40%. With the increased amount of organically licensed land and the number of organic food producers increasing, it is forecast that organic food production in the UK will meet over 55% of sales during 2004. The UK organic retail market was worth over £2,000 million by the end of 2002 and is growing fast.

Many customers are selecting organic meat and produce because of what is left out rather than what it contains. There has been an unprecedented rise in food scares in recent years and consumers are becoming more aware of other issues, such as the routine use of pesticides and toxic chemicals used on crops, which have been linked to many forms of cancer. This, together with growing concern over GM crops, has caused consumers to look for food that is produced naturally, and this has resulted in a growing demand for organic produce. Organic foods are believed to contain higher levels of vitamin C and essential minerals and have higher levels of secondary nutrients and salicylic acid, which has health benefits.

In conventional farming, over 500 pesticides are routinely used and some fruits are sprayed up to 16 times with 36 different pesticides, which are hard to remove, even when the fruit is washed. Organic farming allows the use of only four pesticides. Organic farming is certainly not going to be the way that all food is produced in the future, as with a global population of nine billion forecast for the year 2050, this farming method would not produce enough food. Organic methods yield about half the amount of food that conventional methods produce and there is not the amount of land available for farms to produce all food organically. It is forecast that organic produce will remain as a market sector in rich countries, to meet the demands of consumers who are prepared to pay a premium for organically-produced food.

History of Hall Farm

The Hall family has owned Hall Farm for several generations. After the death in 1994 of David Hall, the owner and farm manager, his eldest son Richard Hall, then aged 37, inherited the land and the business. Richard Hall had qualified with a degree in farm management and had worked in a number of areas of farming and food production. He had not previously wanted to work on his father's farm, as he had strong views on the use of pesticides and insecticides. However, when his father died at the age of 63 after a short illness, he agreed that he would return to Hall Farm.

Richard Hall has a brother, Alan Hall, who is five years younger than he is. Alan Hall had worked abroad for several years but by 1994 he had returned to the UK but he had no interest in farming. Alan Hall worked for a large marketing company.

Richard Hall and his wife, Sarah, and their two young children moved from the small organic farm that he had been working at, to take up the ownership and running of Hall Farm in the summer of 1994. He had already decided that he wanted the farmland to be converted into organic ground. This required the land to be managed organically for over two years, before it was eligible to be certified to be organic. He had registered the land as being "in-conversion" with one of the authorising organic bodies and he had prepared business and operational plans for the next few years. During this conversion period of two years, all food production was sold, but not as organic produce. Hall Farm was granted a certificate for organic production in February 1997 and Richard Hall commenced growing a range of organic produce. The business plan for Hall Farm was to produce a limited number of organic crops that his market research had shown to be in steady demand.

Sales outlets for Hall Farm produce

Richard Hall sold the organic produce from Hall Farm in three ways during 1997 and 1998. These three ways of selling were:

- through market stalls at over twenty local markets, selling direct to customers;
- by mail order;
- bulk sales of some produce to a large regional organic food wholesaler, *Organics for Everyone*, which then sold the produce on to other retailers, including supermarkets.

Richard Hall was very reluctant to sell the majority of his produce to *Organics for Everyone* as he received very low prices compared to selling direct. During 1997 and 1998, the direct sales through markets and the mail order business were managed almost entirely by Richard and Sarah Hall. However, Sarah Hall continually had staffing problems and difficulties meeting customers' demand and each week she experienced trouble with staffing for market stalls. They had employed a close friend, Jonathan Winters (see page 5 for details on Jonathan Winters), who managed the packaging of the produce, with some help from temporary staff.

A farm manager was recruited in August 1998, which allowed Richard Hall to become less involved with the day-to-day running of the farm and enabled him to concentrate on selling the organic produce.

In December 1998, at a large family get-together at Hall Farm, Richard Hall's younger brother, Alan Hall, suggested that the retailing of the organic produce from Hall Farm should become more business-like and better organised. Sarah Hall couldn't agree more, as she had become far less involved in their children's lives due to the demands of the business. She also worried that Richard Hall was going to make himself ill with the long hours and hard work that were needed to manage Hall Farm, as well as being involved with the selling of the produce.

Formation of Ofood4U Limited

After many discussions and meetings, Richard and Sarah Hall decided to form a new company to market and sell organic produce, and Ofood4U Limited (Ofood4U) was formed in March 1999.

There were two differences in the way that Ofood4U operated compared to the retailing business that had been operated from Hall Farm. First, it was going to bulk buy organic produce from a range of suppliers, and it planned to retail organic produce grown in the UK and from overseas. The company was planning to procure overseas-grown produce from a number of organic wholesalers, but it did not plan to procure any overseas-grown produce directly from growers. One of its key UK suppliers would be Hall Farm, but it had also established business links with a few other organic farms and organic dairies, from which it planned to procure the majority of its produce. The production and farm operation costs at Hall Farm are entirely separate from Ofood4U.

Secondly, the company was planning to expand not only the product range, but also the range of routes to the largely untapped market for organic produce. Richard Hall had an enormous number of ideas for expansion, including selling through the Internet and opening shops in key cities. In 1999, it was planned that the existing routes to customers, through mail order and at local markets, would continue for the time being.

Richard Hall had many ideas but lacked the detailed expertise to put his ideas into practice, although many of his early dreams of retailing organic produce had already become a reality. It was Richard Hall's brother, Alan Hall, who had decided to join the new company as Sales and Marketing Director, who felt that with his experience, the company could be a leading player in this growing retail sector. Alan Hall was confident that sales could be rapidly expanded if ready-prepared packaged (cartons and bottled goods) organic foods were available. Ofood4U planned to prepare its own brand of packaged organic goods, which in 1999 were not readily available from other organic food retailers.

The company decided to initially rent a large warehouse, together with offices, in the nearest large town to Hall Farm. Sarah Hall was looking forward to a less stressful lifestyle than she had experienced since she had moved to Hall Farm in 1994. She was hoping that when the new company was adequately staffed, a lot of the crises that had beset the retailing business at Hall Farm would simply not occur. What she had not realised was how quickly the company would grow.

Richard Hall's brother, together with two close friends, who had helped with the pricing, packaging and selling of organic produce over the last two years at Hall Farm, agreed to become even more actively involved and to invest some finance of their own in this new business. The company also recruited a Procurement Director from a competitor that it had been trading with for the past two years. The person appointed as Finance Director, Derek Smythe (details on page 5), had been involved with Hall Farm in an advisory capacity and was a trusted and experienced accountant. Details of the seven Directors in the new company follow:

Sarah Hall – Chairman

It was agreed that Sarah Hall, then aged 40, who was a very organised and entrepreneurial woman, with the ability to delegate and manage many responsibilities well, should be the Chairman. Sarah Hall did not want to take on a full-time role, with the growing demands of family life, but wanted to be involved with the company at all levels.

Sarah Hall had worked in a number of different offices, mainly in secretarial and personal assistant roles to senior managers. She had not had any experience at a senior level in industry, but all of her fellow Directors felt that she was sufficiently experienced to manage this challenging role.

Richard Hall – Chief Executive

Richard Hall, then aged 42, took on the main responsibility of running the new business. He had appointed a new farm manager at Hall Farm, which left him free to work full time at Ofood4U. In addition to his role as Chief Executive, Richard also agreed to be responsible for all IT initiatives for the company and planned to work closely with Derek Smythe, the part-time Finance Director.

Alan Hall – Sales and Marketing Director

Richard Hall's brother, then aged 37, left his role as marketing manager of a medium-sized wine merchanting company, where he had worked for over five years. Prior to that, he had worked in sales at a number of food and wine retailers and had a lot of marketing experience that he felt would be invaluable in his new role.

He was very confident about the future of the new company and felt that his skills would complement those of his brother well. Richard Hall had always had good ideas for new products, or ways to sell the produce, but almost never got round to putting these good ideas into practice. Alan Hall had the ability to convert some of his brother's ideas into reality. Furthermore, Richard Hall respected his brother's opinion, and would not take offence if Alan Hall were to state outright that he considered that a particular idea was unworkable. Alan Hall had inherited some funds from his father some five years earlier, which he had invested wisely, and was very confident in the new company and its possibilities, if it could satisfy the demand for organic produce.

Jonathan Winters – Operations Director

Jonathan Winters, then aged 43, had been involved with Hall Farm's organic produce for the previous two years and had been responsible for the packaging and distribution operations at Hall Farm. He was also responsible for all aspects of customer service. He wanted to get involved with the new company and was confident that Ofood4U could offer unrivalled products and service. He decided to re-mortgage his own home in order to invest £100,000 in the new company.

Peter Collins – Procurement Director

Peter Collins, then aged 34, had previously worked as a buyer for the large regional wholesale organic company named *Organics for Everyone*, which had purchased organic produce from Hall Farm for the previous two years. He had previously worked in procurement for a large national supermarket chain for eight years and had then been recruited to *Organics for Everyone* where he had consolidated his experience in this specialist food retailing market.

He had been very impressed by Richard Hall when they had first met over three years ago and they had got on well together, both in business and socially. He admired all that Richard Hall had achieved at Hall Farm in the few years he had known him. He was keen to join this new company and invest some funds into what he felt could be a leading company in this market within a few years. He resigned from his job in February 1999 and was moving house to be near to the town where Ofood4U was setting up its business. He had also borrowed funds in order to invest in shares in Ofood4U.

He also shared many of Richard Hall's growth ambitions for the company and agreed that the company needed to create innovative organic products, both fresh and prepared packaged foods, and to market them effectively. Most of the suppliers that Ofood4U planned to deal with were small businesses, with the exception of two suppliers who would supply much of the overseas-grown produce. Peter Collins would have a challenging role managing these key suppliers. His role also encompassed selection of new suppliers, which would meet with Ofood4U's stringent organic quality specifications, so that the company could keep up with growing demand levels.

Amy Mullen – Human Resource Director

Sarah Hall's best friend, whom she had known since schooldays, agreed to take on the role of Human Resource Director. Amy Mullen, also aged 40, had worked as a human resource manager for an international bank for over 10 years, but had been made redundant when the bank had downsized its administration staff.

She had then taken a career break, had two children, and was looking to return to the job market. Over the last two years, Amy Mullen had helped Sarah Hall in an informal way with the recruitment and selection of staff and Sarah valued her skills. Amy Mullen was very flattered when she talked over the role with Richard and Sarah Hall, who both had faith in her abilities. She also agreed to invest in the company using her personal savings and by securing a personal loan.

Derek Smythe – Finance Director

Derek Smythe was a partner in a local branch of a national firm of accountants, whom Richard Hall had got to know and trust since he had moved to Hall Farm. The other six Directors had decided that the company would not require a full-time Finance Director initially, and Derek Smythe felt that he could manage this role in addition to his responsibilities at his firm of accountants.

Derek Smythe would also have responsibility for all financial advice for Ofood4U, and his firm of accountants was appointed to undertake all preparation of financial and management accounts. It was agreed that accounts would initially be prepared quarterly. However, to ensure that suppliers were paid in accordance with their contracts, it was agreed that Sarah Hall, supported by an administration assistant, would be responsible for all payments.

Business plans had been prepared by Richard and Sarah Hall with help and advice from Derek Smythe. Derek Smythe decided to borrow £100,000 in order for him to be able to invest in Ofood4U.

Ofood4U was formed with 3 million authorised shares of £1 each, of which 1·6 million shares were allocated and fully paid up at par value. At the time the shares were issued, £1 per share at par value was considered a fair value. All seven Directors invested their own personal funds at £1 per share, as follows:

	Number of shares	*% shareholding*
Sarah Hall	400,000	25·00
Richard Hall	400,000	25·00
Alan Hall	400,000	25·00
Jonathan Winters	100,000	6·25
Peter Collins	100,000	6·25
Amy Mullen	100,000	6·25
Derek Smythe	100,000	6·25
Total shareholdings	1,600,000	100·00

Ofood4U started trading in April 1999, and the company commenced purchasing organic produce from a small range of UK producers of organic produce, including Hall Farm. From April 1999, all produce from Hall Farm was sold to Ofood4U, at agreed prices, and Hall Farm discontinued all of its retail operations. However, the new company continued to use the distribution routes and customer database that Hall Farm had supplied to Ofood4U.

In order to finance the required capital expenditure and working capital requirements, a loan of £2·0 million was agreed with a local bank, using Richard Hall's house at Hall Farm as security for the loan. The terms of this four-year loan were 8% interest per year, payable monthly. The loan would be repayable in 2003.

Ofood4U routes to the market

Ofood4U continued the mail-order business that had been built up at Hall Farm. With the marketing expertise of Alan Hall, the customer base was expanding fast and the range of products was greatly expanded. The challenges facing Ofood4U in 1999 were twofold. First, to have an attractive range of products that were competitively priced and secondly, to have different routes to the market. When Ofood4U began trading in 1999, most of the national supermarkets gave very little shelf space to organic foods, which were then not considered to be in high demand. Therefore, in 1999, the national supermarkets were not serious competitors to companies such as Ofood4U, as the supermarkets had very limited ranges of organic foods. At this time, Ofood4U was able to supply wide ranges of organic produce to customers who had no other local shops which could supply them with the goods that they demanded.

Ofood4U planned to have four routes to the market operational by the end of 2003, which were:

1. mail-order business (already operational in 1999);
2. market stalls (already operational in 1999);
3. Internet trading (planned for late 1999);
4. shops in key cities (planned for 2003 onwards).

During 1999, Ofood4U had operated the mail-order business that had been established by Hall Farm and had retained the majority of its customers. Despite undertaking very little marketing for the mail-order business, the company saw its customer base grow by over 30% in 1999, much of the growth arising from recommendations from existing customers. The mail-order business was operated from Ofood4U's new warehouse, and orders were taken both by post and by telephone.

Ofood4U quickly established a loyalty scheme to retain its customers and offered them discounts for introducing new customers. The company's loyalty scheme entitled customers to discounts as their cumulative order value increased during each calendar year. Therefore, customers who had spent more than £500 for example, were able to enjoy a discount of 5% on all orders for the rest of that calendar year. Lower discounts were available for customers who spent more than £200 each year.

The packaging and despatch of orders worked far better at the new warehouse than they had when they worked from the farm buildings at Hall Farm. Initially, the company employed a small number of full-time staff in its operations and despatch departments and it was a delight for Sarah Hall to see operations running smoothly, with good, well-trained staff processing orders in a business-like, organised way. As turnover grew, more staff were recruited to keep up with the faster-than-expected growth in the business.

For the mail-order business, during 1999 over 95% of orders were despatched for next day delivery. However, Jonathan Winters wanted to increase this to 100% of orders despatched the same day during 2000, but due to the growth in demand, Ofood4U has generally achieved around only 90% of despatches on time from 2000 to 2004. It has always had difficulties keeping up with its growing customer base and the problems of recruiting staff to meet increases in demand.

Ofood4U also continued to buy organic produce and sell it at local markets, and this proved to be an effective way of promoting the mail-order business. By the middle of 2001, with the growth in the mail-order business and also Internet trading, the company decided to cease selling produce at local markets. This decision was based on two factors, which were first, the growth and loyalty of mail-order and Internet customers, and secondly, the increased availability of organic produce in national supermarkets. With organic produce becoming more widely available, Ofood4U had to adapt and change the way it operated. Additionally, the main supermarkets were already able to undercut some prices offered to customers, and Ofood4U had to realign a number of retail prices for fresh produce to remain competitive.

Richard Hall had numerous ideas for new ways to sell organic produce but agreed with Sarah Hall that the company needed to establish itself and its brand name before it expanded too fast. What was unknown to Ofood4U back in 1999 was how quickly the supermarkets would expand their range of organic produce, and indeed the speed of growth in the overall market.

Commencement of Internet trading

One of Richard Hall's first major projects for Ofood4U in 1999 was to launch an Internet trading service. This would enable the company to widen its customer base in the UK, and would also give many consumers access to a wider range of organic produce than was available to them locally. The UK supermarkets did not stock a very wide range of organic produce in 1999, and many consumers simply did not have access to the products that they wanted.

In May 1999, Ofood4U appointed a local IT company that had been recommended to it and set up a website which would allow prospective customers to view the ranges and prices of products available and to order on-line. The specifications for the website were updated several times over the period of a few months, and the fees for the construction of the website and supporting IT solutions grew. The original budget was estimated to be £120,000, but the fees paid to the IT contractors exceeded £300,000 during 1999. Richard Hall managed much of the process and soon became much more IT-literate than he had been previously.

When Ofood4U started Internet trading in December 1999, it had not expected a high level of demand and was taken by surprise. In the first three weeks in December, Internet orders totalled the same turnover level that the mail-order business had for the preceding six months. The only way that demand could be met during December 1999 was by diverting much of the already procured produce from being sold at markets, and by delaying despatch of some of its mail-order deliveries. However, Richard Hall was disappointed in having to let down many of his regular and loyal customers. He wanted Peter Collins to expand the number of suppliers that Ofood4U used and to procure greater quantities where possible for high-selling product lines.

In January 2000, Peter Collins committed the company to purchase much higher levels of stock for the next three months, to meet the expected demand for the Internet service. Trading was even higher than expected in the first three months of 2000, resulting in attracting, on average, over 100 new customers each week. On the basis of forecast demand, Peter Collins had committed to procure even higher quantities of produce. Again, demand for this new service was good and the company was managing to fulfil its commitment to deliver overnight for over 90% of orders.

However, at the beginning of June 2000, Ofood4U experienced several problems. Due to larger than expected usage of the Internet site, the system kept "crashing" causing customers to have to log back in and any orders that had been partially prepared by customers were lost and they had to start preparing their order again. Many frustrated prospective customers simply gave up and did not place an order. Additionally, many customers thought that they had placed an order and Ofood4U had processed it, only to find that nothing was delivered, and they could not access the company's website. This resulted in many frustrated customers who did not order with Ofood4U again. The customer service team was inundated with queries from customers about their orders, and also many angry calls regarding orders that had not been delivered. This caused a lack of confidence in the company's website and all Internet orders were temporarily suspended in mid-September 2000.

Therefore, much of the bulk orders for produce for the next two months, which were now committed, were in excess of Ofood4U sales potential with the Internet service being unavailable. Some of the perishable foods were wasted. The company tried to sell more at lower prices at local markets, but they too had lost some of their regular customers. This was partly caused by not having the quantity and choice of produce that customers had wanted over the past few months, which had caused them to switch their buying to other organic suppliers. Some others, who had purchased Ofood4U produce at local markets, had started to use Ofood4U's Internet service. Richard Hall was very disappointed in this unfortunate turn of events and felt that the company had become a victim of its own success.

The only way to improve the situation would be to ride the temporary storm by winning customers back at their regular markets and to get the website operational again. Richard Hall sought new advice on the company's Internet ordering capacity from a large international IT specialist. The conclusion was that the company's site was well constructed and easy for customers to use, but that it was not built to deal with the level of users experienced by mid 2000. The IT specialist recommended a substantial investment in both upgraded hardware and software requirements. The forecast cost for this was in excess of £1·2 million, and the full cost of the previous system would have to be written off.

The new Internet retailing service went live in February 2001 and the re-launch of the service went well with few operational problems. Alan Hall had arranged good media coverage, and new and returning customers were soon placing regular orders. As the Internet customer base grew, the company found that it continually had to upgrade its IT requirements to cope with demand. It also had to rapidly recruit staff (and associated office space and equipment) to deal with the volume of business generated from its website. By the end of 2002, all office staff had moved to rented offices a short distance away from Ofood4U's main warehouse.

Ofood4U's product range and suppliers

During the first 18 months of the new business, Alan Hall undertook much market research. Alan Hall had identified that an increasing number of new customers were purchasing organic produce for the first time, and that they wanted to be able to purchase not only the produce itself but also ranges of prepared meals, sauces and other organic produce including fresh bread.

Alan Hall was very enthusiastic about introducing a range of bottled and pre-packaged organic foods, some of which were not available from other companies. His market research confirmed that the demand for such products was present. When Ofood4U first started to consider how these new products could be manufactured, there were very few competitors for packaged organic food.

When Peter Collins joined Ofood4U, his first role was to select key suppliers for the organic produce and also to select food preparation companies that Ofood4U could use to manufacture organic foods, such as sauces, soups and other ready-made products that would be marketed under the brand name of Ofood4U. The company also wanted to select a range of current producers of organic foods and to market their products in its mail-order catalogue and on its Internet site.

Peter Collins and his small team selected over 150 suppliers of organic goods who supplied their own brand goods to Ofood4U to sell to the end customer. The gross margin on these products that were bought in was low and averaged only 15% but gave Ofood4U a much larger choice of goods in order to attract and retain customers.

New ideas and recipes were trialled in Sarah Hall's kitchen back in 1999, and then a food processing company was contracted to prepare and bottle ranges of soups and sauces, exclusively for Ofood4U. These were included in Ofood4U's food catalogue in September 1999 and immediately proved popular.

By the end of 1999, Ofood4U had recruited a product development manager, Jane Cole. She was responsible for selecting, preparing and trialling recipes for new own brand prepared packaged organic foods. She also worked closely with Peter Collins in the selection of sub-contractors for bulk manufacturing. The company had invested £0·6 million on equipping a kitchen and food preparation areas that were used exclusively to trial new own brand organic foods. Within the next 12 months, over 220 new own brand prepared organic foods were available in either bottled or carton form. All of the mass production of bottled organic produce was sub-contracted out to specialist food preparation companies, and Peter Collins was responsible for monitoring quality.

In 2001, Ofood4U broke its contract with one of these food manufacturers, as the quality of the finished branded Ofood4U products did not meet the quality standards agreed, despite several warnings and discussions over a two-month period. Richard Hall felt strongly that he did not want Ofood4U's name associated in any way with food that did not meet the company's high standards. However, the food manufacturer felt that it could prove that agreed food standards had been met. Due to its contractual obligations, Ofood4U agreed, reluctantly, to make a one-off payment for terminating the contract, without the proper notice. Peter Collins and Jane Cole both agreed to ensure that quality standards were explicitly agreed in all future contracts and that Ofood4U's inexperience with food manufacturers had been an expensive lesson to learn.

The company procured dairy and fish produce but for a number of reasons decided not to procure any meat products at all. In 2001, Ofood4U launched its own range of dairy products using 100% of the capacity available at one of its regular dairy suppliers. This was the start of much closer business links with some of its key suppliers who saw how successful Ofood4U had become and who were keen to associate themselves with the company and produce organic goods exclusively for Ofood4U.

Early in 2003, the company opened its own bakery in a small manufacturing unit near Ofood4U's main distribution centre and was able to offer its customers organic breads and cakes that were not available from many other organic food retailers. This line of produce also produced a high gross margin, of over 50%, but the overall value of sales was low compared with Ofood4U's total turnover. There was also little wastage as all production was being made to meet orders that had been placed that day.

Peter Collins also introduced a range of organic wines in 2002, that have proved popular with regular customers and these have achieved a higher than usual gross margin of over 40%.

Ofood4U loans

The company had commenced trading in 1999 with a four-year loan from its bankers of £2 million (at 8% interest per year), which it used to finance both capital expenditure and working capital in its first year. The loan was repayable in 2003.

In 2000, the company had added a further loan of £3 million, which was for five years, repayable in 2005 (also at 8% interest per year). The loan was used to expand the assets of the company (such as warehousing equipment, forklift trucks, refrigeration equipment and packaging machines) to support the high growth achieved. At the end of its second year, the company therefore had loans totalling £5 million.

A third increase in the company's loan financing occurred in 2001 for a further £1 million, which was also at 8% interest per annum for a five-year period, repayable in 2006. The company managed to fund all of its working capital and some capital expenditure from operating cash flows in 2002, but needed to finance a large amount of planned capital expenditure during 2003, as it had outgrown much of the warehousing and distribution space that it had rented. The company also needed to expand its office space and its IT capabilities to meet the demands of its growing customer base. By the end of 2002, the company was renting three premises. These were its main distribution centre, a second smaller distribution centre and offices.

In order to expand the company's turnover to meet the increased demand, Ofood4U rented a further building in early 2003, which housed the company's bakery and a large area was allocated to commence food preparation for some of its established own brand product lines (*not* for trialling of possible new product lines). Around 5% of the company's pre-packed foods were forecast to be prepared at these new premises within 2003. Operational staff, under Jonathan Winters, had been recruited to run the food preparation and bottling operations. This would reduce Ofood4U's dependence on some of its external food preparation companies.

During 2003, the company repaid its initial four-year loan of £2 million (that had been taken out in 1999) and took on a new loan for £6 million (also at 8% interest per year), resulting in total loans at the end of 2003 of £10 million. The latest £6 million loan that was taken on in 2003 was over 10 years, and is repayable in 2013. The company's second loan of £3 million, taken on in 2000, is due to be repaid during 2005.

The bank was impressed with the company's business plans and its strong growth and all that it had achieved in the last five years. The loan for £6 million was secured by a floating charge on all of Ofood4U's assets and was used to finance the ongoing purchase of assets to cope with the growth in demand, including the costs of a major upgrade to the company's IT equipment, which was needed in order for the company's new management information systems to become operational in 2003.

Product profitability

Until the end of 2002, very little detailed accounting had been undertaken on product profitability. The Directors were content with two facts, which were that the company was growing fast and that each year had been profitable. However, it was increasingly becoming apparent that it was necessary to be aware of a more detailed breakdown of each product's net profitability.

Until 2003, when a management accountant joined the Finance department of Ofood4U, the only profitability analysis undertaken was to analyse the company's gross profit. Gross profit is defined as turnover less directly attributable variable costs. Direct variable costs include the costs of the produce, sub-contractors' costs for food preparation, packaging costs and distribution costs, and staff costs for staff specifically involved in order taking and packing and distribution, as well as the small number of food preparation staff. The gross margin does not include any costs associated with all of the rented premises, depreciation or product development costs or staff costs for staff involved in marketing, IT and other non-operational staff.

A comparison of the actual gross margins, by product grouping and sales route, for the last two years is shown below:

	2003		2002	
	Gross margin £ million	*Gross margin %*	*Gross margin £ million*	*Gross margin %*
Sales by mail-order and Internet:				
Fresh produce	1·1	11·0	1·2	13·2
Own brand prepared packaged foods	3·9	31·5	3·2	33·6
Bread	0·2	50·1	0·2	52·5
Wines	0·2	41·2	0·1	41·5
Dairy produce	1·2	25·2	0·9	25·3
Other organic products	0·2	30·0	0·1	30·2
Sales by other sales routes:				
Direct sales to supermarkets of own brand prepared packaged foods	0·1	8·9	0·0	–
Ofood4U own shops	0·1	38·0	0·0	–
Total	7·0	23·2	5.7	24·8

Management and IT changes at Ofood4U

Richard Hall learnt two main lessons from the Internet ordering crisis in 2000. First, that Ofood4U needed some senior in-house IT expertise and secondly, how dependent the company was on its ability to respond rapidly to customer demand. Richard Hall felt that the company needed to ensure that it could procure produce from all of its suppliers to meet demand. He considered that IT systems should be in place between Ofood4U and its key suppliers, and that all IT systems should be disaster proof.

The Board agreed to recruit an IT manager in 2002, but the company still planned to outsource all of its IT development work. The IT manager recruited in June 2002 was Geddes Shah, who had previously worked for an international IT company. He saw the potential growth in Ofood4U and liked the opportunity offered, particularly as Richard Hall had discussed the possibility of a directorship and shares in the company in the future. However, no specific dates or commitments had been agreed.

On joining, Geddes Shah reviewed the company's operations and found that the security, running and IT development plans lacked the professionalism that he had been used to. He also missed all the back-up support from IT-literate colleagues, which he had taken for granted in his previous company. As far as staff members at Ofood4U were concerned, any problem related to a computer was referred to him and he quickly found himself inundated with demands on his time. He also realised that he needed more hands-on assistance with staff training and writing IT specifications. Initially, the Board did not approve the request for more staff, but by the end of 2002, it was agreed that more in-house IT staff would be needed to support Geddes Shah.

Geddes Shah was responsible for specifying, selecting and implementing a new management information system for Ofood4U that became operational in 2003. This new system provided Ofood4U with data in order to monitor sales and profitability levels by product. It also enabled the tracking of products from source of produce (by supplier and location of crop) through to batch numbers of final bottled products. Geddes Shah also implemented an IT solution enabling Ofood4U to have a direct on-line ordering system with its suppliers. This latter system became operational at the end of 2003.

By the end of 2001, the Board agreed that more financial assistance with the day-to-day matters was required. Derek Smythe joined the company as the full-time Finance Director in February 2002 and he recruited two other qualified accountants, which eased the strain on Sarah Hall and her administration assistants. All accounting functions were brought in-house at Ofood4U and all of the accounting work that had been undertaken by Derek Smythe's firm of accountants ceased in June 2002. However, with the continued rapid growth in Ofood4U's business, the in-house accounting function has experienced problems. There has been an increasing need for more detailed management information and data on product profitability. The new accounting system that was introduced in 2002 also added to the workload, and there remains a need to improve these IT systems to give more financial data.

Jonathan Winters was initially in charge of all operations including customer service, but with the growth in the customer base, he recruited a new customer service manager, Jackie Lau, in September 2003. Jackie Lau had much customer service experience and had worked for a leading chain of restaurants before joining Ofood4U. Jonathan Winters remained in charge of warehouse operations and deliveries to customers. However, Jonathan Winters continued to work long hours and to get involved with almost everything happening in the distribution centre. While he had an able team, who coped surprisingly well with meeting demand, he always wanted to be involved with everything happening within the business. This had a positive effect, as he was always up-to-date with new trends and the success or otherwise of new product lines and whether new suppliers had met delivery deadlines.

At the end of 2003, Ofood4U employed 265 full-time employees and also up to 50 part-time staff on a temporary basis to meet peak demand, particularly at busy times such as Christmas.

Opening of Ofood4U shops

Richard Hall was very eager to open organic food shops in key positions in large cities as both Alan Hall and himself felt that there was a large market that was relatively untapped. He wanted to establish Ofood4U as a leading brand in the market, before any competitors also opened shops.

During early 2003, the first Ofood4U shop was opened in the suburbs of a major city. A second shop was opened in February 2004. Alan Hall recruited a manager for Ofood4U shops, Robert Cooper, who was responsible for all day-to-day operations at the shops. He was also responsible for seeking new sites for future Ofood4U shops.

Both shops were rented on a short-term rental contract (three-month notice period). Turnover has been slower than anticipated and the first shop is not forecast to break even until the end of 2004. This is due to the relatively high rent costs and the fixed nature of staff costs. Additionally, the level of waste has increased at the shops due to the short shelf life of some products. In the mail-order and Internet side of the business, this level of waste has not been experienced as products are ordered in and despatched to meet customers' specific orders.

A summary of the results, planned and actual, for the shops is as follows:

	Actual	*Planned*	*Actual*	*Planned*
	Jan to May 2004 (5 months)	*Jan to May 2004 (5 months)*	*Jan to Dec 2003*	*Jan to Dec 2003*
	£000	*£000*	*£000*	*£000*
Turnover	610	800	210	500
Costs of sales	370	480	130	300
Gross margin	240	320	80	200
Fixed costs	585	450	650	550
Net loss before interest and tax	(345)	(130)	(570)	(350)

Robert Cooper had spent the agreed marketing budget to launch and establish these two shops and had held a number of promotional events. However, even though the two shops had established a small level of regular customers, they had not achieved the sales levels that had been planned.

Customer service

Sarah Hall wanted to provide all customers with an excellent level of service so that once they had shopped with Ofood4U they would return. Jackie Lau had a number of new ideas and pushed hard to get one of her early ideas accepted. This idea was initially very costly in terms of packaging, but she felt that it might help retain customer loyalty. She also considered that customers would recommend Ofood4U to their friends and that it would be a good marketing ploy. The idea was to send out all pre-Christmas deliveries in smartly packaged hampers, which would impress new customers and exceed the expectations of their regular customers. The plan seemed to have worked, as new customer registrations were the highest ever in the early part of 2004. However, Richard Hall was startled to discover after the event that the marginal costs were almost £1 million.

By the end of 2003, Ofood4U had a customer base of over 40,000 customers, with an average order value of £64. Some customers ordered weekly, some monthly and some at irregular intervals. As the customer base was growing rapidly, it was difficult to identify the trend of customers who ordered on a regular basis.

Jackie Lau is keen to focus attention on all of Ofood4U's customers, including regular customers who place smaller orders. Alan Hall liked Jackie Lau's approach and agreed that this was a positive move for the company. He had always strongly argued that it was important to manage its customer base as it is considered that it can be six times more expensive in marketing spend to attract a new customer than it is to keep a current customer. Jackie Lau was putting together a customer service plan that would focus on customer retention. She was being pro-active about the customer base as she was aware that a number of other organic retailers were now offering Internet-based retailing and she did not want to see Ofood4U losing customers to competitors. This aspect of managing the customer base was new to Sarah and Richard Hall. Jackie Lau had also asked whether she could participate in share ownership of the company in the future, which is something that Amy Mullen was keen to progress.

First supermarket order

In February 2003, Ofood4U signed its first contract to regularly sell some of its bottled own brand packaged goods to one of the large UK supermarket chains. Richard Hall had been reluctant to sell the Ofood4U brand produce through supermarkets for several reasons and had resisted their approaches up until now. However, the brand name of Ofood4U was starting to get established and all of the Directors agreed that this was a good opportunity. Additionally, it was considered that it would increase demand for other products by customers who liked the limited range that had been contracted for by the supermarket. The actual and forecast value of goods sold to the supermarket chain in 2003 and 2004 are as follows:

	Forecast 2004		*Actual 2003*	
	Turnover £ million	*Gross margin %*	*Turnover £ million*	*Gross margin %*
Sales of branded Ofood4U packaged goods to supermarket chain	1·50	8·8	1·22	8·9

The supermarket chain was not prepared to negotiate terms at all with Ofood4U and simply treated it as another of its many suppliers and imposed its standard terms. However, Alan Hall considered that it was important that Ofood4U's products started to become more widely known and that this would not detract from their main method of selling direct to customers.

Some of the other leading UK supermarkets had recently approached Ofood4U and were keen to stock a similar range of Ofood4U branded packaged goods in their stores. However, the margins offered were low, although the sales volumes forecast were substantial. At present, the Ofood4U Board was considering whether it should supply to these other supermarket chains.

Ofood4U's expansion plans

With the increase in the volume of orders from the Internet business, the company has almost outgrown its warehouse and distribution centres. By the end of 2003, Ofood4U operated from four different rented sites, all geographically close, with around 95% of its prepared organic foods sub-contracted to a variety of food manufacturers.

The company is planning to move to a large purpose-built site on the edge of a major city during 2006 that would accommodate all of the company's needs until 2009, assuming the growth that has been forecast in the current five-year plan (shown as *Appendix 3*). The company has invested in food preparation areas and a bakery that produces fresh bread and cakes each day, but with the planned move, much of this equipment would be impossible to take to the new site and would have to be written off. If the company did not move to new premises in 2006, it would need to rent additional space at another site. Derek Smythe feels that this option would not be cost effective and would further complicate the business if the company had to manage its operations around five different sites.

The proposed site, together with the cost of the food preparation areas and bottling and packaging areas, is forecast to cost £18 million. Although a site had been identified, the company had not yet made any firm commitment.

Richard Hall has been very keen to continue to expand the business, but is concerned that the company had not paid any dividends up until the end of 2003, although a small dividend is planned for 2004. All of the cash generated from operations had been re-invested in the business to finance growth.

Summary profit and loss accounts and balance sheets for Ofood4U, since it commenced trading in 1999, are shown in *Appendices 1* and *2*.

Derek Smythe has worked closely with all of the Ofood4U's managers and has prepared a business plan for the next five years. This is shown as *Appendix 3*. This plan was prepared in November 2003 and was approved by the Ofood4U Board at the Board meeting in December 2003. However, some Board members remain concerned about whether the five-year plan is achievable as some of the underlying assumptions are considered to be over-optimistic. The plan shows that over the next five years, Ofood4U plans to open a further 22 shops, and have 25 shops operational by 2009. These 25 shops are forecast to generate a net profit before interest and tax of £18·3 million in the five-year plan period.

The company has prepared a capital expenditure plan showing a total proposed spend, subject to authorisation of each project by the Board, of £35·1 million over the five-year plan period. The net operating cash flow (after tax) generated in the five-year plan period is £59·0 million, but this is before interest loan repayments, capital expenditure and dividends.

Update of Ofood4U and its competitive position in 2004

Over the last four years, organic produce has been available in an increasing number of high-street stores and also from a number of Internet-based companies. There is an ever-increasing number of products available, and more retailers are stocking organic produce in its various forms. Ofood4U has been at the leading edge of some of the retailing initiatives, including returnable packaging for dairy products. This not only cut down on the packaging costs but also helped the company to appear to be environmentally friendly by recycling some of its packaging.

The company has also developed and uses a unique seal for its products that gives customers assurance that the foods have not been tampered with. While the cost of developing these seals, and the additional cost of packaging, is higher than some of its competitors, it is a feature that Richard Hall has always considered of great importance. With all of the food safety scares that have occurred in recent years, this feature has enhanced Ofood4U's reputation as a high-quality food producer. The Ofood4U brand, and distinct labelling, is used on its own range of packaged foods, which is currently manufactured by a large range of food processing companies.

The information contained in the boxed areas above has been amended. If you downloaded the pre-seen element of the Case Study from the CIMA website prior to 8 April 2004, please note these amendments.

As the main supermarkets have increasingly stocked more ranges of organic produce, the retail price has fallen and Ofood4U has had to realign its prices to stay competitive. Additionally, due to the limited amount of organic produce produced, both grown in the UK and imported, there is a scarcity value on this produce. This has helped maintain prices at a higher level than will continue in the future, as more farming land in the UK becomes licensed as organic and the quantity of organic produce available increases. Therefore, in the medium term, it is expected that prices, and levels of profitability, will fall. To offset this, however, is the continued high growth in the demand for organic produce, partly fuelled by food scares, and also by the increasingly selective consumer, who wants food of a higher quality.

Ofood4U has always worked closely with all of its suppliers, and the company has especially close links with the key farmers who supply 100% of their produce to Ofood4U. Ofood4U has maintained its high reputation as a quality producer and the perception by its customers is that the company is one of the leading producers and distributors of organic produce.

Aside from the large supermarkets, there are a number of small, mainly local companies, selling organic produce, as well as a small number of similar Internet and mail-order businesses operating in the UK and Europe.

Appendix 1

Ofood4U

Summary profit and loss account

	Actual	*Actual*	*Actual*	*Actual*	*Actual*	*Forecast*
	1999	*2000*	*2001*	*2002*	*2003*	*2004*
	£ million	*£ million*	*£ million*	*£ million*	*£ million*	*£ million*
Turnover	6·2	10·9	15·5	23·0	30·2	37·5
Total operating costs	5·6	9·2	14·2	21·2	27·3	32·5
Net profit before interest and tax	**0·6**	**1·7**	**1·3**	**1·8**	**2·9**	**5·0**
Loan interest	(0·2)	(0·3)	(0·4)	(0·5)	(0·8)	(0·8)
Tax (at 30%)	(0·1)	(0·4)	(0·3)	(0·4)	(0·6)	(1·3)
Net profit	**0·3**	**1·0**	**0·6**	**0·9**	**1·5**	**2·9**
Dividends	0·0	0·0	0·0	0·0	0·0	0·6
Amount transferred to reserves	**0·3**	**1·0**	**0·6**	**0·9**	**1·5**	**2·3**

Appendix 2

Ofood4U

Balance sheet	*Actual*	*Actual*	*Actual*	*Actual*	*Actual*	*Forecast*
	End Dec 1999	*End Dec 2000*	*End Dec 2001*	*End Dec 2002*	*End Dec 2003*	*End Dec 2004*
	£ million	*£ million*	*£ million*	*£ million*	*£ million*	*£ million*
Tangible fixed assets (net of depreciation)	**4·2**	**8·2**	**10·5**	**12·0**	**18·6**	**21·9**
Current assets						
Stock	0·1	0·2	0·3	0·4	0·4	0·5
Debtors	0·7	1·0	1·5	1·8	2·1	2·5
Cash and short-term investments	0·1	0·1	0·1	0·1	0·1	0·4
Total current assets	**0·9**	**1·3**	**1·9**	**2·3**	**2·6**	**3·4**
Creditors						
Amounts due within one year	(1·2)	(1·6)	(2·9)	(3·9)	(5·3)	(7·1)
Net current assets / (liabilities)	**(0·3)**	**(0·3)**	**(1·0)**	**(1·6)**	**(2·7)**	**(3·7)**
Creditors falling due after one year						
Loans	(2·0)	(5·0)	(6·0)	(6·0)	(10·0)	(10·0)
Net assets	**1·9**	**2·9**	**3·5**	**4·4**	**5·9**	**8·2**
Financed by:						
Called-up share capital	1·6	1·6	1·6	1·6	1·6	1·6
Profit and loss reserve	0·3	1·3	1·9	2·8	4·3	6·6
Total equity shareholders' funds	**1·9**	**2·9**	**3·5**	**4·4**	**5·9**	**8·2**

Ofood4U
Extracts from five-year plan

	ACTUAL 2003	FORECAST 2004	PLAN 2005	2006	2007	2008	2009	Total five-year plan
	£ million	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Turnover:								
Internet sales	19·6	24·7	27·0	32·5	38·0	41·0	44·0	182·5
Mail-order sales	9·2	9·3	9·8	10·1	10·2	10·4	10·5	51·0
Ofood4U shops	0·2	2·0	6·6	12·4	21·4	33·1	48·7	122·2
Sales to supermarkets	1·2	1·5	2·5	3·0	3·6	4·2	5·2	18·5
Total turnover	**30·2**	**37·5**	**45·9**	**58·0**	**73·2**	**88·7**	**108·4**	**374·2**
Net profit before interest and tax:								
Internet and mail-order sales	3·4	4·7	4·7	5·8	7·2	8·2	9·8	35·7
Ofood4U shops	(0·6)	0·2	0·5	1·4	2·9	5·2	8·3	18·3
Sales to supermarkets	0·1	0·1	0·2	0·3	0·3	0·4	0·4	1·6
Total net profit before interest and tax	**2·9**	**5·0**	**5·4**	**7·5**	**10·4**	**13·8**	**18·5**	**55·6**
After-tax net operating cash flows generated from operations (defined as before interest, new loans, loan repayments, capital expenditure and dividends)	**4·7**	**6·3**	**6·7**	**8·8**	**11·9**	**14·0**	**17·6**	**59·0**
Capital expenditure								
Increased warehousing / new distribution centre	2·3	0·0	0·0	18·0	0·0	0·0	0·0	18·0
Additional in-house food processing equipment	0·9	0·6	0·6	0·0	0·0	1·2	0·0	1·8
Shop-fitting costs (assuming all shops rented)	0·6	0·3	0·9	1·2	1·5	1·5	1·5	6·6
Capital expenditure to meet growth in business (office / computers / operating equipment)	4·1	4·3	2·0	0·9	2·0	2·3	1·5	8·7
Total capital expenditure	**7·9**	**5·2**	**3·5**	**20·1**	**3·5**	**5·0**	**3·0**	**35·1**
Number of Ofood4U shops (at year end)	**2**	**3**	**6**	**10**	**15**	**20**	**25**	

Ofood4U – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 21 – 25.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are the consultant appointed by Derek Smythe to prepare a report for the Ofood4U Board.

Prepare a report that reviews and prioritises the issues facing Ofood4U.

Your report should include discussion and evaluation of the company's proposed expansion strategies and provide recommendations.

You should also provide a recommendation and justification of the most appropriate financing strategy.

Note: The Assessment Matrix, which your script will be marked against, is on the next page for your reference.

Ofood4U – Unseen material provided on examination day

Read this information before you answer the question

Ofood4U in 2004

Sarah Hall had been struggling to maintain the demands of the Chairmanship of the fast-growing company and family life, and felt that she could no longer cope with both. She was also rather worried about how quickly the company had grown and felt out of her depth. Sarah Hall was also concerned that her husband was too involved with the company and should be benefiting financially from the company's success, instead of investing in it further. At the Board meeting in March 2004, she resigned and it was agreed that Alan Hall would temporarily take over as Chairman, in addition to his responsibilities as Sales and Marketing Director. The company is currently considering what skills and characteristics are needed for the role of Chairman, prior to recruiting and appointing a new Chairman. The company is also looking to recruit two or three non-executive directors who would be able to bring fresh ideas and commercial experience.

In addition to Sarah Hall leaving the company in March 2004, another problem arose in early April 2004 when Jonathan Winters was taken ill. Jonathan Winters is responsible for all warehousing and distribution operations, and is currently still off sick from work suffering from a stress-related illness. At this early stage of his illness it is not known when he will return to work, or whether he will have to take early retirement.

Amy Mullen was very concerned that Ofood4U currently had over 280 employees and many of them had been told when they had been recruited that they would be able to participate in a

share ownership scheme. However, at present only the original seven Directors hold shares in Ofood4U. The company wishes to raise finance for expansion and the Board was considering asking staff whether they wanted to invest in the company. It would also be relevant for the seven Directors themselves to consider whether they wished to invest further in the company.

At the Board meeting in March 2004, Derek Smythe stated that the company should be looking at ways to finance the company's expansion. He undertook to prepare a proposal for the next quarterly Board meeting in June 2004. Derek Smythe stated that he considered that the company should become listed in the future. While some Board members want to retain the company's independence, they remain to be convinced.

Derek Smythe was also worried that his small finance team was too inexperienced and over-stretched to cope with the demands of the rapidly-expanding business. Furthermore, the additional time spent with Geddes Shah, identifying and implementing improvements to the IT systems to provide more reliable and timely management information, has taken up much of the time of his senior finance staff.

Expansion plans

The Internet and mail-order business was continuing to grow but with the increased competition, both in terms of price and choice, the company was starting to lose some of its customers, mainly to high-street supermarkets. Alan Hall felt that with the increased competition, the five-year plan (shown in *Appendix 3* on page 18) may have *overstated* turnover. It is estimated that the reduced level of turnover could adversely affect profits and cash flows generated by approximately *10%*. The company is reviewing its current five-year plan and two new opportunities have arisen, aside from those that are included in the plan, as detailed below.

Ofood4U shops

Richard Hall considers that Ofood4U should have more control over producing and selling its own brand goods and that the company should ensure that operational plans are put in place to achieve the five-year plan of operating 25 shops by the end of 2009. At the end of 2003, the company had two shops operational and a third shop was planned to open in November 2004. No further sites had yet been identified, although the company's five-year plan included the opening of between three and five shops each year. The plan assumed that all shops would be rented on a short-term basis.

The forecast capital expenditure included in the five-year plan is £6·6 million on fixtures and fittings and refrigeration equipment over the next five years for 22 shops. There is no capital expenditure planned for purchase of shops. The five-year plan shows that by 2009, the operating profit from Ofood4U shops will grow rapidly with the expansion of shops and will be £8·3 million, and will represent 45% of the company's operating profit. Even if the forecasts for operating profit are overstated by 10%, this new retail area of Ofood4U's business will be significant.

The first two shops are still loss-making and Richard Hall was losing confidence in Robert Cooper's ability to turn them into profitable shops. Alan Hall and Richard Hall were both confident that the locations of the two chosen shops were good and the shops had attracted some favourable publicity. They were starting to realise that perhaps Robert Cooper did not have the management skills necessary to manage the shops and motivate the staff. Furthermore, the company's IT systems are structured to monitor and provide management information on the home-delivery business. Very little management information is currently available for the retailing area of the business and the IT systems installed at the two Ofood4U shops that are operational have not proved satisfactory. Geddes Shah and Robert Cooper are currently reviewing whether the IT systems for shops should be replaced.

Ofood4U shops in FFT centres

In March 2004, a leading firm of garden centres, FFT, which was expanding in the UK, had approached Ofood4U. It wants to sub-let areas of its garden centres to a variety of shops.

Ofood4U was offered up to 15 sites in the UK on a three-year trial. On detailed investigation of this proposal, Robert Cooper and Alan Hall considered that only the 10 larger FFT sites were suitable for possible Ofood4U shops. This possible route for expansion is *not* included in the five-year plan.

The terms of the arrangement are a royalty of 10% of turnover and a fixed annual rental for each site of £0·5 million per year for the three-year contract period (these cost items are included in the net after-tax cash flows shown in the table on page 23). FFT wants a firm commitment from Ofood4U to open outlets at a minimum of 10 sites and FFT requires an answer by July 2004. Derek Smythe continued to be very reluctant to expand too fast but prepared the forecast cash flows shown on page 23. A paper was being prepared by Derek Smythe for the June 2004 Board meeting, when it was envisaged that a decision on whether Ofood4U should open shops in FFT centres would be made. The company considers that a suitable risk-adjusted discount rate for evaluating this proposal is 12% post tax.

Both Richard Hall and Peter Collins, the Procurement Director, were in favour of this proposal and were flattered that Ofood4U had been offered this opportunity, which they felt would not arise again.

Figures below are for all ten shops at FFT centres:

		2004	*2005*	*2006*	*2007*
	Probability	*£ million*	*£ million*	*£ million*	*£ million*
Capital expenditure		3·0	-	-	-
Net after-tax cash inflows:					
High growth	70%		5·5	6·9	8·9
Low growth	30%		1·2	1·5	1·6
Expected net after-tax cash inflows			4·2	5·3	6·7

The cash flows above are for all ten shops and they incorporate rental and royalty payments.

If Ofood4U decided to open shops in FFT centres, it has not yet been decided whether the company should put its planned expansion of other shops on hold or not.

Proposed strategic alliance with TZ

Ofood4U has extended its range of prepared organic foods, both packaged and bottled, to cover large ranges of foods, but at the end of 2003 it still had not launched its own brand of baby food. It was an area that Jane Cole had researched, and Ofood4U planned to launch a range of baby foods during 2005. This planned new range of baby foods is included in the figures shown in the five-year plan (shown as *Appendix 3* on page 18).

In May 2004, Ofood4U began talks with a leading international food manufacturing and retailing company, TZ plc (TZ), which has several divisions. The current turnover for the whole of TZ is £1,100 million. The baby food division of TZ is aware that a number of competitors in the baby food market have been selling a growing range of organic baby food for some time, and its current range of non-organic baby foods has experienced a significant decline in sales. It had considered the potential market for this product to be too small but is now more confident that a market exists. TZ has approached Ofood4U to form a strategic alliance to prepare and launch a new range of organic baby foods. The proposed strategic alliance with TZ is *not* included in the five-year plan.

The nature of the proposed strategic alliance would be that TZ and Ofood4U work together to manufacture, launch and sell branded baby foods in a legal arrangement, but there would be no exchange of equity between the two companies. TZ has drafted the strategic alliance whereby all cash flows, net of agreed shared costs, would be split ***70% to TZ and 30% to Ofood4U***. TZ has stated that it is not prepared to offer Ofood4U a larger share of the strategic alliance, which it states it already considers generous, given the much smaller size of Ofood4U.

Under the strategic alliance, the proposed agreement would be that Ofood4U would be responsible for selection and procurement of organic produce, preparation of all recipes and foods and managing the food manufacturing process. Ofood4U would also have the responsibility of food packaging and labelling using the agreed joint brand names (Ofood4U and TZ), which would appear on all products. While TZ has offered that some of the manufacturing of the new range of organic foods could be undertaken within TZ's existing food processing plants, Ofood4U could choose to use its current food manufacturers for this new range.

TZ would be responsible for the distribution and sales of the new range of baby foods, through its supply chain to supermarkets, both in the UK and overseas. TZ would also be responsible for all marketing. It is envisaged that over 50% of sales would be outside of the UK. Alan Hall considers this an excellent opportunity to get the Ofood4U name established in households, and as a stepping-stone for expansion overseas and he welcomes the approach from TZ. He is also pleased that TZ has even approached Ofood4U and that this demonstrated what a strong reputation Ofood4U has already established.

TZ has a number of conditions to this potential contract, which are as follows:

- three-year agreement to supply organically produced baby food;
- Ofood4U should not produce and sell any other organic baby foods during this three-year period.
- after three years, a new agreement may be negotiated but neither company would have any commitment to continue.

The total forecast net post-tax operating cash flows for baby foods produced under this strategic alliance are as follows:

	2004	*2005*	*2006*	*2007*
	£ million	*£ million*	*£ million*	*£ million*
Capital expenditure	2·7			
Total forecast net post-tax operating cash flows (due to TZ and Ofood4U)		11·0	13·7	17·0

It is assumed that the risk-adjusted discount rate for the proposed strategic alliance is 10% post tax.

Alan Hall has considered the implications for this proposed strategic alliance and feels that this is an opportunity that is unlikely to be offered to Ofood4U again. However, Richard Hall feels that Ofood4U does not need to form a strategic alliance to market a range of baby foods, and that the cash flows generated by sales in the UK will have to be shared with TZ. Richard Hall also argued that the fact that TZ has approached Ofood4U demonstrates that TZ considers that Ofood4U has a good reputation in the marketplace. He feels that he does not want the company to be dictated to by a large company such as TZ. Another fear that Richard Hall has stated is that if the strategic alliance was successful, then TZ could even consider making an offer for Ofood4U in the future, so as to secure its market share and sources of organic produce.

It was considered that this strategic alliance would require much management time and that Ofood4U would be unable to procure the volume of organic produce required if it also decided to open shops in FFT centres. Therefore, the company would *only* be able to expand into FFT centres *or* to manufacture baby food for TZ in a strategic alliance, *but not both.*

Ofood4U to sell its own range of baby foods

The five-year plan envisaged that Ofood4U would launch and sell its own range of baby foods from 2005, which it would be unable to do if it entered into the proposed strategic alliance with TZ. The forecast net operating cash flows that would result from the range of Ofood4U's baby foods that *are included in the five-year plan* are shown below. It is assumed that the risk-adjusted discount rate for the production of its own range of baby foods is 10% post tax.

	2004	2005	2006	2007	2008 onwards
	£ million	£ million	£ million	£ million	£ million
Capital expenditure	0·7				
Net post-tax operating cash flows for Ofood4U's range of baby foods		1·1	1·4	1·7	2·1

Cash flow requirements

For the first time, Ofood4U was planning to pay a dividend in 2004. Up until now all cash had been re-invested in the company and had either funded working capital or the purchase of assets, such as refrigeration and kitchen equipment and IT equipment.

At the end of 2003, all of the company's offices, warehousing and distribution operations were accommodated in rented premises on several sites located close to each other. The company was struggling to operate out of its existing premises and there was no room for any expansion. The five-year plan envisaged that the company would purchase and move to a purpose-built site that would accommodate all of the requirements for Ofood4U, assuming growth as shown in the five-year plan in *Appendix 3* on page 18. The cost of this move is forecast to be £18 million in 2006, and this new property would provide the company with a base that would be able to accommodate the business on one site, rather than the current arrangements spread over several sites.

The future after-tax cash flows, before interest and capital expenditure, is forecast in the five-year plan to be £59·0 million, as shown in *Appendix 3*. However, as stated in the *Expansion plans* section on page 21, Alan Hall now considers that this could be overstated by up to 10% and that a more realistic figure for the after-tax net operating cash flows before capital expenditure, loan repayments, interest and dividends is now forecast to be around £53 million. However, to achieve these cash flows, the planned capital expenditure would remain at £35·1 million, as shown in *Appendix 3*.

Valuation of Ofood4U

Many of Ofood4U's competitors, who are small, newly-established Internet trading companies, are also unlisted, and so valuation of Ofood4U is difficult. Some competing food retailing businesses, which are listed, have a P/E ratio of 12·0. The company's cost of capital is estimated to be 10% post tax.

Appointment of a consultant

With so many changes and new opportunities occurring within the company, Derek Smythe suggested to his fellow Directors that the company should obtain some external advice on its expansion plans. The other Directors agreed and asked Derek Smythe to organise this. In May 2004, Derek Smythe chose to ask the firm of accountants that he used to work for, and who had worked closely with Ofood4U in its initial years, to assist. The consultant appointed was familiar with Ofood4U's fast growth to date and has much experience with small companies.

The consultant was briefed on the opportunities that were currently available and about the company's current operations and future plans, and was asked to prepare a report for the next Board meeting in June 2004.

Present value table

Present value of $1, that is $(1-r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods	Interest rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Interest rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Periods	Interest rates (r)									
(n)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	0.683	0.672	0.661	0.650	0.640	0.630	0.620	0.610	0.601	0.592
3	0.564	0.551	0.537	0.524	0.512	0.500	0.488	0.477	0.466	0.455
4	0.467	0.451	0.437	0.423	0.410	0.397	0.384	0.373	0.361	0.350
5	0.386	0.370	0.355	0.341	0.328	0.315	0.303	0.291	0.280	0.269
6	0.319	0.303	0.289	0.275	0.262	0.250	0.238	0.227	0.217	0.207
7	0.263	0.249	0.235	0.222	0.210	0.198	0.188	0.178	0.168	0.159
8	0.218	0.204	0.191	0.179	0.168	0.157	0.148	0.139	0.130	0.123
9	0.180	0.167	0.155	0.144	0.134	0.125	0.116	0.108	0.101	0.094
10	0.149	0.137	0.126	0.116	0.107	0.099	0.092	0.085	0.078	0.073
11	0.123	0.112	0.103	0.094	0.086	0.079	0.072	0.066	0.061	0.056
12	0.102	0.092	0.083	0.076	0.069	0.062	0.057	0.052	-	-
13	0.084	0.075	0.068	0.061	0.055	-	-	-	-	-
14	0.069	0.062	0.055	-	-	-	-	-	-	-
15	0.057	0.051	-	-	-	-	-	-	-	-

Cumulative present value of $1 per annum, Receivable or Payable at the end of each year for *n* years $\frac{1-(1+r)^{-n}}{r}$

Periods	Interest rates (*r*)									
(*n*)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Interest rates (*r*)									
(*n*)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	7.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Periods	Interest rates (*r*)									
(*n*)	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	1.509	1.492	1.474	1.457	1.440	1.424	1.407	1.392	1.376	1.361
3	2.074	2.042	2.011	1.981	1.952	1.923	1.896	1.868	1.842	1.816
4	2.540	2.494	2.448	2.404	2.362	2.320	2.280	2.241	2.203	2.166
5	2.926	2.864	2.803	2.745	2.689	2.635	2.583	2.532	2.483	2.436
6	3.245	3.167	3.092	3.020	2.951	2.885	2.821	2.759	2.700	2.643
7	3.508	3.416	3.327	3.242	3.161	3.083	3.009	2.937	2.868	2.802
8	3.726	3.619	3.518	3.421	3.329	3.241	3.156	3.076	2.999	2.925
9	3.905	3.786	3.673	3.566	3.463	3.366	3.273	3.184	3.100	3.019
10	4.054	3.923	3.799	3.682	3.571	3.465	3.364	3.269	3.178	3.092
11	4.177	4.035	3.902	3.776	3.656	3.544	3.437	3.335	3.239	3.147
12	4.278	4.127	3.985	3.851	3.725	3.606	3.493	3.387	3.286	3.190
13	4.362	4.203	4.053	3.912	3.780	3.656	3.538	3.427	3.322	3.223
14	4.432	4.265	4.108	3.962	3.824	3.695	3.573	3.459	3.351	3.249
15	4.489	4.315	4.153	4.001	3.859	3.726	3.601	3.483	3.373	3.268
16	4.536	4.357	4.189	4.033	3.887	3.751	3.623	3.503	3.390	3.283
17	4.576	4.391	4.219	4.059	3.910	3.771	3.640	3.518	3.403	3.295
18	4.608	4.419	4.243	4.080	3.928	3.786	3.654	3.529	3.413	3.304
19	4.635	4.442	4.263	4.097	3.942	3.799	3.664	3.539	3.421	3.311
20	4.657	4.460	4.279	4.110	3.954	3.808	3.673	3.546	3.427	3.316

FORMULAE

Valuation Models

(i) Irredeemable preference share, paying a constant annual dividend, d, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_{pref}}$$

(ii) Ordinary (Equity) share, paying a constant annual dividend, d, in perpetuity, where P_0 is the ex-div value:

$$P_0 = \frac{d}{k_e}$$

(iii) Ordinary (Equity) share, paying an annual dividend, d, growing in perpetuity at a constant rate, g, where P_0 is the ex-div value:

$$P_0 = \frac{d_1}{k_e - g} \text{ or } P_0 = \frac{d_0[1+g]}{k_e - g}$$

(iv) Irredeemable (Undated) debt, paying annual after tax interest, $i(1-t)$, in perpetuity, where P_0 is the ex-interest value:

$$P_0 = \frac{i[1-t]}{k_{dnet}}$$

or, without tax:

$$P_0 = \frac{i}{k_d}$$

(v) Future value of S, of a sum X, invested for n periods, compounded at r% interest:

$$S = X[1 + r]^n$$

(vi) Present value of £1 payable or receivable in n years, discounted at r% per annum:

$$PV = \frac{1}{[1+r]^n}$$

(vii) Present value of an annuity of £1 per annum, receivable or payable for n years, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r}\left[1 - \frac{1}{[1+r]^n}\right]$$

(viii) Present value of £1 per annum, payable or receivable in perpetuity, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r}$$

(ix) Present value of £1 per annum, receivable or payable, commencing in one year, growing in perpetuity at a constant rate of g% per annum, discounted at r% per annum:

$$PV = \frac{1}{r - g}$$

Cost of Capital

(i) Cost of irredeemable preference capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_{pref} = \frac{d}{P_0}$$

(ii) Cost of irredeemable debt capital, paying annual net interest, $i(1 - t)$, and having a current ex-interest price P_0:

$$k_{d\text{net}} = \frac{i[1 - t]}{P_0}$$

(iii) Cost of ordinary (equity) share capital, paying an annual dividend, d, in perpetuity, and having a current ex-div price P_0:

$$k_e = \frac{d}{P_0}$$

(iv) Cost of ordinary (equity) share capital, having a current ex-div price, P_0, having just paid a dividend, d_0, with the dividend growing in perpetuity by a constant g% per annum:

$$k_e = \frac{d_1}{P_0} + g \quad \text{or} \quad k_e = \frac{d_0[1 + g]}{P_0} + g$$

(v) Cost of ordinary (equity) share capital, using the CAPM:

$$k_e = R_f + [R_m - R_f]\beta$$

(vi) Weighted average cost of capital, k_0:

$$k_0 = k_e\left[\frac{V_E}{V_E + V_D}\right] + k_d\left[\frac{V_D}{V_E + V_D}\right]$$

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FLCS

Management Accounting – Case Study

Thursday afternoon

Case Writer's Answer for Management Accounting – Case Study

REPORT

27 May 2004

To: Ofood4U Board From: Management consultant

Review of Ofood4U

Report contents:

1.0 Introduction
2.0 Terms of reference
3.0 Review and prioritisation of the issues facing Ofood4U
4.0 Discussion of Ofood4U's proposed expansion strategies
5.0 Recommendations for Ofood4U's expansion strategy
6.0 Recommendation and justification of the most appropriate financing strategy

Appendix 1 Strengths, weaknesses, opportunities and threats analysis for Ofood4U
Appendix 2 Evaluation of Ofood4U shops at FFT garden centres
Appendix 3 Evaluation of Ofood4U baby food range, both in the proposed strategic alliance with TZ and if Ofood4U sells its own range
Appendix 4 Summary of future cash flows and financing requirements

1.0 Introduction

Ofood4U was established in 1999, some five years ago, and has grown rapidly in this competitive, but expanding, market of retailing organic foods. Ofood4U has an established customer base for its mail-order and Internet home delivery service, and in 2003 opened its first shop. It now has two shops open, which are not yet profitable. The company's turnover is forecast to be over £37 million at the end of 2004. The company is financed by equity from the seven original investors and a series of short-term bank loans. It currently has an ambitious five-year plan but a financing strategy needs to be put in place in order for the company to achieve its planned growth. The company also has a choice of alternative expansion strategies.

2.0 Terms of reference

I have been appointed as a management consultant, to undertake a review of the issues facing Ofood4U. This report also discusses and evaluates the company's proposed expansion strategies, and includes a recommendation of which expansion strategy should be implemented. The report also addresses the company's financing strategy, and this report recommends the most appropriate financing strategy to achieve the expansion plans.

3.0 Review and prioritisation of the issues facing Ofood4U

There are a number of issues facing Ofood4U, and these are summarised and discussed below:

- Competition
- Staffing
- IT systems
- Expansion opportunities
- Future financing strategy – cash shortage in 2006
- Ofood4U premises and proposed purchase of a new site

3.1 Competition

Ofood4U is facing increasing competition from supermarkets and other organic food retailing companies. It is not an option simply to remain doing only what it does at present, as it could see its customer base reduce.

The size of the UK, and global, markets for organic produce is growing and more consumers are looking for ready prepared ranges of organic foods, with which Ofood4U has established a good brand name.

As more organic produce is available, customers are becoming more discerning. Therefore, if Ofood4U is to retain its existing customers and increase its customer base, it will have to meet other market-driven criteria, such as price, quality and range.

Ofood4U should capitalise on the Ofood4U brand name and market its goods more widely. Perhaps a marketing campaign should be prepared and targeted carefully so that maximum impact on its market segment is achieved. More marketing especially needs to happen to promote the two newly-opened shops to build up a higher core base of regular customers.

The company needs to continue to be innovative with new food ranges and also to be more innovative with packaging and marketing of products. It is ultimately the 'appeal' to customers that will sell the products. If they are badly packaged or marketed, then customers will not select the products, however good they are. The company has established a good food safety record and should continue to maintain consumer confidence (for example, food seals), particularly if it is to sell prepared baby foods, which have been the subject of several food 'tampering' scares in recent years.

3.2 Staffing

It is apparent that Robert Cooper is too inexperienced to manage the shops and Richard Hall is losing confidence in him. At present there are only two shops open and both still making losses. Furthermore, there is only one site planned to open in late 2004. The challenging five-year plan includes a further 22 shops opening in the next five years.

Since there is a loss of confidence by Richard Hall in Robert Cooper, and the poor IT systems that he has introduced, it is recommended that a more experienced retail manager is recruited to manage all of the retail shops and to expand into suitable additional sites more swiftly.

The company is under a greater strain with Jonathan Winters off sick with a stress-related illness. What immediate effect has this had on business operations and staff morale? How

long should Ofood4U keep his position open and would Jonathan Winters be capable of returning to this stressful position? A temporary internal promotion (or an external senior temporary manager) must be put in place as soon as possible so that day-to-day operations, that affect customers, are not adversely affected.

It is apparent that the overstretched and inexperienced finance staff cannot keep up with business expansion and IT systems. Improved control of cash flows and future planning is required. The company has continually run short of cash, although it is profitable, and it has simply used short-term loans to meet the immediate shortfall. A more permanent financing strategy should be developed and put in place, as proposed later in this report.

There has been no permanent Chairman since Sarah Hall's resignation (although Alan Hall is the temporary Chairman). With so many expansion opportunities available, and the concerns over the company's financing strategy, it is imperative that an experienced businessperson, who is familiar with the competitive food retailing market, is identified urgently. The Board should also recruit non-executive directors.

IT is an important business tool, which could determine Ofood4U's competitive edge (or indeed could lead to loss of customers and market share if it experienced major problems). Clearly Ofood4U has had much success with its IT systems as it currently supports a customer base of over 40,000 customers who order regularly. It should not, however, become complacent, with technology improving at the pace it is. The company's competitive ability lies with satisfying its customers and it should review its systems and its contingency plans. Currently Geddes Shah is responsible for IT in the company. It is suggested that an IT Director is appointed, and that if Geddes Shah is suitable for this high-profile role, he should be promoted and more in-house expertise should also be brought in to support this key area.

Overall, there is a need for more professional, commercially-experienced managers (rather than the 'home-grown' friends and family who currently manage Ofood4U), particularly if the company is to possibly become listed in the future.

There is an HR issue to be addressed whereby staff motivation and retention of key staff could be improved if staff were to be able to buy (or be given) shares in the company. With the possibility of the company becoming listed in the future, this would help motivation and goal congruence.

Additionally, the company could ensure that key members of staff are not contractually allowed to move directly to competitors. Furthermore, key man insurance should be taken out to cover the additional costs incurred to the business by the loss of a key member of staff. Certainly all of the seven Directors, and perhaps also the IT Manager Geddes Shah should be covered by key man insurance. However, it should be noted that it is unlikely that key man insurance would be available for Jonathan Winters who is already off sick with a long-term illness.

3.3 IT systems

It is unclear as to whether Robert Cooper has been totally responsible for the weak IT systems implemented for the shop retailing area of the business. The IT systems need to be rapidly improved, or replaced, and this is particularly important before more shops are opened.

It is suggested above that an IT Director be appointed, which may be the current IT Manager, Geddes Shah, who would be responsible for company-wide IT solutions and maintenance of best commercial practice.

New and improved IT systems are required so that management in the shop retailing part of the business are given accurate and timely information, which should help them to

identify and minimise waste, and minimise the amount of short shelf life products currently held at the shops.

Additionally, with the increased competition in the organic food retailing business, Ofood4U will find itself under more pressure to manage its gross margins. Therefore, IT solutions are required that could identify costs and margins, which management could use to try to improve product profitability.

Similarly, Jackie Lau will need to have access to such things as customer data and frequency of ordering so that the company can target its marketing campaigns and also for customer retention purposes.

The company should improve its ability to prepare accurate forecasts and also the ability to update them with changed market conditions, so that early management action can be taken to meet agreed financial targets. An improved forecasting and planning system is recommended, to ensure that all forecasts are as accurate as possible. For example, it has just been identified that the current planned cash flows are already 10% over-stated due to over-optimistic assumptions. These should be revised immediately, so that short and medium-term financing plans can be put in place.

3.4 Expansion opportunities

Ofood4U has several expansion opportunities. The five-year plan assumed a growth in its sales from £30 million in 2003 to over £108 million in 2009 (a threefold increase in turnover).

The five-year plan assumed a strong growth in its Internet sales (from £27 million in 2003 to £44 million in 2009, which is over 62% increase in the five-year plan), and also assumed the opening of 22 further shops, with 25 shops operational by the end of 2009. It is planned that the 25 shops would generate a net profit before interest and tax of £18.3 million in the five-year plan (which is now reduced by 10% to around £16 million).

Some of the increased sales in the five-year plan include the planned new production of baby food, which Jane Cole planned to launch in 2005, which is evaluated below.

In addition to the growth in the five-year plan, Ofood4U also has two totally new opportunities. These are to open shops in 10 FFT garden centres, for which a decision is required by July 2004. The other alternative opportunity is to form a strategic alliance with TZ to produce baby food for the global market.

These two new opportunities are discussed in the next section of this report.

3.5 Future financing strategy for Ofood4U

The company has identified that it needs to put a more appropriate financing strategy in place, instead of simply adding on further bank loans when a cash crisis looms. More forward planning and alternative sources of finance should be sought. The forecast cash shortfall and proposed financing strategy is discussed below in section 6.0.

In the five-year plan, by the end of 2009 the forecast is that the company is a net generator of cash, even with the forecast overstated. Overall in the plan the reduced forecast of £53 million (£59.0 million less 10% overstated) is approximately £18 million greater than the total capital expenditure planned. However, these figures exclude loan repayments and ignore the fact that in the early years of the five-year plan the company has a huge cash shortfall, which needs to be urgently addressed.

In 2006, the company will simply run out of cash. A summary of the future cash flows and the financing requirements is shown in *Appendix 4*.

The position is that the company cannot do what it is planning to do, without a large injection of cash. Alternatively, the company needs to change its five-year plan. The one major cash outflow is the proposed purchase of new premises, of £18.0 million planned for 2006. At this stage, this is a luxury the company simply cannot afford. However, perhaps the move to new premises could be financed a different way, such as a sale and lease back, or a further loan secured on the premises.

Additionally, the company is forecasting to pay a dividend for the first time in 2004, of £0.6 million. Given the forecast cash shortage, it is recommended that no dividends be paid until a more permanent financing strategy is put in place. Additionally, any dividend payments made in 2004 would create expectations of dividends for the future as well.

3.6 Ofood4U premises

Apart from the fact that the company cannot afford the proposed move in 2006 to the new £18 million site, what cost justification is there for the move? The fact that all premises are currently rented gives the business flexibility. A move to a large-cost owned building would impose a long-term fixed cost for Ofood4U. While the running costs and operational efficiencies would improve profitability, the company simply cannot afford this new site. As it is running out of space it would be forced to rent a further additional site. Additionally, it is proposed that the planned additional in-house manufacturing of food should not be pursued. Ofood4U should concentrate on the retailing side of its business, and not venture into new territories, which has added complications. The company's chosen sub-contractors for food manufacturing have achieved the desired quality standards and this method should continue.

Therefore, this could free up space in the sites currently rented and also save on the planned capital expenditure, which is included in the five-year plan (£1.8 million in the five-year plan for in-house food processing equipment).

4.0 Discussion of Ofood4U's proposed expansion strategies

Ofood4U has a number of areas for possible expansion, as well as maintaining, and increasing its customer base for its mail-order and Internet home-delivery service. Ofood4U needs to assess each opportunity that presents itself and to ensure that it fits in with its agreed business strategy.

It is experiencing price competition and is losing customers to supermarkets. It could never hope to compete with supermarkets on price, and therefore must differentiate itself by its products and its service. It has a good reputation for both and needs to build upon this. The strengths, weaknesses, opportunities and threats for Ofood4U are shown in *Appendix 1* attached.

The company has attracted, and retained, its customer base by good customer service and innovative products (as well as other issues such as recycled packaging and unique food safety seals). It needs to continue to be innovative to survive in this increasingly competitive market.

The company is keen to open shops, but the two shops opened so far have not been as profitable as planned and have been slow to build up trade. Is this just early days, or should the financial viability of shops be re-examined? This is particularly relevant to the possible planned expansion into FFT garden centres.

Additionally, Ofood4U sells some of its product lines to one leading supermarket and also has been asked to supply other supermarkets. While the margins are low, the volumes

could be high. However, Ofood4U cannot hope to continue to attract Internet customers and retail customers to its own shops if an increasing range of its own brand products is readily available in the high street from leading supermarkets. The company therefore has a clash in its marketing plan that could be dangerous if both of these competing strategies are allowed to continue.

Since the Ofood4U Board has approved the five-year plan, which includes the expansion in the number of retail shops, it should be assumed that the company would not want to wholesale its own brands widely to all UK supermarkets.

In addition to the expansion shown in the five-year plan, the company had two totally new expansion opportunities. Therefore, the four new areas of expansion are summarised as follows:

1. open a total of 25 Ofood4U shops by 2009;
2. Ofood4U shops in 10 FFT garden centres;
3. strategic alliance with TZ to manufacture and sell jointly branded baby food;
4. launch Ofood4U own brand baby food in the UK.

Each of these four expansion strategies is discussed below.

4.1 Ofood4U shops

The five-year plan envisages 25 shops by 2009, but apart from opening 2 and planning a third for late 2004, no further sites have been identified. Additionally, Robert Cooper has not been successful in turning the first two shops into profit, as yet, and Richard Hall has lost confidence in his abilities. A further problem that has been identified is that the IT systems for the shop retailing side of the business are weak and may need to be replaced.

It would be dangerous for Ofood4U to continue to expand the number of shops until these problems have been resolved. The Board should decide whether Robert Cooper is capable of continuing in his position and if not, he should have his contract terminated. A replacement shop manager with a proven track record should be recruited as soon as possible. This post requires strong management and marketing skills. Additionally, perhaps the selection of future sites of Ofood4U shops should be the responsibility of an agent, or a further new post at a senior level, leaving the shop manager free to manage the shops that are operational.

Other issues that should also be reviewed are the sales forecasts, and whether they are realistic, and whether more market research should be conducted prior to site selection for additional shops.

A different alternative, that has been highly successful for other health food areas, is franchising. Ofood4U could franchise the company's name and supply the franchisee with branded Ofood4U products and would not be involved with the day-to-day operations, nor the capital cost of setting up shops. This method of expansion could lead to faster growth for the company but at the cost of reduced margins, but could have a positive effect of increasing brand awareness, which is key to the company's success in the long term.

If Ofood4U decides not to franchise out the shops, then the best method to increase sales is to incentivise shop managers, as well as all sales staff, so that sales and profitability targets are met.

As the method of direct sales through shops is new to the company, the company must become more proactive in its methods of marketing, so that new customers are attracted to visit the new shops. A large marketing compaign in each area of each shop should be launched to coincide with each shop opening, to increase awareness and build up a local regular customer base. Additionally, a customer loyalty scheme should be introduced.

4.2 Ofood4U shops in 10 FFT garden centres

This seems a good opportunity for expansion, and has the added advantage of setting up shops in places where business is already established. If the FFT garden centres are profitable, they must be attracting customers into their premises. It needs to be established, by market research, whether these types of customers would also shop at Ofood4U shops.

The expected NPV, which is shown in *Appendix 2*, is £9.8 million. While this is very profitable, the underlying assumptions should be re-checked as there is a 30% probability of low growth, which would only generate a very small positive NPV.

The NPV evaluations for the expected, as well as the high and low growth scenarios are shown in *Appendix 2*. These are summarised below:

	Probability	*NPV for 3 years £ million*
Expected NPV		9.8
High growth NPV	70%	13.7
Low growth NPV	30%	0.4

As can be seen above, the low growth scenario would produce an NPV of only £0.4 million. Overall, the proposed expansion into FFT garden centres could proceed, as the NPV for the proposal is positive, even in the low growth scenario.

However, the information provided states that this expansion method *cannot* be selected as well as the strategic alliance with TZ.

Therefore, the proposal with the highest NPV over the three-year period should be selected, assuming both expansion proposals meet with Ofood4U's agreed business strategy. The NPV for the FFT garden centres is £9.8 million, whereas the NPV for Ofood4U's share of the strategic alliance is £9.4 million (see paragraph 4.3 below). On face value, the FFT centre expansion is the preferred choice solely on NPV.

However, I have recommended that the strategic alliance with TZ is more important than opening 10 shops in FFT garden centres (see paragraph 5.0 below). Therefore, the offer from FFT would have to be declined.

4.3 Strategic alliance with TZ to manufacture and distribute baby food

As shown in *Appendix 3*, the proposed strategic alliance with TZ would generate a positive NPV for both companies, over the three-year agreement, of £31.4 million. Ofood4U has been offered a share of 30%, which would result in a positive NPV for Ofood4U of £9.4 million. This is slightly less than the NPV from expansion into FFT garden centres.

The proposed strategic alliance is an important step for Ofood4U and the longer-term advantages should not be ignored. The proposed strategic alliance could open up new routes to the market for other Ofood4U products in the future. If Ofood4U turned down this offer, it may never arise again and perhaps it would miss this opportunity to have its products marketed as widely, particularly outside of the UK.

The disadvantages are that the profit from the baby food products would be shared with TZ and Ofood4U may have to launch its own range at the end of the three-year agreement period if the two companies decide not to carry on working together. Another disadvantage is that if Ofood4U entered the strategic alliance, it could find itself totally overruled on all manufacturing and marketing matters by this large food manufacturing company, which is a plc with international links. A small company like Ofood4U would have little ability to influence this large established food company.

There is the risk that at the end of the three year period, TZ would drop Ofood4U and continue to manufacture and sell baby foods, albeit without the Ofood4U brand name, and that Ofood4U would have greater difficulty entering this competitive market in three years time.

Another concern that Richard Hall has stated is that this could be just a preliminary move by TZ to attempt to purchase shares from existing Ofood4U Directors, with a longer-term view of acquiring Ofood4U. Ofood4U has a good brand name, access to (relatively) scarce organic food producers and a growing customer base. Although the company is currently a private company with the shares held by only seven individuals, if an attractive price were to be offered to any of the existing shareholders in the future, it is possible that some of them would sell. Furthermore, the risk of take-over by TZ (or another food retailer) is greater if Ofood4U became listed in the future.

This is an important decision as to whether to form this strategic alliance. My recommendation is that this is not an opportunity to be missed and that Ofood4U should accept it. Since TZ has approached Ofood4U it obviously feels that their joint names can make this new product very successful, or TZ would have produced the product range on its own.

TZ needs Ofood4U for a number of reasons, which include its sources of organic produce (as there is a shortage of supply) and its brand name and the high consumer confidence in Ofood4U.

The NPV from the proposed strategic alliance is £9.4 million compared to the expected value of £9.8 million from expanding into FFT garden centres. Therefore, on face value, the greater NPV should be chosen. However, they are very close and the strategic alliance offers a much wider opportunity for Ofood4U to expand.

As the company feels that it cannot take this strategic alliance and expand into FFT garden centres, the final decision is one of which strategy would offer Ofood4U greater success in the longer term.

I recommend that the strategic alliance with TZ should be selected. Therefore, the company cannot expand into FFT garden centres, but it would be able to open shops at other sites (if it chose to do so) in accordance with its five-year plan. However, perhaps it should concentrate its limited management resources on making the strategic alliance successful.

4.4 Ofood4U to sell its own range of baby foods

If the company chose not to enter the proposed strategic alliance with TZ, it is planning to prepare a range of baby foods to be launched in 2005. The case flows for this baby food produces a positive NPV of £2.8 million in the three years to 2007, as shown in *Appendix 3*.

However, if the forecast cash flows were to continue in perpetuity, then the total NPV for this range could be as high as £18.6 million, assuming forecasts are correct. Given the level of competition, and the many unknowns in the future, the three-year NPV of £2.8 million should be used for comparison purposes.

The company's five-year plan includes this new range of products and the resultant cash flows. They are considerably smaller than the proposed cash flows that could arise from the proposed strategic alliance, where the total NPV for three years is £31.4 million, almost 12 times greater, due to the marketing abilities of TZ to get these products sold in the UK and overseas.

Ofood4U needs to decide whether it can afford to pass up the opportunity offered by TZ. If it chose not to enter the strategic alliance then the positive NPV from its own range of baby foods confirms that this range is profitable and should proceed. However, if TZ

launches its own range (separately from Ofood4U) then the market would become even more competitive and Ofood4U's cash-flow forecasts could be overstated. It would also adversely affect the success of Ofood4U's own range and would, perhaps mean that greater marketing spend would be required to generate interest in this new range of foods.

A further consideration is that after the end of the three-year strategic alliance, the agreement could continue but neither TZ nor Ofood4U would have any further legal obligations to continue the alliance. Both companies could then be free to launch their own range of baby foods if this strategic alliance was not renewed. This could make it difficult for Ofood4U to launch its own brand in 2008 as the market would be more competitive and it would be looking to build up its own market share against already established brands.

My recommendation is that Ofood4U should form a strategic alliance with TZ.

Therefore, when the legal arrangements have been agreed upon, Ofood4U could share all of the planning and research work that it has already undertaken for its planned new range of baby foods, so that the new jointly branded range can be launched as soon as possible.

5.0 Recommendations for Ofood4U's expansion strategy

5.1 Recommendation for Ofood4U shops

As stated above, it is key that the management and IT systems for the shop retailing area of the business are brought under control prior to additional shop openings. Furthermore, in the light of Ofood4U's limited experiences with shop retailing to date, and the two loss-making shops, this retailing area of the business should be reviewed.

If the company decides that it is stretching its limited management resources with the problems of new shop openings with all of the other expansion opportunities, then this could be handled in two different ways. Firstly, the expansion of the retail business and the roll out of 25 shops could be put on hold. Secondly, the rollout of Ofood4U shops could be expanded by the use of franchisees.

Due to the limited management, and cash, resources, I recommend that Ofood4U shops be offered to entrepreneurial individuals (or small companies) on a franching arrangement. Therefore, expansion of shops could increase at a faster pace, with minimal risk to Ofood4U, and the company would be able to charge a franchising fee and a margin on all branded Ofood4U food supplies to franchisees.

This would also have the added benefit of removing £6.6 million of capital expenditure that is in the five-year plan. More importantly, it would free up management time to concentrate on the core Internet sales business, and on retaining existing customers and growing the customer base. This will in itself be extremely challenging with the increased high-street competitors. It would also leave Ofood4U's management free to pursue other alternative expansion strategies, such as the proposed strategic alliance with TZ.

5.2 Recommendation of expansion into FFT garden centres

As discussed above, this potential route for expansion produces a positive NPV of £9.8 million. It has been made clear that this expansion route cannot be selected as well as the strategic alliance with TZ.

I recommend that the strategic alliance with TZ offers to Ofood4U more potential for long-term growth and stability, at this point in time, than the mere expansion into 10 FFT

garden centres. Additionally, there is a 30% chance that the NPV at the FFT garden centres would only be £0.4 million, which, while positive, is very low.

Therefore I do **NOT** recommend that Ofood4U accept the offer from FFT to open shops in ten of the FFT garden centres.

5.3 Recommendation of expansion into a strategic alliance with TZ

This opportunity also encompasses many risks, but the reputation and experience of TZ can only benefit Ofood4U. The chance to enter into the proposed strategic alliance should enable Ofood4U to enter new markets and learn more about the marketing and distribution routes in this competitive food retailing market.

The forecast NPV after three years due to both companies is shown in *Appendix 3*. The forecast NPV due to both companies is £31.4 million. Ofood4U has been offered a 30% share of the proposed strategic alliance, which would result in a NPV for Ofood4U of £9.4 million. If Ofood4U were to be able to negotiate a higher percentage share of the strategic alliance (although this is unlikely), each 1% point increase would result in an increased NPV of £0.3 million.

The NPV of £9.4 million for this proposed strategic alliance is a little lower than the NPV from opening shops at 10 FFT garden centres, which is £9.8 million (assuming the expected level of growth). However, the difference is very small and it is considered that the overall benefits and the lower risk of entering into the strategic alliance with the internationally recognised company TZ would be the better choice for its expansion strategy.

If the proposed jointly branded baby food range is as successful as TZ forecasts that it will be, it would enable Ofood4U's name to become recommended as a quality brand of organic foods in many new overseas markets. It would also have a positive knock on effect on Ofood4U's market in the UK.

This could lead to other benefits, such as new customers for Ofood4U's Internet sales of satisfied customers who regularly buy the new jointly branded baby foods. If the Ofood4U name became more widely known, it could also help with the success of its shops, whether operated by Ofood4U or franchised out.

There are many reasons why TZ may wish to enter into the proposed strategic alliance. These include the fact that Ofood4U has ready access to producers of organic produce and a proven track record of developing successful new organic food products. Additionally, TZ is also probably aware that Ofood4U plans to launch its own range of baby foods in 2005. This would introduce yet another competitor (in this already competitive market) that any new range that it could introduce on its own would have to compete against. TZ has probably considered that by forming a strategic alliance with Ofood4U, it has easy access to (relatively scarce) organic produce, an already trialled and almost ready to launch range of baby foods and also the good reputation of Ofood4U's branded foods.

There are the risks of TZ dictating all of the terms and 'over-powering' ideas generated by Ofood4U's managers. However, it has approached Ofood4U as it clearly considers that Ofood4U has a good reputation and brand name, and also high consumer confidence in food safety issues. This last point is very important in the marketing of baby foods, where the purchasers of the products are looking for well-known brand names that instil confidence in their products. The proposed strategic alliance between TZ and Ofood4U could be a winning combination.

Many of the large international food manufacturers have taken the route of some form of alliance or take-over of smaller companies, to obtain access to their branded goods. Both companies can obtain benefits, and Ofood4U stands to gain more in the longer term than attempting to compete against 'giants' like TZ.

It is recommended that Ofood4U enters into discussions to accept the proposed strategic alliance with TZ.

5.4 Recommendation of launching its own range of baby foods in the UK

As stated above, Ofood4U is preparing to launch its own range of baby foods for the UK retail market in 2005. This is included in the growth in sales in the five-year plan.

Appendix 3 shows that after three years, the forecast NPV that would be generated from this new range is £2.8 million and that if the cash flows were to continue into perpetuity (a rather risky assumption in this competitive market), the NPV could be as high as £18.6 million.

However, as it is recommended that Ofood4U should enter into the proposed strategic alliance with TZ, it would be unable, for at least three years, to market its own range of baby foods.

The capital expenditure that is in the plan for Ofood4U's own range of baby food is £0.7 million. This would no longer be required, but a 30% share of the capital expenditure required for the strategic alliance would be required instead. This is forecast to be 30% of £2.7 million, which is £0.8 million, a very similar amount.

5.5 Overall recommendations for Ofood4U's expansion strategy

As discussed above, the company's expansion strategies are summarised as follows:

- expand the number of shops by franchising;
- Ofood4U should enter the proposed strategic alliance with TZ;
- at this time, it is recommended that the proposed expansion of shops in FFT garden centres be declined;
- as it is recommended that Ofood4U enters into the strategic alliance with TZ, it would not be able to launch its own branded range of baby foods until after the end of the three-year agreement at the earliest.

In addition to these expansion strategies, the following issues need to be addressed by Ofood4U's management.

Jonathan Winters, who is currently away ill, due to stress related illness, may choose not to return to his stressful job. However, he cannot sell his 100,000 shares in Ofood4U (6.25% of the company) and realise their value, as there is no market for his shares, although some of the other six shareholders may choose to purchase his shares.

It is important that the two key roles of Chairman and Jonathan Winters' role of Operations Director are filled with suitably qualified and experienced staff at the earliest opportunity.

The long-term implications of having the wrong people in these posts could have an adverse effect on the entire company. With such a small, almost family run company, the importance of identifying the right person who could work well with existing management and staff should not be underestimated.

Other recommendations:

- Non-executive directors to be recruited;

- More senior finance and IT staff should be recruited to ensure that the company manages its growth effectively;
- A share ownership scheme should be introduced to ensure staff loyalty and motivation.

6.0 Recommendation and justification of the most appropriate financing strategy

To date, the company's financing has been rather haphazard, with loans used exclusively to fund working capital and purchase of fixed assets. All of the company's premises are rented and the company should be looking towards purchasing or leasing its main operating assets. The company's gearing ratio is high at almost 63% at the end of 2003.

The company has prepared, and the Board has approved, the current business plan for the next five years. This plan should form the basis of identifying its financing requirements. The current five-year plan shows a capital expenditure requirement of £35.1 million. Before this expenditure is committed, a capital appraisal using DCF analysis should be prepared to ensure that cash is invested only in positive NPV projects.

As the company has only been trading for five years, it does not meet many of the requirements for a listing on the main Stock Exchange. However, it could decide to go for a listing on the Alternative Investment Market (AIM), but this would take up valuable management time and would not happen within two years. An AIM listing would raise the company's profile and gain new investors and much needed finance. It would also enable the current owners to retain control if they wished. Another advantage of an AIM listing would be to make its shares marketable. This would also enable the company to run an employee share scheme and involve its employees in the ownership of the company.

However, *Appendix 4* demonstrates that the company has a total cash requirement, in order to achieve the current five-year plan (updated only for the forecast reduction of 10% in cash flows), of £15 million. This assumes that no dividends are paid, although the 2004 forecast includes a dividend of £0.6 million. It is strongly recommended that no dividends be paid until a longer-term financial strategy is put in place.

The company has a cash shortfall of £0.7 million in 2005 and a further shortfall of £13.5 million in 2006, resulting in a cumulative cash shortfall of £14.2 million. If this is rounded up each year, the total financing shortfall is around £15 million.

However, this is based on the current plan and this has not been updated for the recommendations above. However, these would not materially affect the cash position in the next two years, which is showing a net cash outflow of £13.5 million in 2006, due almost entirely to the planned purchase of the new premises for Ofood4U.

If the purchase of these new premises were to proceed, it could be financed by a further loan (probably secured on the premises). Alternatively, perhaps the new site could be leased. Therefore the cash shortfall in 2006 would not occur. However the new premises are financed, a detailed capital appraisal for the justification of the move should be put to the Ofood4U Board.

Ofood4U needs to be looking for more long-term equity finance. This could be achieved in the medium term by obtaining an AIM listing and this is recommended.

A further financing method would be to ask employees to invest in the company. A disadvantage is that there would be no available share price or market to sell their shares until such time as the company did become a listed company. The company has 3 million

authorised shares and currently only 1.6 million shares have been issued. The company has around 280 employees and many could be keen to invest their personal funds in the company if the longer-term potential for future gains were to be demonstrated to them, together with the risks of share ownership.

If shares were to be offered to employees, and the average investment that each employee makes would be only £1,000, then assuming only 50% of employees bought shares, this could raise £140,000. Another way to raise finance would be a rights issue to existing shareholders, but this is unlikely to be very successful. Apart from Sarah and Richard Hall, who have a separate income from Hall Farm, the other Directors are entirely dependent on their salaries from Ofood4U and it would be unlikely that they would have access to much finance to invest. However, if some of the existing Directors were to invest additional funds, then perhaps the forecast shortfall of £1 million in 2005 could be overcome.

Another possible method would be to seek venture capital (a real-life Internet trading company, Simply Organics, has recently secured venture capital loans). This would no doubt lead to becoming a listed company within the next five years, and would give Ofood4U a sound financial footing to enable it to undertake the chosen expansion routes. A venture capital company would also offer sound financial advice about future expansion and would be experienced in the rapid growth experienced by Ofood4U. However, a venture capital company would require a high return on its investment and perhaps Ofood4U would be better off securing further loan finance until it were able to obtain a listing.

However, it should be noted that the company has survived the first difficult years and built up a high turnover, and is a profitable business that has now been chosen to form a strategic alliance with a well-known international food company, TZ. Therefore, it is considered that the venture capitalist method of financing the company's growth is a little too late.

If Ofood4U is to continue to grow and compete with the large food manufacturers and retailers, it is recommended that it should become listed within the next five years. In order for the Hall family members to maintain control, they could ensure that they retain a majority shareholding, by keeping a share of, say, 51% between them.

I recommend that shops should be expanded throughout the UK by a franchising arrangement and that the company plans to become listed within the next five years.

The company should also be looking to expand its geographical markets by selling its own brand products abroad, in other carefully selected countries. In order to expand abroad, it would need to recruit suitably experienced senior managers, so that large losses are not incurred on badly planned expansion of its markets.

The company has successfully grown its customer base and its turnover, but cash management and a proper long-term financing strategy is key to Ofood4U's long-term success.

Appendix 1

SWOT analysis for Ofood4U

Strengths

- Established company with a profitable business
- Good reputation in the marketplace
- Recognised own brand goods
- Consumer confidence in Ofood4U brand
- Unique food seals
- Customer loyalty and large customer base
- Quality product
- Close links to organic food producers

Weaknesses

- Lack of management expertise
- Ofood4U is currently without permanent Chairman
- No non-executive directors at present
- Weak IT systems, particularly in shop retailing area of the business
- High gearing
- There is no long-term financing plan in place
- Difficult to react to changes in market as it has few experienced managers
- Outgrown current premises but not enough available finance for proposed move to a new site in 2006
- The proposed move to a new site will cause a disruption to the business in the short term

Opportunities

- Expansion of business by opening more shops
- Proposed strategic alliance with TZ
- Proposed shops in FFT garden centers
- To increase Internet and mail-order customer base
- Continued growth in demand for organic foods
- Improved IT systems will improve management control and profitability
- Increasing brand awareness and customer loyalty

Threats

- Increased competition from supermarkets
- Increased number of Internet retailing competitors
- Lack of financing plan
- Increased capital cost of move to proposed new premises and loss of flexibility
- Customer base erosion to other retailers
- Ofood4U needs to be more reactive and supply products that are in demand and also to create demand for new product ranges by more effective marketing
- Needs to improve its marketing and promote own brand products to ensure that brand loyalty is maintained

Appendix 2

Evaluation of Offood4U shops at FFT garden centres

		2004	2005	2006	2007
Net operating cash flows:		*£ million*	*£ million*	*£ million*	*£ million*
High growth	70.0%		5.5	6.9	8.9
Low growth	30.0%		1.2	1.5	1.6
Expected net operating cash inflows			**4.2**	**5.3**	**6.7**
NPV for expected operating cash flows:					
Capital expenditure		3.0			
Net cash flows		(3.0)	4.2	5.3	6.7
Discount rate	12%	1.000	0.893	0.797	0.712
NPV		(3.0)	3.8	4.2	4.8
Cumulative NPV		(3.0)	0.8	5.0	9.8
NPV after 3 years					**9.8**
NPV for high growth operating cash flows:					
Capital expenditure		3.0			
Net cash flows		(3.0)	5.5	6.9	8.9
Discount rate	12%	1.000	0.893	0.797	0.712
NPV		(3·0)	4.9	5.5	6.3
Cumulative NPV		(3.0)	1.9	7.4	13.7
NPV after 3 years					**13.7**
NPV for low growth operating cash flows:					
Capital expenditure		3.0			
Net cash flows		(3.0)	1.2	1.5	1.6
Discount rate	12%	1.000	0.893	0.797	0.712
NPV		(3.0)	1.1	1.2	1.1
Cumulative NPV		(3.0)	(1.9)	(0.7)	0.4
NPV after 3 years					**0.4**

Appendix 3

Evaluation of baby food range (with and without the proposed strategic alliance with TZ)

Evaluation of the proposed strategic alliance with TZ

	2004	*2005*	*2006*	*2007*
	£ million	*£ million*	*£ million*	*£ million*
Capital expenditure	(2.7)	–	–	–
Net operating cash flows	–	11.0	13.7	17.0
Discount rate 10%	1.000	0.909	0.826	0.751
NPV	(2.7)	10.0	11.3	12.8
Cumulative NPV	(2.7)	7.3	18.6	31·4
NPV after 3 years due to both companies				31.4
Ofood4U share at 30%				9.4

Evaluation of Ofood4U baby food cash flows (assuming it sells its own range NOT in a strategic alliance with TZ)

	2004	*2005*	*2006*	*2007*	*2008 onwards*
	£ million	*£ million*	*£ million*	*£ million*	*£ million*
Capital expenditure	(0.7)	–	–	–	–
Forecast net operating cash flows	–	1.1	1.4	1.7	2.1
Forecast cash flows in perpetuity					21.0
Discount rate 10%	1.000	0.909	0.826	0.751	0.751
NPV	(0.7)	1.0	1.2	1.3	15.8
Cumulative NPV	(0.7)	0.3	1.5	2.8	18.6
NPV				2.8	18.6

2005.1

Appendix 4

Ofood4U – Summary of future cash flows and financing requirements

	FORECAST 2004	*2005*	*2006*	*2007*	*2008*	*2009*	*TOTAL Five-Year plan*
	£ million	*£ million*	*£ million*	*£ million*	*£ million*	*£ million*	*£ million*
After-tax net operating cash flows (per *Appendix 3*)	6.3	6.7	8.8	11.9	14.0	17.6	59.0
10% reduction due to overstated plan		(0.7)	(0.9)	(1.2)	(1.4)	(1.7)	(5.9)
Reduced after tax net operating cash flows (before interest, loan repayments, capital expenditure and dividends)		6.0	7.9	10.7	12.6	15.9	53.1
Capital expenditure		(3.5)	(20.1)	(3.5)	(5.0)	(3.0)	(35.1)
Loan repayments		(3.0)	(1.0)	0.0	0.0	0.0	(4.0)
Interest (after tax)		(0.6)	(0.3)	(0.3)	(0.3)	(0.3)	(1.8)
Sub-total cash outflow (before dividends)		(7.1)	(21.4)	(3.8)	(5.3)	(3.3)	(40.9)
Total net cash in / (outflows) [before dividends]		(1.1)	(13.5)	6.9	7.3	12.6	12.2
Planned closing cash position	0.4	(0.7)	(14.2)	(7.3)	0.0	12.6	12.6
Forecast financing requirement for the year [before dividends] in whole millions		£1 *million*	£14 *million*				
Cumulative forecast financing required to achieve five-year plan [before dividends] in whole millions			**£15 million**				

Appendix 3 – Mayah Group of Hospitals (November 2004)

Mayah Group of Hospitals

1. Introduction and context for change

The Mayah Group of Hospitals (MGH) is a public sector organisation operating over three sites in the city of Mayah in the north of Zamorna, a fictitious country in Western Europe.[1] This part of the country is affluent and the population has a better than average state of general health. There are, however, pockets of deprivation where there is a higher than average incidence of some types of disease and "life style" ailments such as obesity and smoking-related illnesses. The demographic profile of the region covered by MGH is shown in *Appendix A*. MGH is not the only public sector hospital in the region, but it is by far the largest and offers the widest range of services.

In Zamorna, health services are provided by a combination of public and private sector organisations. The public sector providers, such as MGH, are financed by a mixture of national and local taxation and most treatments are free to the patient at the point of delivery. However, the current government has encouraged greater private sector participation in a variety of ways, for example in providing finance for new buildings and, recently, by using (and paying for) private sector facilities to supplement those provided by the public sector. More contentiously, it is considering allowing expenditure on private healthcare and health insurance premiums paid by individuals to be partially tax deductible. A sizeable minority of the population is able to afford private healthcare or health insurance.

The Zamorna government has determined a range of objectives and targets that public sector providers must achieve. The objectives deal broadly with the efficiency and effectiveness of healthcare in the context of improving health and obtaining value for money. On many performance measures, both clinical and managerial, MGH has demonstrated a worse performance than the majority of hospitals of similar size in areas of similar demographic profile. Not only is it worse than other comparable organisations, but also in many areas of service its performance is declining.

The MGH Board had for some time recognised that its poor performance was largely for the following reasons:

(i) the increasing cost of providing services from three separate sites;

(ii) the changing health needs of the local population;

(iii) poor human resource relations with all categories of staff, partly because of poor communications and partly because of poor working conditions.

There is also a shortage of good, qualified staff but this is a common problem throughout Zamorna.

The need to achieve more cost-effective provision and improved quality of clinical services has been a key feature of Board discussions for some time. However, the real impetus for change was the government's demand for a thorough strategic review of MGH's operations. This was concluded six months ago and major redevelopment and reorganisation has become inevitable.

2. Organisation and management structure and corporate objectives

2.1 Organisation structure

There are three hospitals in the group under the same management. The main areas of business of these three hospitals are explained below. The group as a whole employs around 5,500 staff (full-time equivalents), 75% of whom are in clinical professions.

1 *Zamorna is* **not** *the UK and the health system is* **not** *the UK's National Health Service (NHS).*

The district hospital (DH)

This is the largest hospital in the group. It provides a wide range of medical and surgical procedures from minor operations to treatment of major illnesses and injuries. Certain specialised procedures, such as organ transplants, are referred to a specialist hospital in another part of the country.

DH treats around 52,000 in-patients each year. It also has an out-patient facility treating around 160,000 cases each year and an accident and emergency department treating 85,000 casualties a year.

The average length of stay of in-patients in this hospital is 3 to 4 days, but there is a very large variation. The majority of treatment episodes are one- or two-day stays but some patients with serious illnesses or injuries may be there for six months or more.

The mental hospital (MH)

This hospital caters for patients with mental illnesses and psychological problems and disorders. It also provides residential rehabilitation and detoxification facilities for patients suffering from substance abuse. MH treats 150 in-patient cases each year and also provides day clinics to assist patients maintain their state of health once they have been discharged from residential treatment programmes. Many of its patients are from neighbouring districts as it is the only hospital in the region providing this type of facility.

It suffers from a disadvantage of being located some distance from the Mayah city centre and transport services and other amenities are poor. This means many people in need of the clinic's services are frequently unable or unwilling to travel to the clinic.

The maternity and child welfare clinic (MCWC)

This clinic provides maternity and child welfare services. In an average year, the clinic will have 2,500 deliveries and treat 4,500 children for various illnesses and diseases. The number of deliveries is likely to decrease over the next few years due to the changing demographics of the region and the increase in popularity of home births and use of private sector clinics.

Typically, new mothers leave hospital within two days of the birth of their child unless there is a complication. Most children are treated as out-patients. If their condition is serious or requires major surgery, they are referred to the children's ward of the district hospital.

2.2 History of current organisation

The current configuration of hospitals has come about by accident rather than by managerial design. Until 10 years ago, the two hospitals and the clinic were three separate organisations with their own management board and funding streams. The government of the day was keen to reduce the costs of managing and administering health services and had forced the three boards to review their management structures and operations.

In 1995, in response to these government pressures, a consultation paper was issued that suggested merging the maternity and child welfare services with a similar clinic in a neighbouring district. The neighbouring clinic would provide maternity services and Mayah clinic child welfare. There was also a proposal to re-site the mental health services hospital to a low-usage building within the district hospital complex. This would provide a much more accessible location and allow considerable cost savings.

The financial and organisational logic was compelling but the public outcry to both sets of proposals resulted in them being abandoned. A compromise solution was to merge the three organisations' management under the current organisational structure. This allowed some cost savings but did nothing to improve the service levels. There are now serious tensions within the organisation, mainly between clinical and administrative staff, that have led to a high staff turnover in recent years and a difficulty in recruitment.

A further problem is the age and condition of the district hospital's buildings. The main building was built over 80 years ago and does not lend itself to the major renovations necessary to provide the facilities required by modern hospitals. The other peripheral buildings are newer but they are spread out around the city and most are in need of refurbishment.

2.3 Management structure

The MGH Board currently has nine members – four executive and five non-executive Directors. There is a vacancy for a sixth non-executive Director that has been unfilled for over twelve months. Brief details of the Board are as follows:

Executive Directors:

Chief Executive: John Asta has worked in the hospital sector since leaving university with a degree in biotechnology. He started his career as a clinician and moved into management eight years ago. He has been Chief Executive of MGH since 2001.

Director of Finance and Performance Measurement: Olivia Owulu is a qualified management accountant and holds an MBA from an American business school. She worked in the private sector until five years ago when she was headhunted for this position.

Director of Human Resources: Dolores Rossiter is a recent recruit to MGH. She is an American citizen who moved to Zamorna last year with her husband who is a consultant anaesthetist, also now working for MGH.

Director of Planning: Georges Papadopoulous is the longest serving member of the Board. He was a senior manager at the maternity hospital before it merged with Mayah. The responsibilities for planning were until that time undertaken by the Director of Finance. The decision to split the role and award Georges a director's post led to the resignation of the then Director of Finance and the appointment of Olivia Owulu.

Non-Executive Directors (all part-time appointments):

Non-Executive Chairman: Professor Frances Cluna is a full time academic at the local university. Her area of expertise is pharmacy and pharmacology. She is also politically astute and understands the political imperatives of managing any public sector organisation. She has been Chairman for three years.

She has known John Asta since university and it was as a result of his invitation that she applied for and was appointed to the position of Chairman.

Non-Executive Directors
Brigitte Binardi is a retired social worker who has been a non-executive director on a variety of health sector boards. She is also actively involved in voluntary work in health-related charities. She is an advocate of MGH maintaining a full service provision, and wholly opposed to private sector involvement in the health service. This frequently brings her into conflict with colleagues who generally take a more pragmatic view and accept change is inevitable.

Carlos Cluntz is a local businessman who runs his own successful computer company that specialises in systems and software design. He is a relative newcomer to the role of non-executive having joined the Board only six months ago. He is frustrated by the administrative complexities and bureaucracies inherent in hospital management.

Dr Indira Mehra is an industrial chemist who works full time for a large pharmaceutical company. She has been a non-executive director at MGH for three years and Vice Chair for the past twelve months, although she has been ill for much of the past six months.

John Vance is a freelance stress management consultant. His business involves delivering one-day seminars to employees of client companies and also individual stress counselling, contracted either by organisations for their staff or by individuals.

2.4 Corporate aims

The MGH Annual Report states that the Group has four main aims within its overall mission, which is *"To serve the people of the region by improving standards of health and providing high quality services"*. The four main aims are:

- to deliver high quality healthcare to the residents of the region in which MGH operates;
- to provide value for money in terms of output per € spent;
- to improve the health of the local population by the use of pro-active measures;
- to recognise the needs of all the organisation's stakeholders and treat them with equal respect.

With the possible exception of value for money, these objectives are not quantified and are difficult to measure. When Carlos Cluntz joined the Board of MGH he felt little more than lip service was paid to these aims and he attempted to persuade his fellow Directors that it was necessary to translate them into tangible goals and actions. To help achieve this, he argued for the introduction of a balanced scorecard approach. He has not had much success; the pressure of dealing with frequent "urgent" management issues meant that merely important issues were usually forgotten or ignored.

3. Future service needs and proposals for change

The strategic review required by the government concluded that major investment and reorganisation of services were required to meet the government's financial and other performance targets. A selection of comparative performance targets is shown in *Appendix B*. Organisations that consistently under-perform on these key targets will be subject to a government-instigated review.

The MGH Board initially drew up a "long list" of proposals for redevelopment. These proposals were evaluated firstly against the non-financial criteria listed below:

- provision of a locally available and accessible in-patient facility;
- critical mass of service provision to ensure adequate staff coverage and the ability to recruit and retain high quality staff;
- access to relevant treatments and therapies;
- expansion capability for future service development;
- minimum disruption to existing service provision;
- acceptability to other health providers in the locality.

On the basis of the outcome of this evaluation, the Board reduced the choice of proposals to three. As well as meeting the minimum requirements of the non-financial evaluation, these three proposals were considered to have the greatest potential to offer value for money. Whichever proposal is chosen, at least some of the finance for the capital costs must be sought from private sector providers probably as part of a "Build, Operate, Lease" arrangement.

The main features of the three proposals, their expected strategic benefits and practical constraints are discussed below. The expected effects on performance measures are shown in *Appendix B*.

Proposal 1

Main features

Build a completely new hospital on a new site that would provide the full range of services currently available within MGH (excluding very specialised procedures, as now). A suitable "brown-field" site has been identified just outside the main city centre, approximately two miles from the current hospital. The seller, Romstat Properties, has had difficulty selling this land because the planning authorities have consistently refused applications for housing

development. The cost of this land is currently €10 million. The sale value of the land and buildings on the existing three sites is estimated as €25 million as their location is suitable for housing and / or commercial development.

Benefits

There would be a public sector full-service health provider in the district, which would meet with widespread support from the public, local health groups and politicians. There would also be economies of scale from single-site provision of services that would allow substantial improvement in many performance measures.

A government requirement is that major redevelopment projects that propose full-service provision, such as Proposal 1, should have a formal procedure in place for ongoing evaluation of the project after completion. Some, especially the Finance Director, consider this a benefit but others think it is a waste of time and money and that the money would be better spent directly on patient care.

Additional income would be provided by the government for the provision of services as a consequence of increased activity (that is, higher numbers of patients treated for comparable health complaints).

Constraints / concerns

Government approval is required for all capital investment projects over €70 million irrespective of how they are to be financed. When building costs are taken into account, this Proposal will almost certainly exceed this limit and the process of obtaining approval will inevitably introduce delays into the decision process.

A potential area of concern is the need to obtain planning permission from the local authority for the change of use of the three former hospital sites. The estimated sale value of these sites assumes they will be accompanied by planning permission for housing development. A representative from the local government office was invited along to discuss this issue with the Board. Board members have been given to understand that there would be no problems in obtaining the necessary permission, subject to an environmental audit. A firm of environmental consultants has been asked to prepare a detailed report on the likely environmental impacts of the proposed redevelopment.

Proposal 2

Main features

This Proposal would be to build a completely new hospital on a new site that would provide services only for acutely ill patients, out-patients and accident and emergency. Other services would be "de-merged" and possibly re-merged with other, similar units in neighbouring districts. Maternity and child welfare services could be merged with a neighbouring clinic on the other side of the city. Mental health services could be taken over by a private organisation that has for some years shown interest in such a venture. The private organisation, however, does not wish to buy the land and buildings. MGH would therefore retain ownership of the land and buildings and lease them to the private provider for the duration of the contract, which is likely to be for an initial period of five years.

If this Proposal was selected, MGH would have no managerial responsibility for the operation of maternity, child welfare and mental health services although there would be some need for co-operation on referrals to and from the main hospital. The Romstat Properties' site would also be suitable for this Proposal, although it will be larger than necessary. The proceeds from land sales would be around €15 million, which is €10 million lower than with Proposal 1, as MGH would retain ownership of the land and buildings occupied by the privatised mental health service.

Benefits

This Proposal is likely to yield the greatest improvement in many performance measures, both managerial and clinical. It would also allow the Group to focus on "core" business. The maternity and child welfare services will benefit from greater specialisation – for example, with more patients, the enlarged organisation in the neighbouring district can employ more specialist staff on a full-time basis rather than, as at present, sharing specialist human resources.

The benefits to the mental health service are less obvious, other than freeing MGH management time.

There will be an increase in the volume of activity of comparable treatments, but a decrease in overall activity because of the de-merging of maternity and mental health. However, because treatments have widely varying costs, it is possible that income from activities will increase while the overall volume of activities decreases.

Constraints / concerns

This Proposal would cause some local opposition, although the Board believes it can manage the protests and political interference more successfully than ten years ago.

As noted above, the land identified for Proposal 1 is being considered for this Proposal also although there would be land to spare, at least for the foreseeable future. The Romstat Properties' board is unwilling to split the site into two or more lots so MGH must buy it all or look for another suitable site. A suggestion would be for MGH to buy the entire site and then sell the surplus land, if a buyer could be found at all given Romstat's difficulty in selling the entire site.

As with Proposal 1, government approval for the capital spend would be required.

The company secretary of MGH has informed the Board that although there are no major legislative issues that might affect the redevelopment, there is a minor concern in respect of the Human Rights Act because certain sections of the population would have to travel a short distance outside the region to obtain treatment. This is being investigated.

It is also apparent that some staff will no longer be required by MGH. The MGH Board believes these staff will be taken over by the acquiring providers and that there will be no serious opposition by the staff concerned and no severance costs for MGH.

Proposal 3

Main features

This is the "minimum" change Proposal. This would mean refurbishment of existing premises and some reorganisation and relocation of service provision. This Proposal barely meets the non-financial criteria but is included as a benchmark.

Benefits

The main benefits are:

(a) That it is likely to be the lowest-cost Proposal and can be completed in the shortest time.

(b) That as it is below the government's capital cost approval level, the MGH Board could approve the expenditure and financing.

Constraints / concerns

This is considered the least favourable Proposal by the Board and most staff but is included to provide a benchmark against which the undoubted higher costs of the other two Proposals will be compared. However, if this "minimum" change Proposal is chosen, many clinical staff have indicated they will leave, causing a staffing crisis.

A major constraint on "rebuild" redevelopments is the need to maintain capacity while the renovations are taking place. This involves closing down sections of the hospital one at a time and transferring the activity to another part of the hospital or buying the required services from

another health provider, either in the public or private sector. There will therefore be a substantial amount of upheaval and dual running costs for a period of time with this Proposal.

A further potential problem is that private providers of funds are likely to be less than enthusiastic about loaning this amount of money for what is mainly a refurbishment project, other than at an unacceptably high cost of finance over a relatively short (15 years) period of time. An alternative way of raising the money would be a combination of public appeal for funds and government grants. It is also possible some European Union funds would be available for some aspects of the renovation.

4. Selection criteria, short-listing and choice of contractor

4.1 Selection criteria

The MGH Board advertised for expressions of interest from building contractors and development consortia. All potential bidders were provided with information about the three Proposals under consideration. They were required to submit details about their organisation and any proposed sub-contractors, and also to demonstrate a proven ability to deliver on similar sized contracts. At this stage they were not required to submit estimates of costs.

The selection process was done in two stages by a project planning team that consisted of staff from the finance and planning departments. The first stage was to review all bids to determine whether they met the six basic selection criteria listed below. The project planning team established these criteria, which were based on criteria used by similar organisations undertaking similar redevelopment reviews.

- *(i)* An ability and willingness to contract for any of the three Proposals.
- *(ii)* Evidence of sound contractual arrangements, existing or proposed, between the lead contractor and sub-contractors.
- *(iii)* An ability to provide, or arrange, financing for the project although the MGH Board is hopeful that the Zamorna government will provide some assistance with the capital costs.
- *(iv)* An outline redevelopment plan including profiles of the management team and evidence that a suitably qualified workforce is available for design and construction.
- *(v)* Statement of ability to observe the environmental and regulatory requirements of the chosen Proposal.
- *(vi)* Statement of compliance with MGH's policies on equality and diversity.

4.2 Expressions of interest and short-listing

Twelve companies or consortia submitted expressions of interest. Ten companies or consortia were eliminated because they failed to meet adequately all the criteria. This has resulted in a short list of only two contractors who have now been asked to submit cost estimates for the three Proposals.

Contractor 1 – ArkFin Consortium

Fifteen companies are involved in this consortium as main or sub-contractors. The "lead contractor" is the main building firm, Arkwright plc, a UK-based construction company, whose shares are listed on a UK stock exchange. Its five-year financial summary is shown in *Appendix D*.

Arkwright plc has been established for over 50 years and has a sound financial history, apart from a three-year loss-making period some ten years ago. This was due to the company under-pricing its bids in order to win large public sector contracts. A shareholder revolt caused management changes and the company returned to profitability within two years.

Two non-executive Directors (NEDs) of MGH expressed concern about the short-listing of ArkFin. The consortium has been assembled specifically for the MGH contract and some of the participating firms have little or no experience of major health sector construction work. Also, Arkwright plc's contractual agreements with its sub-contractors were contained in a briefer

document than the Board had expected. Arkwright plc's Chief Executive argued that the relationship with its sub-contractors was a commercial one and, as the lead contractor would hold ultimate responsibility for completion of the contract, the MGH Board did not need to concern itself with the details. As there were only two companies being short-listed, and to re-advertise for expressions of interest would involve an unacceptable delay to the start of the project, the NEDs' concern was over-ruled by the rest of the MGH Board.

Contractor 2 – LinMel Group

This is a US group that was originally a construction company but has now diversified into other areas, including providing financing for its larger projects. It has been working in Europe for some years on similar large-scale public sector projects with private finance involvement. It has a good reputation for delivering on time and within budget. The senior management team of LinMel believes the company can provide all the services necessary using its own companies but reserves the right to sub-contract if necessary. Its five-year financial summary is shown in *Appendix E.* Its shares are listed on a US stock exchange.

4.3 Submission of cost estimates

The two short-listed contractors were asked to submit outline cost estimates and finance terms for all three restructuring Proposals. Key information from the two bids is shown below.

Proposal 1 - Centralised services in new hospital

	ArkFin	*LinMel*
	€ million	*€ million*
Building costs (including costs of equipment and fittings)	115·00	105·00
Total finance required (net of proceeds from land sales – see *Note 1*)	100·00	90·00
Annual lease charge – see *Note 2*	7·82	9·37
Finance period	25 years	25 years
Estimated completion date (number of months from date of signing contract)	+36	+40

Note 1: This is the sum of:	*€ million*	*€ million*
Building costs	115·00	105·00
Cost of the Romstat Properties' land	10·00	10·00
Less estimated sale value of land and buildings of all three old sites	(25·00)	(25·00)

Note 2: The lease payments are for the provision of finance for the total capital cost of the redevelopment, that is €100 million (ArkFin) or €90 million (LinMel).

Proposal 2 – Centralisation of acute services in new hospital and de-merger of maternity, child welfare and mental health services.

	ArkFin	*LinMel*
	€ million	*€ million*
Building costs (including cost of equipment and fittings)	100·00	93·00
Total finance required (including net cost of land – see *Note 1*)	95·00	88·00
Annual lease charge – see *Note 2*	7·43	9·16
Finance period	25 years	25 years
Estimated completion date (number of months from date of signing contract)	+30	+35

Note 1: This is the sum of:	*€ million*	*€ million*
Building costs	100·00	93·00
Cost of the Romstat Properties' land	10·00	10·00
Less estimated sale value of land and buildings of old DH and MCWC sites	(15·00)	(15·00)

The cost may be reduced if MGH decides, and is able, to sell the portion of the Romstat Properties' land that would be surplus to immediate requirements with this Proposal.

Note 2: The lease payments are for the provision of finance for the total capital cost of the redevelopment, that is €95·0 million (ArkFin) or €88·0 million (LinMel).

Proposal 3 – "Minimum" proposal to refurbish and reorganise.

	ArkFin	*LinMel*
	€ million	*€ million*
Building costs (including structural work)	30·00	28·50
Annual cost of finance	3·05	2·90
Finance period	15 years	15 years
Estimated completion date (number of months from date of signing contract)	+36	+30

The following contractual obligations and conditions will be imposed by MGH on the winning contractor if Proposal 1 or 2 is chosen.

- MGH will start the lease payments only when the buildings and specified support services are available and performing to defined quality standards.
- The buildings will be maintained as part of the contract throughout the lease period. At the end of this period, the hospital group can acquire the buildings, renew the financing contract, or put it out to re-tender. These end-of-lease terms are still to be negotiated.
- Penalty deductions will be applied if the building and specified support services are not available or not performing to defined quality standards.

4.4 Choice of contractor

After some delays, the decision was to award the contract to ArkFin, despite the lack of experience with this type of contract of some of the member firms in the consortium, as its bid carried the lowest annual charges for Proposals 1 and 2 and its estimated completion dates for these two Proposals were shorter than LinMel's proposal. Its completion date for Proposal 3 is slightly longer than LinMel's but the MGH Board believes it is unlikely Proposal 3 will be the preferred choice.

The MGH Board called a special meeting to review the evaluation team's recommendation. Some of the Non-Executive Directors, especially Carlos Cluntz, were strongly opposed to the choice of ArkFin as the costs and completion dates suggested by the contractor appeared extremely optimistic. The costs factor in particular caused concern. As Mr Cluntz pointed out, it was not sensible to give the contract to the lowest-cost bidder if those costs were cut so fine they threatened the long-term survival of the contractor and its associates. However, the dissenting Non-Executive Directors were over-ruled by the overwhelming support given by the executives and the reluctant compliance of the other Non-Executive Directors.

4.5 Resignation of Non-Executive Director and launch of investigation

Two days after the special meeting to approve the award of the contract, Carlos Cluntz made a very public resignation. He stated his reasons as the "unjustifiable and unsupportable" choice of ArkFin. He very readily agreed to discuss the reasons for his resignation with local health groups, media and politicians. The resulting public outcry has led the government to send a senior health executive from a neighbouring region to conduct an investigation. This investigation is expected to take between six and eight weeks.

Appendix A

Demographic statistics for the region

	Actual as at 2003	*Forecast for 2013*
Population total	518,000	534,000
Percentage:	%	%
Aged under 4	5.2	4.8
Aged 5–16	12.5	11.7
Aged 17–25	10.6	9.7
Aged 26–45	26.3	24.3
Aged 46–60	17.4	18.5
Aged 61–80	20.3	22.5
Aged over 80	7.7	8.5

The male / female split is roughly equal until the age bands 61–80 and over 80 when there is an increasingly higher percentage of women than men.

Population in 2003 by social category (to nearest 000)

Total population of working age	292
By category:	
Professional	18
Managerial / technical	90
Skilled	125
Semi skilled	46
Unskilled	13

Notes:

1. No forecast is available of future population by social category.
2. Unemployment in the region is 5·5% compared with the national average of 7·5%. It is mainly concentrated in the semi-skilled and unskilled categories. Unemployment in the other categories is typically of the "between jobs" type.
3. Unemployed people are included within the relevant social category.

Appendix B

Performance measures

	MGH	*Average for comparative organisations*	*Expected outcomes (1st full year of activities)*		
			Proposal 1	*Proposal 2*	*Proposal 3*
Hospital waiting times					
Out-patients:					
percentage of treatments completed within 3 months	68%	60%	75%	80%	72%
In-patients					
percentage of patients admitted within 3 months	65%	75%	78%	80%	70%
percentage of patients admitted within 12 months	95%	100%	100%	100%	100%
Complaints					
Number of complaints received and investigated	1,250	950	1,050	950	1,150
Number of complaints upheld	175	50	75	60	80
Number of staff complaints – all causes (harassment, unfair dismissal etc)	185	85	85	50	65
Financial					
Percentage under/(over) spend on cash limit	(5%)	0	0	0	0
Staff costs as percentage of total operating costs	75%	70%	73%	70%	75%
Average cost per out-patient treatment (excluding accident and emergency cases)	€850	€775	€775	€765	€825
Average cost per in-patient treatment (excluding maternity)	€1,450	€1,425	€1,550	€1,425	€1,550
Approx fixed/variable cost ratio	75/25	68/32	70/30	68/32	75/25

Note: Expected outcomes are at 2003 cost levels.

Appendix C

Financial statements of Mayah Group of Hospitals

Profit and loss account		For the year 2003	For the year 2002
	Note	*€000*	*€000*
Income from activities	*1*	231,520	215,250
Other income	*2*	14,500	23,500
Expenses connected with activities		(257,350)	(245,200)
Surplus / (deficit) on activities		(11,330)	(6,450)
Profit / (loss) on disposal of assets		550	(365)
Surplus / (deficit) before interest		(10,780)	(6,815)
Interest receivable		650	425
Interest payable and other finance charges		(250)	(125)
Surplus / (deficit) for the year		(10,380)	(6,515)

Balance sheet					
	Note	*€000*	*€000*	*€000*	*€000*
Fixed assets:					
Intangible			150		150
Tangible			132,655		135,260
Current assets:					
Stock		3,520		2,560	
Debtors	*3*	19,250		22,500	
Cash and short-term investments		780		250	
Total current assets			23,550		25,310
Current liabilities:					
Amounts due within 1 year			(25,025)		(19,500)
Total assets less current liabilities			131,330		141,220
Creditors falling due after 1 year			(650)		(560)
Provisions for liabilities			(2,350)		(1,950)
Total assets less liabilities			128,330		138,710
Financed by:					
Capital and reserves:					
Public capital	*4*		122,710		133,090
Revaluation reserve			3,520		3,520
Other reserves			2,100		2,100
Total capital and reserves			128,330		138,710

Notes

1. Income from activities is money provided by government, based on standard rates for the activities undertaken.
2. Other income is mainly from the treatment of private patients.
3. Debtors is mainly money owed by the government for treatments provided and from other hospitals whose patients have been treated by MGH. Money owed by private health insurers for patients treated privately is also included here.
4. Public capital is roughly the equivalent of shareholders' capital. Public capital plus reserves is the value of the organisation to its owners; that is the public.

Appendix D

Five-year financial summary for Arkwright plc

	2003 £ million	2002 £ million	2001 £ million	2000 £ million	1999 £ million
Profit and loss account					
Group turnover	2,650·30	1,850·20	1,622·20	1,450·00	1,205·50
Group operating profit	247·50	195·20	175·20	125·00	95·50
Profit on disposal of fixed assets	5·60	12·50	65·00	–	6·50
Net interest payable	(35·20)	(25·00)	(22·50)	(19·50)	(19·80)
Profit before taxation	217·90	182·70	217·70	105·50	82·20
Taxation charge	(62·50)	(51·20)	(65·00)	(25·20)	(21·20)
Profit for the financial year	155·40	131·50	152·70	80·30	61·00
Dividends declared	(38·50)	(32·50)	(28·55)	(18·50)	(16·50)
Profit retained	116·90	99·00	124·15	61·80	44·50
Balance sheet					
Intangible assets – goodwill	171·85	–	–	–	–
Investment properties	465·00	465·00	449·50	187·30	175·30
Other fixed assets	225·00	179·50	145·00	132·70	132.70
Net current assets	935·50	705·55	595·00	438·50	345·20
Non-current creditors and provisions	(40·50)	(15·10)	(16·50)	(25·00)	(21·50)
Capital employed	1,756·85	1,334·95	1,173·00	733·50	631.70
Represented by:					
Called-up ordinary share capital	240·00	240·00	240·00	150·00	150·00
Share premium account	425·00	425·00	425·00	235·50	235·50
Revaluation reserve	161·00	161·00	108·05	72.20	72·20
Profit and loss account	480·85	363·95	264·95	140·80	79·00
Shareholders' funds	1,306·85	1,189·95	1,038·00	598·50	536·70
Long-term debt	450·00	145·00	135·00	135·00	95·00
	1,756·85	1,334·95	1,173·00	733·50	631·70
Statistics					
Number of shares in issue at year end (millions)	480·00	480·00	480·00	300·00	300·00
Basic earnings per share	0·32	0·27	0·32	0·27	0·20
Dividends per share	(0·08)	(0·07)	(0·06)	(0·06)	(0·06)
Shareholders' funds per share	2·72	2·48	2·16	2·00	1·79
Dividend cover (times)	4·04	4·05	5·35	4·34	3·70
Debt : debt + equity	25·61%	10·86%	11·51%	18·40%	15·04%
Interest cover (times)	7·03	7·81	7·79	6·41	4·82
Profitability (profit before tax/turnover)	8·22%	9·87%	13·42%	7·28%	6·82%

Appendix E

Five-year financial summary for LinMel Inc

	2003	*2002*	*2001*	*2000*	*1999*
	$ million	*$ million*	*$ million*	*$ million*	*$ million*
Profit and loss account					
Group turnover	1,352·20	1,150·20	952·25	1,250·20	1,050·20
Group operating profit	235·00	184·03	142·84	225·04	178·53
Profit on disposal of fixed assets	0·00	0·00	25·30	0·00	0·00
Net interest payable	(28·00)	(28·00)	(22·50)	(22·50)	(22·50)
Profit before taxation	207·00	156·03	145·64	202·54	156·03
Taxation charge	(53·82)	(40·57)	(37·87)	(52·66)	(40·57)
Profit for the financial year	153·18	115·46	107·77	149·88	115·46
Dividends declared	(105·20)	(46·19)	(43·11)	(59·95)	(46·18)
Profit retained	47·98	69·27	64·66	89·93	69·28
Balance sheet					
Fixed assets	778·50	710·41	527·91	433·50	354·66
Intangible assets	52·50	50·00	50·00	45·00	45·00
Net current assets	192·87	216·16	227·46	237·43	228·62
Non-current creditors and provisions	(9·24)	(9·92)	(8·00)	(8·22)	(10·50)
Capital employed	1,014·63	966·65	797·37	707·71	617·78
Represented by:					
Called-up ordinary share capital	125·00	125·00	125·00	125·00	125·00
Share premium account	115·00	115·00	115·00	115·00	115·00
Revaluation reserve	25·00	25·00	25·00	0·00	0·00
Profit and loss account	399·62	351·64	282·37	217·71	127·78
Shareholders' funds	664·62	616·64	547·37	457·71	367·78
Long-term debt	350·00	350·00	250·00	250·00	250·00
	1,014·62	966·64	797·37	707·71	617·78
Statistics					
Number of shares in issue at year end (millions)	125·00	125·00	125·00	125·00	125·00
Basic earnings per share	1·23	0·92	0·86	1·20	0·92
Dividends per share	(0·84)	(0·37)	(0·34)	(0·48)	(0·37)
Shareholders' funds per share	5·32	4·93	4·38	3·66	2·94
Dividend cover (times)	1·46	2·50	2·50	2·50	2·50
Debt : debt + equity	34·50%	36·21%	31·35%	35·33%	40·47%
Interest cover (times)	8·39	6·57	6·35	10·00	7·93
Profitability (profit before tax/turnover)	15·31%	13·57%	15·29%	16·20%	14·86%

Note: The accounts of this US company are laid out in a similar form to those of Arkwright plc for ease of comparison.

Appendix F

Glossary of Terms

Acute hospital

A hospital that offers a wide range of medical and surgical services and procedures for both in-patients and out-patients. Usually also provides accident and emergency services.

Brown-field site

A site that has been built on previously and the old buildings demolished (as compared with a "green-field" site that has never been developed).

Build, Operate, Lease (BOL)

A type of lease arrangement whereby a company or consortium builds and services a facility and leases it to the client (in this case, MGH). Such a deal is usually over a very long period of time, typically 30+ years. Build, Operate, Lease arrangements typically incorporate aspects of both finance and operating leases. A finance lease is where the agreed term of the lease approximates the expected lifetime of the asset. These are often also termed *capital lease* or a *full pay out lease*. An operating lease is usually specific to the purchase of a specific type of equipment and typically there are break clauses in the contract, which can be cancelled much more easily than a finance lease. However, there are usually financial penalties for early termination.

Clinical staff

Staff employed to provide any form of medical or nursing treatment, including dentistry and midwifery.

Completed treatment

Successful or terminated treatment or series of treatments for the same complaint. Treatments may be terminated for a variety of reasons; for example a patient chooses to discontinue treatment or treatment is having no beneficial effect.

Efficiency adjusted annual cost savings

The reduction in operating costs (excluding staff costs) of providing an equivalent number of comparable treatments (compared with the current organisational configuration) directly attributable to improvements in efficiency of service.

Full-time equivalent

Staff numbers are expressed in full-time equivalents, as MGH employs a number of part-time staff. For example, an employee who works half of the hours of a full-time employee is half a full-time equivalent.

Health provider

Any hospital, clinic or surgery, public or private, that provides any type of healthcare.

In-patient

Patients who are allocated a bed and stay in the hospital for at least eight hours for treatment. In-patients do not necessarily stay overnight.

Out-patient

Patients who have short consultations or series of consultations with clinical staff and do not require the allocation of a bed.

Treatment and treatment episode

Any medical or surgical procedure or series of procedures for the same complaint.

Mayah Group of Hospitals – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 21–25.

Read all of the additional material before you answer the question.

ANSWER THIS QUESTION – 100 MARKS

You are employed by Ross, Jackson and Broomes, the firm of professional advisers which is working with MGH. You have been seconded to the group to lead the project management team.

Write a report to the MGH Board in which you

- evaluate and prioritise the strategic issues facing MGH at the present time;
- evaluate the three redevelopment Proposals;
- recommend actions for addressing the strategic issues, including the most appropriate redevelopment Proposal.

Note: The assessment matrix, which your script will be marked against, is on the next page for your reference.

Mayah Group of Hospitals – Unseen material provided on examination day
Read this information before you answer the question

Note: a reminder of the abbreviations used, for your reference:

DH = the district hospital

MH = the mental hospital

MCWC = the maternity and child welfare clinic

Results of investigation

The senior health executive from a neighbouring region sent in to investigate the allegations made by a Non-Executive Director (Carlos Cluntz) of misconduct in the awarding of the redevelopment contract (the "Investigating Executive") has completed his investigation and delivered three main conclusions:

1. There were a number of irregularities in the process of selecting the contractor.
2. Carlos Cluntz's contention that there were serious managerial weaknesses in the MGH Board was upheld. In particular, the investigating executive discovered that John Asta, the Chief Executive, was a shareholder in Romstat Properties. Although there was no evidence that he had attempted to influence the purchase terms of the Romstat land, he was required by his contract of service to declare such interests. The investigation also revealed that a Non-Executive Director, John Vance, undertakes freelance consulting work for MGH which he has not declared at Board meetings when contracts for the provision of such services have been discussed and awarded.
3. Although there were documents detailing MGH's corporate governance policy and procedures and the Chief Executive had ultimate responsibility, there was no supporting managerial or administrative framework to ensure the policy was followed and monitored.

The main recommendation from the Investigating Executive is that MGH needs to strengthen and improve its management structure.

A second recommendation was made that strategies for MGH achieving its objectives must recognise a wide range of issues, including ethical considerations.

As a result of the Investigating Executive's critical report, the Chairman, Chief Executive, Finance Director and John Vance have resigned. The Vice Chairman, who has recovered from her period of ill health, has been appointed Acting Chairman. Temporary appointments have also been made to the positions of Chief Executive and Director of Finance. The Acting Chairman, with the approval of her Board, has invited Carlos Cluntz back onto the Board as Non-Executive Director. He has accepted. This still leaves a vacancy for a Non-Executive Director. No one has yet been appointed.

The Investigating Executive criticised ArkFin for "inappropriate" discussions with some of the outgoing MGH Directors during the original bidding process but stopped short of claiming that ArkFin had done anything illegal or unethical. Its selection as "preferred building contractor" was therefore allowed to stand, subject to the following criteria:

- acceptance of its detailed cost estimates;
- that the *financing* of the contract be re-opened to limited competitive tender by at least one other company.

Appointment of advisers

As a result of this investigation, the new Board has appointed a firm of professional advisers, Ross, Jackson and Broomes, to assist with re-evaluating the choice of lead contractor and evaluating the restructuring Proposals. This advisory firm specialises in public sector consultancy work of this kind and is very experienced, if expensive. Ross, Jackson and Broomes will lead a Project Evaluation Team that will include representatives from managerial, administrative and clinical departments in MGH. Its terms of reference are:

- to evaluate and prioritise the strategic issues facing MGH at the present time;
- to evaluate the three redevelopment Proposals;
- to recommend actions for addressing the strategic issues, including the most appropriate redevelopment Proposal.

Projected overspend

ArkFin has now submitted detailed cost estimates for building and financing the three redevelopment Proposals. The totals are shown in *Table 1* (below) along with other forecast information prepared by the Project Evaluation Team. The costs of the project if Proposal 1 or 2 is chosen are likely to be much higher than originally expected and the project would take much longer to complete. The main reasons for these changes have been identified as:

- Land prices have increased since the outline bid was submitted and Romstat Properties believes that new planning laws mean the company might now be able to obtain permission for the site to be developed for limited commercial use. The Romstat land now has an estimated market value of €25 million. However, the estimated sale value of the land and buildings on the existing sites has also increased.
- Surveys of the proposed Romstat Properties' site have discovered geological faults that were not evident at the time of the initial bid. This will make the building work more difficult and more expensive.
- The environmental study has resulted in requirements for a number of costly changes to the original building design. The local authority has indicated this work will be required as a condition of planning permission being given. This also will introduce a delay into the timescale for completion.

Table 1	Note	Proposal 1	Proposal 2	Proposal 3
Cost of Romstat land *(€ million)*		25·00	25·00	0
Building costs *(€ million)*		145·00	115·00	35·00
Less: estimated sale proceeds of old land and buildings *(€ million)*	*1*	(30·00)	(24·00)	0
Net capital costs *(€ million)*	*2*	140·00	116·00	35·00
ArkFin's annual lease charge *(€ million)*		13·12	10·87	4·87
Duration of lease		25 years	25 years	15 years
Estimated completion date (months from date of signing contract)		+40 months	+36 months	+32 months
Forecast increase in activity	*3*	13·6%	21·4%	4·20%
Required income per annum *(€ million)*	*4*	266·25	246·00	253·31
Efficiency adjusted annual cost saving *(€ million)*	*5*	7·76	8·32	2·51

Notes

1. The Project Evaluation Team commissioned an independent valuer to value the land and buildings. With Proposal 1 the land and buildings of all three sites would be sold, although the value is almost exclusively for the land, as the buildings have virtually no alternative use other than as hospitals. With Proposal 2, only the MH and MCWC land and buildings would be sold.

The proceeds from the sale of the surplus Romstat Properties' land that would be available with Proposal 2 has now been estimated at €8 million. This estimate assumes planning permission for housing is received. This amount is excluded from the figures above, as it is so uncertain.

2. The Zamorna government has told MGH it can expect no financial assistance with capital expenditure for the investment required for redevelopment, which must now all be raised from private sector funding.

3. Increase in activity is, broadly, an increase in the number of patients treated for comparable health complaints. The required annual income reflects this increase in activity.

4. The government has indicated it will provide additional annual income required as a consequence of the redevelopment provided there is a "substantial" improvement in MGH's performance on patient-related performance measures. To date, it has not been more specific about the level of improvements required and has not seen the figures in *Table 1* or any supporting documents. The Project Evaluation Team has incorporated forecast lease charges into the required annual income.

5. Government targets require efficiency-adjusted cost improvements to be a minimum of 3% of annual income on major redevelopment projects and 1% on rebuild or refurbishment projects. These efficiency gains are reflected in the required annual income.

Competitive tender for the provision of finance

As required by the independent investigator, the MGH Board approached two companies for a competitive tender for financing the project. One was LinMel, which had bid for the original contract. The other was a subsidiary of an international bank. LinMel informed the Board they did not wish to tender. The bank submitted the following lease terms:

	Proposal 1	*Proposal 2*	*Proposal 3*
Annual lease charge (€ million)	15·42	12·78	4·60
Duration of lease	25 years	25 years	15 years

Methods of appraisal and evaluation of Proposals

The decision process in choosing the most favourable Proposal will involve expressing MGH's requirements in output terms. In other words, what outcomes would it be getting for the money invested. The following key variables will be considered as part of the appraisal and evaluation process. Each of the variables has been ranked on a scale of 1 to 3 (where 1 = best and 3 = worst) and weighted according to its relative importance. The resulting weighted scores have been determined by the project evaluation team but are in line with the government's guidelines.

		Proposal 1		*Proposal 2*		*Proposal 3*	
Variable	*Weighting*	*Rank*	*Weighted score*	*Rank*	*Weighted score*	*Rank*	*Weighted score*
Capital cost	0·10	3	0·30	2	0·20	1	0·10
Annual funding requirement	0·20	3	0·60	2	0·40	1	0·20
Reduction in cost per treatment	0·22	2	0·44	1	0·22	3	0·66
Increase in activity	0·25	2	0·50	1	0·25	3	0·75
Reduction in complaints received and investigated	0·05	2	0·10	1	0·05	3	0·15
Improvement in quality of patient care, as measured by reduced waiting times for treatment	0·18	2	0·36	1	0·18	3	0·54
Totals	1·00		2·30		1·30		2·40

These are not the only variables that will be considered in the evaluation process, but they are the ones most easily quantifiable. Also to be considered is how each Proposal will contribute to the achievement of MGH's four aims and how they will help address the strategic issues facing MGH at the present time.

Public sector organisations in Zamorna are required to show a 5% return on investment (that is, they use a discount rate of 5% to evaluate cash flows).

Operating and financing the project

In addition to the construction of the new buildings, ArkFin will provide building and equipment maintenance and replacement services as required by the terms of bidding. The costs of these services are included in the lease charge. Discussions are taking place with ArkFin about the consortium also providing ancillary services such as catering, laundry and cleaning services. If ArkFin is given the contract for these services, it will have a favourable effect on the terms of finance for the land and construction. The annual lease charge for Proposals 1 and 2 would reduce to €12·57 and €10·40 respectively. The charge for Proposal 3 would be unaffected.

The required annual income from government, shown above, has included an estimate of costs for ancillary services. The difference in costs between ArkFin providing the services and MGH continuing to provide them in-house is minimal. The possible differences in the quality of the services are difficult to quantify, although there are strong and differing views about this issue among the management and staff of MGH. At present MGH uses local suppliers for most of its consumables. It would probably lose this business if ArkFin took over the ancillary services. The main benefit of using ArkFin is in the favourable lease finance terms.

Demographic changes

A new demographic forecast has just been produced which is likely to have an impact on the future requirements of hospital services. This forecast shows a likely increase in the average age of the local population, and declining birth rate, due to its popularity as a retirement area. Many younger people are moving to other districts or regions. The revised forecast is shown below. These effects have not as yet been quantified or the effect on the hospitals in the group assessed.

	Actual as at 2003	*Original demographic forecast for 2013*	*Revised demographic forecast for 2013*
Population total	518,000	534,000	519,000
Percentage:	%	%	%
aged under 4	5·2	4·8	4·7
aged 5 - 16	12·5	11·7	11·4
aged 17 - 25	10·6	9·7	9·7
aged 26 - 45	26·3	24·3	22·5
aged 46 - 60	17·4	18·5	18·6
aged 61 - 80	20·3	22·5	24·3
aged over 80	7·7	8·5	8·8

The above information was provided in the pre-seen material

Case Writer's Answer for Management Accounting – Case Study

MAYAH GROUP OF HOSPITALS

Report to: The Board of Mayah Group of Hospitals

From: Lead Consultant, Ross Jackson and Broomes

Date: 25 November 2004

Subject: Evaluation of the Strategic Issues facing MGH and Recommendations

REPORT CONTENT

Main sections

1.0 Introduction and background to the project
2.0 Terms of reference, aims and content of the report and acknowledgements
3.0 Strategic issues facing MGH
4.0 Evaluation of the redevelopment proposals
5.0 Recommendations

Appendices

A Effect of the redevelopment proposals on MGH surplus/deficit
B Investment appraisal of redevelopment proposals
C Balanced Scorecard
D Comparison of Performance Measures
E Summary of Recommendations

1 INTRODUCTION

The Mayah Group of Hospitals (MGH) has suffered in recent years from poor and declining performance in many important areas of its operations. The reasons were identified as:

- the cost and inefficiency of operating over three sites;
- poor service delivery, as measured by established performance measures and compared with the national averages for comparative organisations;
- a general level of dissatisfaction of staff and high staff turnover;
- the changing health needs of the local population.

Following a strategic review of its operations the MGH board concluded that major investment and reorganisation of services were required. A "long list" of proposals for change was developed and evaluated, resulting in a short list of three proposals for change.

In summary, these are:

1. Provision of a full range of services in a new-build hospital;

2. Provision of selected services in a new-build hospital with de-merger of midwifery, child welfare and mental health services;

3. Refurbish and reorganise – a "minimum change" proposal.

A consortium has already been selected to undertake the redevelopment once the most appropriate proposal has been chosen, subject to the approval of final estimates of cost and time to completion. Following the resignation of a non-executive director, this selection was subject to scrutiny of an independent investigation by a senior health executive from a neighbouring region. This investigation allowed the choice of contractor to stand but led to the resignation of a number of executive and non-executive directors. The vacancies have been filled by permanent or temporary appointments.

As a consequence of the investigation and the major board upheavals, RJB was appointed to head a project evaluation team, which includes representatives from managerial, administrative and clinical areas of MGH's operations. The terms of reference and the aims of this report are discussed in the following section of the report.

2.0 TERMS OF REFERENCE, AIMS AND CONTENT OF THE REPORT AND ACKNOWLEDGEMENTS

2.1 Terms of reference

The terms of reference for the project were:

- To evaluate and prioritise the strategic issues facing MGH at the present time;

- To evaluate the three redevelopment proposals;

- To recommend actions for addressing the strategic issues, including the most appropriate redevelopment proposal.

2.2 Aims and content of report

The report has been produced by the RJB/MGH evaluation team in accordance with the terms of reference outlined above and following extensive consultations with staff and, where necessary and appropriate, outside experts. It aims to inform the MGH Board of the results of our evaluation and provide the required recommendations.

This report proceeds as follows. In section 3 we discuss the strategic issues currently facing MGH and our suggestions for manageing those issues. In section 4 the strengths, weaknesses, opportunities and threats of the three redevelopment proposals are evaluated together with an assessment of how each of the three proposals might contribute to the achievement of each of MGH's four objectives. In section 5 we present our recommendations.

2.3 Acknowledgements

The evaluation team wishes to acknowledge the advice, information and assistance given to it by staff and associates of MGH. Without their help the production of this report would not have been possible.

3 STRATEGIC ISSUES FACING MGH

3.1 Review of corporate aims

Before examining the strategic issues facing MGH, the project evaluation team considered the Group's aims. These are stated in the latest Annual Report and Accounts as:

- To deliver high quality health care to the residents of the region in which MGH operates;
- To provide value for money in terms of output per Euro spent;
- To improve the health of the local population by the use of pro-active measures;
- To recognise the needs of all the organisation's stakeholders and treat them with equal respect.

With the exception of "value for money", they are difficult to measure or quantify and even value for money has an element of subjectivity. However, they are similar to those of other comparable organisations and a re-examination of aims or overall objectives was not included in our terms of reference. We have therefore evaluated strategic issues in the context of the current aims, assuming their continuity.

Although all the issues discussed here are considered to be important, they have been prioritised in accordance with the informed opinion of the PET.

3.2 Evaluate and Prioritise Strategic Issues

3.2.1 Serious weaknesses in the management

These weaknesses have been manifest by poor performance on a range of measures and a weak board that has allowed serious concerns to be ignored. The composition of the board is also questionable; there is no clinician and there has been a vacancy for a NED for some time. These are basic governance issues that should have been addressed by the Chair and Chief Executive.

The recent report by an independent investigator has led to the resignations of some directors, but unless further action is taken in the immediate future, the governance problems will continue. The current Chair is in an acting capacity and only temporary appointments have been made to the positions of Chief Executive and Director of Finance. There is a vacancy for a non-executive director.

3.2.2 Financial performance

The financial position of MGH has deteriorated over the last year. From appendix C (in the pre-seen) it is noted that the deficit from last year of €6·515 million has increased to €10·380 million in the current year. This has been partly attributed to the costs of operating from three sites.

Of potential concern is the significant drop in "other income" down from €23·5 million to only €14·5 million despite a relatively affluent and ageing local population.

Using the Zamorna government's target return of a 5% return on investment, MGH should have achieved a surplus for the current year of €6·416 million on a capital and reserves balance of €128·330 million at the end of the current year.

3.2.3 Government targets and performance measures

The financial position has already been commented on in section 3.2.2. However there are also a number of important non-financial performance concerns as highlighted by appendix B (in the pre-seen). In terms of waiting times and complaints, MGH is only better then comparative organisations on one statistic – the percentage of treatments completed within three months. MGH needs to improve these performance measures in order to meet the Zamorna government's targets. Page 2 (pre-seen) states that not only are many of MGH's performance

measures worse than comparable organisations, in many areas of service its performance is declining.

The consequences of these failures are that:

- Funding will be withheld;
- Patients will complain because of MGH's falling position in league tables relative to other comparative organisations;
- Recruitment will be even more difficult because staff will choose to work for better performing organisations.

3.2.4 Poor, outdated buildings and facilities
There is clearly a need for more modern facilities. This particular issue is being addressed by the redevelopment programme and is discussed further in section 5 of this report.

3.2.5 Resource limitations: staff and money
In any organisation or system where services are free at the point of delivery, demand will always exceed supply. Health services have additional strains as they are politically sensitive and new treatments and procedures increase patient/client expectations and put increasing pressures on limited resources.

This problem of demand exceeding supply is both a resource and ethical issue. There are two resource constraints, staff and money. There is a shortage of qualified staff, which has a direct impact on quality of health care, and government funding is never sufficient to meet all demands. This raises the ethical issues of "rationing" and prioritising patients and treatments. This issue is beyond the scope of the current evaluation.

3.2.6 Marketing/PR issues
Marketing in the public sector has a different meaning from in the private sector. To some extent, it is more akin to PR. The image of MGH is currently poor, and falling. Patients will choose to go to private hospitals if they can afford it, which means only the most disadvantaged patients, who are usually the ones with most ill health, will be treated by MGH. This creates a downward spiral, worse health outcomes means poorer performance on many measures. This may be happening already, as evidenced by the decline in "other income".

There is also evidence that people will move house to a different region if that region has better health facilities and outcomes, as measured by government targets. It is not proven, but possible, that the reasons for the demographic changes are related to the provision of health care in the region.

3.2.7 Balancing the needs of the various stakeholder groups.
There is a diverse range of stakeholder interests in any health organisation, and many will fit into more than one category so may have conflicting needs within themselves. For example, most patients will be taxpayers and all taxpayers will at some time be patients.

The main groups can be identified as:

- Government and local politicians, whose main aim is value for money and gaining electoral support through improved services.
- Patients, who want high quality services delivered on time in convenient locations but do not necessarily want to pay the appropriate rate for them.
- Staff and non-salaried associates, who want adequate salaries and good working conditions but also recognition for their contribution to health.
- Suppliers, who want to be paid on time but also have continuity of contractual relationships.

- Local community, who – like patients – want a good quality health service within reach but not always at their backdoor, the "NIMBY" argument.

- Taxpayers of Zamorna, who want value for money. There are diverse opinions in this group, for example some want good quality services and are prepared to pay more tax to get them, others do not want any tax increases but still want the services. This is the nature of the public sector.

Policies in relation to corporate governance, the awarding of contracts, and ethical issues need to be strengthened to ensure appropriate consideration of the needs of the stakeholder groups. A procedure for ensuring compliance needs to be put in place. These are necessary in order to meet the three main conclusions of the Investigating Executive (in the un-seen).

3.2.8 Demographic changes

The population of MGH's catchment region is ageing. This also will have an effect on health and performance measures. There has as yet been no attempt to determine the implications for this, but on the latest forecasts the region will have around 21,000 more residents over the age of 61 and around 13,000 fewer residents under 26. The current proposal to demerge maternity and child welfare does not appear to have considered these revised figures.

3.3 Use of balanced scorecard approach to evaluation of strategic issues

Many organisations in both the public and private sectors are using the balanced scorecard approach to translate their objectives and strategies into a "comprehensive set of performance measures that provide the framework for a strategic measurement and management system" (Kaplan and Norton 1986). Although this approach is not a panacea for poor judgment and management, it is a very useful tool that we are recommending MGH considers adopting. In this section of the report we discuss, briefly, what a balanced scorecard means in general and in the context of MGH.

The balanced score card approach to performance management specifically links performance measures to the strategic direction of an organisation. It is a multi-dimensional framework that utilises measurement as a means of describing an organisation's strategy. In essence the BSC aims to clarify an organisation's vision and strategy and translate them into tangible objectives and measures, which are selected because of their significance as drivers of future financial performance.

The BSC framework typically addresses four perspectives, normally defined as: (1) financial, (2) customer, (3) internal business processes, and (4) learning/growth. Each of these 4 perspectives, or quadrants, of the BSC will have a main aim, the achievement of which the chosen targets are expected to address. MGH has four objectives that can broadly be described as aims, which can then be attributed to each of the four quadrants of the BSC without too much difficulty. These are summarised in Appendix C. We have identified which of the current performance measures could be attributable to each quadrant and made some preliminary suggestions about additional measures that could be adopted.

EVALUATION OF REDEVELOPMENT PROPOSALS

Note: There are a large number of assumptions made in the following evaluation and many different approaches are available and valid.

4.1 Effect of redevelopment proposals on MGH's surplus/deficit

A financial summary showing the effect on MGH's surplus or deficit for the three proposals are shown in table 1 below. The supporting calculations and assumptions are to be found in appendix A at the end of this report.

TABLE 1

	Proposal 1	*Proposal 2*	*Proposal 3*
	€ (m)	*€ (m)*	*€ (m)*
Surplus/(deficit) before interest and lease costs	26.401	17.220	10.268
Lowest lease charges (1)	13.120	10.870	4.600
Surplus/(deficit) for the year (2)	12.281	6.350	5.668

Notes:

1. Lease charges are for the ArkFin for proposals 1 and 2 assuming ArkFin also supplies ancillary services. The International bank's quotation has been used for proposal 3, as this is lower than ArkFin.

2. These figures ignore any gains there may be from disposal of land for proposals 1 and 2. In the case of proposal 1, there would be net cash receipts of €5 million over the 40-month build period (that is €25 million cost of Romstat land to be purchased, offset by the eventual sale of existing land for €30 million). In the case of proposal 2, there could be net cash receipts of €7 million over the 36-month build period (that is €25 million cost of land less €24 million sale of existing land and less €8 million estimates sale of surplus Romstat land).

These figures show that in the immediate future proposal 1 offers the most positive impact on MGH's surplus.

In terms of efficiency gains, only proposals 2 and 3 meet the government's targets in percentage terms (a minimum of 3% of annual income on major redevelopment projects and 1% on rebuild or refurbishment), as shown in table 2 below.

TABLE 2

	Proposal 1	*Proposal 2*	*Proposal 3*
Annual Income €m	266.250	246.000	253.310
Efficiency gains €m	7.76	8.32	2.51
Efficiency gains % per annum	2.91	3.38	0.99

4.2 Investment appraisal of redevelopment proposals

Public sector organisations in Zamorna are required to show a 5% return on investment. An NPV analysis on each investment was performed, in the first instance simply using MGH's "cost of capital". The key figures are shown in table 3 below. The detailed calculations are shown in appendix B.

TABLE 3

	Proposal 1	*Proposal 2*	*Proposal 3*
	€ (m)	*€ (m)*	*€ (m)*
NPV before lease costs	11.10	110.94	-1.22
NPV after lease costs (including the ancillary services)	-141.94	-15.68	-42.46

After lease costs none of the proposals show a positive NPV. However, the government would not be providing finance at commercial rates, so decisions are more appropriately made on the pre-lease cost calculations. Other considerations are:

- The figures are provisional and forecasting so far into the future is subject to inaccuracies;
- The order of preference of the proposals is likely to stay the same.

We subsequently reviewed each of the proposals against the given criteria and the weighted scores already established, which were (in total)

	Proposal 1	*Proposal 2*	*Proposal 3*
Totals	2.30	1.30	2.40

However, this method does mix ranking absolute measures, such as capital cost and annual funding requirement, with relative measures such as a reduction in cost per treatment and increase in overall activity.

It is also useful to look at the percentage improvement in each measure, by proposal, against the current situation and against competitors. The figures are summarised in Appendix D. This shows that on a percentage basis proposal 2 shows the greatest improvement on all measures, except the waiting period for in-patients within 12 months, where the improvement ranks equally with proposals 1 and 3.

As we are required to assess the outcomes of the investment, it is necessary to use this initial exercise as the basis on which to build a more reasoned evaluation, taking into account other issues that are associated with each proposal.

We used a SWOT analysis framework to discuss the proposals. We have also evaluated each proposal in the context of the strategic issues identified and discussed in section 3.

The second part of our evaluation assesses the contribution of each proposal to the Group's objectives.

4.3 Strengths, weaknesses, opportunities and threats

Proposal 1

Strengths
This proposal aims to continue to provide a full service delivery of treatments and care but in modern buildings with better equipment. Main strengths are:

- It is likely to be the most favoured proposal by staff and the local population as it maintains the status quo but to a much higher standard than at present;
- Additional income from government can be expected to cover the additional activities; indeed this proposal demonstrates the highest annual surplus in the short term;
- All the performance measures detailed in Appendix B of the pre-seen will be improved;
- It will help MGH meet its main corporate aims, but to a lesser extent than proposal 2.

Weaknesses/threats
The key weakness is its lack of strategic focus. Modern health care facilities rarely combine such disparate activities as mental health, accident and emergency and maternity services. This lack of strategic focus is evident by the poorer performance forecast of most activity and efficiency measures when compared to Proposal 2. Other weaknesses are:

- It has the most expensive build costs at €145 million;
- It has a lower NPV than proposal 2;
- It has the longest completion date at 40 months, which introduces the potential threats of delays and budget over-runs.

An additional threat, which is also present in proposal 2, is the terms of the lease. The discount rates implied by ArkFin in their proposals are as follows:

	Excluding ancillary services % per annum		*Including ancillary services % per annum*	
	ArkFin	*International Bank*	*ArkFin*	*International Bank*
Proposal 1	8.0	10	7.5	Not available
Proposal 2	8.0	10	7.5	Not available
Proposal 3	11.0	10	9.0	Not available

The ArkFin rates seem very low compared with the international bank on proposals 1 and 2. However, as some of the NED's commented at the time ArkFin was approved by the MGH board, it is in no-one's interest for the terms of the contract to be so low the survival of the contractor is threatened.

ArkFin's latest quote for proposal 3 is much higher than both its original quote and that of than the international bank. This suggests the consortium is not interested in financing this type of refurbishment project.

Opportunities
There are two identifiable opportunities associated with "state of the art" facilities:

- The ability to attract and retain high quality staff;
- The ability to bid for additional funding from government and the private sector, for research as well as treatments. If this additional money were to be estimated and factored into the NPV analysis, the results might be more favorable.

Proposal 2

Strengths
This proposal should meet the same standards of care as proposal 1, but on selected services. Its main strength is financial – it has by far the most favourable outcome on the NPV analysis and demonstrates the greatest improvement on almost all performance measures in percentage terms. It still shows a negative NPV when lease costs are considered and this is discussed further in the recommendations section.

Another major strength is that it should allow greater specialisations of services across the region – not just in its own new hospital, but also in the "de-merged" maternity, child welfare and mental health services. It also shows the greatest improvement in some activity measures and at lower cost. This proposal has the lowest (therefore best) total weighted score. It ranks highest of the three proposals on the activity measures (reduction in cost per treatment, increase in activity and reduction in complaints). However, this is inevitable given that two of its main services are being de-merged.

Weaknesses/threats
The main weakness is the fact that it does not provide a full range of services. This is not a weakness from strategic, organisational or clinical perspectives but raises a potential threat, which is opposition from local population and health groups. Such opposition may cause extensive delays if, for example, the government orders a review.

Other threats with this proposal are:

- Surplus land which may be unsaleable;
- The value of the old land is less than expected, for example planning permission is not received and a buyer cannot be found. The converse of this is the opportunity it presents if planning permission is received and the land proves to be worth more than expected;
- The terms of the lease, as discussed under proposal 1;
- Some staff will no longer be required by MGH. They may well be offered employment by the acquiring providers, as suggested by the MGH Board, but there may be issues of redundancy or early retirement. This is a risk that should be costed and factored in to the evaluation.

Opportunities
These are likely to be similar to those with proposal 1, that is:

- The ability to attract and retain high quality staff;
- The ability to bid for additional funding from government and the private sector, for research as well as treatments. If this additional money were to be estimated and factored into the NPV analysis, the results might be more favourable.

Proposal 3

Strengths
This proposal's main strengths are:

- lowest overall cost in terms of both capital and revenue requirement;
- It has the shortest completion date at +32 months;
- It provides for a surplus in the immediate future, although less than the other two proposals;
- It maintains a full service provision;
- All performance measures would be improved, although to a lesser extent than is generally the case with the other two proposals;
- No ongoing evaluation will be required to satisfy the government.

Weaknesses
The weaknesses are:

- It does not provide a positive NPV. Also, the evaluation does not take into account the probability that further renovations and redevelopment will be necessary within the next 25-28 years – to a much greater extent than with proposals 1 or 2;
- Many performance measures continue to be below comparative organisations;

- It continues to use old buildings. The problems associated with this are unlikely to be completely overcome by refurbishment;
- Health services for the region would continue to be provided over more than one site;
- There would be significant adverse impact on patients during the build period because of upheaval on the present main site;
- It is a "sticking plaster" solution that will almost certainly only delay the inevitable and, in the long term, result in higher total costs;
- Apart from creating a financial surplus in the year this proposal would appear to conflict with some of MGH's main aims, and in particular the need to consider all the organisation's stakeholders.

Threats

- The staff discontent is the greatest threat, as many may leave and recruiting new staff of sufficiently high calibre may prove difficult;
- Providers of funds are not enthusiastic about financing refurbishment projects. It may prove difficult to find financing at all if this proposal is chosen.

Opportunities

There are no opportunities that can be identified with this proposal, other than the – possible – opportunity cost of the money saved. If the money saved on buildings can be spent on more and better equipment, to the benefit of patients, then the potential staffing crisis may be overcome. However, it is unlikely that new and more equipment will compensate for remaining in antiquated buildings.

4.4 Assessment of contribution to Group objectives

A summary of the development proposals is shown below:

Objective 1 – Delivering High Quality Health Care

As a strategy to assist MGH meet its objectives, proposal 1 contributes directly to this first objective. It clearly aims to deliver high quality health care to the residents of the region, although the quality of care is likely to be as high with proposal 2. Proposal 3 is unlikely to deliver the same quality of service, whatever amount is spent on equipment.

Objective 2 – Value for Money

In terms of value for money, proposal 2 is probably more likely to achieve this objective as it has the highest rankings on all the activity measures.

Objective 3 – Improving Health

This objective will be largely unaffected by the choice of proposal, although if proposals 1 and 2 allow recruitment of higher calibre staff and better retention of existing staff there could be a positive impact on the development and implementation of public health policies.

Objective 4 – Stakeholder interests

The proposal that assists the most with the achievement of objective 4 is more difficult to assess. To some extent it depends on the stakeholder being considered. Each group is discussed, briefly, below.

Patients will probably benefit most from proposal 2 in clinical terms, although many may prefer proposal 1 (or even proposal 3) because of greater convenience of location.

Staff may benefit most from proposal 1 as there is no indication this proposal will have any negative effects. The impact of proposal 2 on staff currently working in the services to be demerged has not been fully considered. Those in maternity and child welfare may benefit because of the scope for greater specialisation. The impact of private sector management on mental health services is impossible to judge, but experience from hospitals in other regions which have taken similar decisions has not been universally positive.

The government and local politicians will no doubt prefer the proposal that gives the greatest improvement in activity measures, which is proposal 2. However, they will also want the proposal that causes least complaint and unrest, which is proposal 1, or even proposal 3. This is a difficult trade off for this group of stakeholders.

Suppliers is the one group of stakeholders that may prefer proposal 3 outright. MGH sources its consumable supplies locally. If ArkFin acquires the contract to supply ancillary services then these local companies will lose substantial amounts of business and some smaller ones may have to close, with resultant loss of jobs in the community.

It is fair to say that prioritising the variables is a difficult task, especially those that are qualitative rather than quantitative. To aid the decision we extended the ranking and weighting exercise to include the "contribution to objectives" issues discussed in this section. We have assumed equal weighting of objectives and allocated a score (rather than a rank) of between 1 and 3 (1 = very good, 2 = good, 3 = satisfactory) to each proposal depending on how it contributes to the achievement of the objective. To some extent the determination of these scores is subjective but they have been determined after much discussion among members of the project evaluation team and other staff.

		Proposal 1		*Proposal 2*		*Proposal 3*	
Objective	*Weight*	*Score*	*WS*	*Score*	*WS*	*Score*	*WS*
High Quality Health Care	0.25	1	0.25	1	0.25	3	0.75
Value for Money	0.25	3	0.75	1	0.25	2	0.50
Improving Health	0.25	2	0.50	1	0.25	3	0.75
Stakeholder Interests	0.25	1	0.25	2	0.50	3	0.75
Totals			1.75		1.25		2.75

On the basis of this evaluation, proposal 2 again becomes the most attractive choice.

5.0 RECOMMENDATIONS

In section 3 we identified eight strategic issues facing MGH at the present time. In section 4 we reviewed the strengths, weaknesses, threats and opportunities of each of the proposed redevelopment proposals. In this section we discuss recommendations of actions to address each issue, noting where relevant any concerns we have that need to be addressed before the recommendation could be implemented. All our recommendations are summarized as a list in Appendix E.

Each recommendation in the following section is referenced, for example R1, R2 etc. These reference numbers are used also in Appendix E for ease of cross-referencing.

5.1 Serious weaknesses in the management

This issue has been evident for some time. The recent board changes have done little more than provide a temporary solution. Our recommendations here are in two parts: immediate and longer term.

The immediate recommendation is that permanent appointments are made to the posts of Chair, Chief Executive and Director of Finance. Subsequently, an additional NED needs to be appointed, preferably from a clinical profession (R2).

Our second recommendation is that the Group's governance procedures be strengthened (R3). Responsibility for this should be placed in an appropriate department, such as Corporate Secretariat or HR.

5.2 Financial performance

Proposal 1 would contribute most to providing a surplus in the immediate future. However, we believe to choose this proposal for this reason would put short-term gain against longer term overall benefits.

Our main recommendation here (R4) is to undertake an immediate review of the deteriorating financial performance, in particular to:

- Try and ascertain why "other income" is declining;
- Review all costs to determine if there could be cost savings introduced without affecting service quality.

5.3 Government targets and performance measures

These are a given and must be achieved if MGH is not to lose funding and reputation. The adoption of either redevelopment proposal 1 or 2 will help MGH meet targets, and in many cases exceed the minimum expectations based on the averages of comparative organisations. The introduction of a balanced scorecard approach will also assist in monitoring performance in target areas.

Only proposal 2 exceeds the target efficiency gains percentage for rebuild projects (3·38% compared with target of 3%) although proposal 3 is very close to target (0·99% against a target, for refurbishment projects of 1%). Proposal 1 falls short of the target (2·91% compared with 3%) In terms of meeting the efficiency adjusted cost savings percentage, all three proposals meet the minimum requirement, with proposal 2 exceeding it.

Our recommendation (R5) is to set improvement targets for the coming year, independently of the evaluation of the three proposals.

5.4 Poor, outdated buildings and facilities

This issue can only be addressed by implementing one of the redevelopment proposals. The advantages and disadvantages of each were discussed in section 4. On almost all criteria, proposal 2 was the preferred choice. It ranked most highly on most of the evaluation criteria although it does not meet the required return on investments when lease payments are taken into account. Recommendation 1.3 below addresses this issue.

Our main recommendation (R1) is that the MGH Board adopts proposal 2. The project evaluation team will then need to be converted to a Project Management Team. The members of that team may or may not be the same people as are currently on the project evaluation team but this is a management issue yet to be discussed.

We also recommend that the surplus land is retained by MGH for future likely development (R1.1). There is a "real option" feature here; given the changing demographic profile of the region, there may be future requirements for, say, elderly care facilities that could be built here. If the land is sold MGH could be back to the situation of split sites.

Our main concerns about adopting this recommendation are:

1. Planning permission for housing development on the old land and buildings is refused;
2. Public objection to the proposal causes serious delays and disruptions;
3. The lease terms contain a risk, as discussed in section 4.

The first two concerns need active management and, if our main recommendation is adopted, we make three further recommendations:

- Establish a project management team (R1.2);

- MGH appoints a representative to the project management team to initiate discussion with ArkFin about the terms of the lease (R1.3). One possibility is that the length of the lease is extended to 30 or more years. This is not untypical of redevelopment projects of this type. As part of these negotiations, we could enquire if they would be interested in buying the old land and buildings as part of the overall financing arrangements. This would not be uncommon in deals of this kind and would have two advantages: ease of sale of the old land and buildings and possible favourable impact on terms of financing. The main disadvantage is the potential opportunity costs of profit foregone if the land and buildings could be sold for a higher sum on the open market. The fact that an independent valuer has valued the land provids some measure of confidence here.

The third concern is more problematic. We cannot, of course, prove that ArkFin is dangerously under pricing its 25 year lease terms, but we suggest the issue is included in the discussions with ArkFin about the purchase of the old land and buildings.

5.5 Resource limitations: staff and money

To some extent, this is an issue that will never be fully resolved for the reasons explained in section 3. Where demand exceeds supply, services are free at the point of delivery and public expectations constantly increase there will always be resource pressures. Our recommendation to adopt redevelopment proposal 2, which is the proposal with the highest NPV, will provide the greatest value for money and the most improvements in service delivery, but is not the cheapest proposal in terms of capital and financing costs.

When lease costs are taken into account, all three proposals show negative NPVs, with Proposal 3 being the least negative. However, as noted earlier, taking lease payments based on commercial rates of interest may not be appropriate for the investment decision here.

On a comparison between ArkFin and the International Bank, ArkFin should be allowed to provide finance for the contract. It is considerably cheaper than the competitive bidder. However, the concerns expressed earlier in this report should be considered.

Proposal 2 is likely to be popular with most staff, which should aid retention of personnel. The introduction of a balanced scorecard approach recommended above will also contribute to the organisation's ability to measure and monitor what is most important to MGH in terms of its objectives and strategic aims.

There are two specific recommendations:

- Improve staff relations and retentions in the immediate future by better communications. The HR department could be made responsible for establishing policy and procedures here (R7);

- Launch a recruitment campaign for key staff by emphasising the advantages of the Mayah region and the potential offered by the new facilities. Recruitment could be extended overseas subject to controls on language ability and equivalence of qualifications (R8).

5.6 Marketing/PR issues

This is an issue that needs urgent attention if other strategic issues are to be addressed. In particular, staff need to be retained and the public won over to the redevelopment proposal choice.

The recommendation is to strengthen the marketing function and make it a main board responsibility (R9).

5.7 Balancing the needs of the various stakeholder groups

If our recommendation to adopt redevelopment proposal 2 is approved, this recommendation will help meet the needs of most of the stakeholder groups, with the possible exception of suppliers and some patient groups. The introduction of a balanced scorecard approach has been discussed as a way forward.

A NED, Carlos Cluntz, identified the need to translate strategic objectives into tangible goals and actions at a Board meeting last year and we recommend here that he is asked to Chair a Committee to review the development and implementation of the BSC framework (R6).

5.8 Demographic changes

The forecast changes in the demographic profile of the region have significant implications for MGH. The current evaluation of the redevelopment proposals was based on current forecasts. The need in 10 years time may now be for less maternity/child welfare and more geriatric and age-related treatments. The new forecast reinforces the decision to proceed with redevelopment proposal 2. The merging of maternity services and child welfare with another region makes even more sense if this is a diminishing market. Similarly, as noted above, the retention of the surplus land if proposal 2 is adopted allows flexibility of use for changing requirements.

Nevertheless, our final recommendation is that a full evaluation of the implications for MGH should be initiated as soon as possible (R10). This might involve collection of additional data and more robust statistical demographic trend forecasts for the region.

Appendix A

EFFECT OF REDEVELOPMENT PROPOSALS ON MGH'S SURPLUS/DEFICIT

Forecast of annual profit or loss:

	Proposal 1	*Proposal 2*	*Proposal 3*
	€(m)	*€(m)*	*€(m)*
Income (table 1 un-seen)	266.250	246.000	253.310
Other income (note 1)	14.500	14.500	14.500
Current expenses	(257.350)	(257.350)	(257.350)
Profit impact of expense adjustments:			
For activity (note 2)	(8.750)	(4.053)	(2.702)
Staff cost savings (note 3)	+3.991	+9.803	nil
Efficiency savings	+7.760	+8.320	+2.510
Surplus/-deficit on activities before interest and lease costs	+26.401	+17.220	+10.268

Notes:

1. The latest figure for the current year has been used. This could be too conservative since this was €23·5 million last year, and MGH is in a relatively affluent area and with an increasing ageing population who may wish to pay privately. The decline could have been a blip.

2. Current year costs are €257.350 (appendix C in the pre-seen) of which 75% are fixed costs (appendix B in the pre-seen). Therefore current fixed costs are €257.350 x 75% = €193.013. The adjustment for activity related costs (Table 1 in the unseen) are then calculated as follows:

Proposal 1: €257.350 x 25% x 13.6% increase = €8.750

Proposal 2: This is more difficult to quantify and more assumptions are needed. Although table 1 (un-seen) shows a 21.4% increase in activity the income from activities at €246 million is only around 6.3% higher than the current year's income for MGH. Information in the pre-seen states that volumes will decrease for proposal 2 because of the loss of maternity and health care patients. Although different kinds of patients will be funded differently by the government, a practical solution would be to treat variable costs increasing by only 6.3% (in line with income) that is €257.350 x 25% x 6.3% = €4.053.

Proposal 3: €257.350 x 25% x 4.2% increase = €2.702

3. Staff costs are 75% of current costs. Under proposal 1 these will fall to 73% and under proposal 2 to 70%. These savings are therefore calculated as:

   Proposal 1 – (€257.350 + €8.750) x 75% x 2% = €3.991
   Proposal 2 – (€257.350 + 3.860) x 75% x 5% = €9.803
   Proposal 3 – no effect

Appendix B

INVESTMENT APPRAISAL OF REDEVELOPMENT PROPOSALS

Proposal 1

Year	*Cashflows €(m)*	*5% discount factor*	*Present value € (m)*	*Notes*
0	-25.0	1.000	-25.00	(1)
1-3	-145.0	0.908	-131.67	(2 & 3)
4	+30.0	0.823	+24.70	(4)
4-28	+11.751	12.175	+143.07	(5 & 6)
		Net present value over 28 years	+11.10	
4-28	-12.57	12.175	-153.04	(7)
		Net present value after lease costs	-141.95	

Notes:

1. Cost of Romstat land.
2. Building costs over 40 months (say 3 years).
3. Average discount factor for years 1 to 3.
4. Sale of current land and buildings.
5. Estimated savings for staff costs and efficiencies.
6. Cumulative discount factor for year 28 (14.898) less the cumulative discount factor for year 3 (2.723) that is 12.175 is for 25 years.
7. Lease costs including ancillary services, discounted at 5%.

Proposal 2

Year	*Cashflows €(m)*	*5% discount factor*	*Present value € (m)*	*Notes*
0	-25.0	1.000	-25.00	(1)
1-3	-115.0	0.908	-104.42	(2 & 3)
4	+24.0	0.823	+19.75	(4)
4-28	+18.12	12.175	+220.61	(5 & 6)
		Net present value over 28 years	+110.89	
4 – 28	-10.4	12.175	-126.89	(7)
		Net present value after lease costs	-15.68	

Notes:

1. Cost of Romstat land.
2. Building costs over 36 months.
3. Average discount factor for years 1 to 3.
4. Sale of current land and buildings. There could be further land sales of €8m in year 4 of the spare Romstat land.
5. Estimated savings for staffing costs and efficiencies.
6. Cumulative discount factor for year 28 (14.898) less the cumulative discount factor for year 3 (2.723) that is 12.175 is for 25 years.
7. Lease costs including ancillary services, discounted at 5%.

Proposal 3

Year	*Cashflows €(m)*	*5% discount factor*	*Present value € (m)*	*Notes*
1-3	-35.0	0.908	-31.78	(1 & 2)
4-28	+2.51	12.175	+30.56	(3 & 4)
Net present value over 28 years			-1.22	
4-18	-4.6	8.966	-41.24	(5)
Net present value after lease costs			-42.46	

Notes:

1. Building costs over 36 months.
2. Average discount factor for years 1 to 3.
3. Estimated savings for efficiencies.
4. Cumulative discount factor for year 28 (14.898) less the cumulative discount factor for year 3 (2.723) that is 12.175. Proposal 3 evaluation had also been taken over 25 operational years to be comparable with proposals 1 and 2.
5. Lease costs over 15 years, discounted at 5%.

Appendix C – BALANCED SCORECARD

Client Perspective
Aim:
To deliver high quality health care
Existing:
Outpatient waiting times
Inpatient waiting times

Proposed:
For example:

Reduction in mortality [from disease]
Elderly care
Accident and emergency
Time to be seen
Patient satisfaction

Internal Process Perspective
Aim:
Improving Health
Existing:
none given

Proposed:
For example:

Reduction smoking related diseases
Reduction obesity

Learning and Growth Perspective
Aim:
Stakeholder interests
Existing:
None noted

Proposed:
For example:
Staff satisfaction levels
Reduction staff turnover

Cost Perspective
Aim:
Value for money
Existing:
Spending within limits
Staff costs as percentage
Av costs

Proposed:
For example:
Reduction management costs

Appendix D

Performance measures

	Current			*% improvement on*			*% improvement on*			*% improvement on*	
	Mayah	*Comparative Orgs*	*Proposal 1*	*Current*	*Comparative Orgs*	*Proposal 2*	*Current*	*Comparative Orgs*	*Proposal 3*	*Current*	*Comparative Orgs*
Hospital waiting times											
Out-patients:											
Within 3 months	0.68	0.60	0.75	10.29	25.00	0.80	17.65	33.33	0.72	5.88	20.00
In-patients:											
Within 3 months	0.65	0.75	0.78	20.00	4.00	0.80	23.08	6.67	0.70	7.69	−6.67
Within 12 months	0.95	1	1	5.26	0.00	1	5.26	0.00	1	5.26	0.00
Complaints											
Number	1,250	950	1,050	16.00	−10.53	950	24.00	0.00	1,150	8.00	−21.05
Upheld	175	50	75	57.14	−50.00	60	65.71	−20.00	80	54.29	−60.00
Staff complaints	185	85	85	54.05	0.00	50	72.97	41.18	65	64.86	23.53
Financial											
Under/over spend	−0.05	0	0			0			0		
Staff costs as % of total operating costs	0.75	0.7	0.73	2.67	−4.29	0.7	6.67	0.00	0.75	0.00	−7.14
Average cost per out-patient €	850	775	775	8.82	0.00	765	10.00	1.29	825	2.94	−6.45
Average cost per in-patient €	1,450	1,425	1,550	−6.90	−8.77	1,425	1.72	0.00	1,550	−6.90	−8.77

Appendix E – SUMMARY OF RECOMMENDATIONS

1 Adopt redevelopment proposal 2:

  1.1 Retain surplus land under proposal 2;
  1.2 Establish a project management team;
  1.3 Appoint representative to PMT to manage the concerns about the terms of the lease, including discussions with ArkFin on purchase of old land and buildings.

2 Make permanent appointments to the senior board positions currently held by temporary or acting staff and the NED vacancy.
3 Establish formal responsibility for corporate governance in an appropriate department.
4 Review deteriorating financial performance, especially “other income” and potential for cost savings.
5 Set targets independent of the proposals being evaluated.
6 Establish a committee to evaluate the adoption of a balanced scorecard approach to performance management under the chairmanship of Carlos Cluntz.
7 Allocate responsibility for staff communications to the HR department.
8 Launch a national and international recruitment campaign.
9 Strengthen the marketing/PR function and make it a main board responsibility.
10 Initiate a review of the implications for MGH of the forecast change in demographic profile of the region.

Appendix 4 – ReuseR and NOW (the first TOPCIMA exam in May 2005)

Recycling - ReuseR and NOW

Background

The marketplace

Recycling has two significant impacts on the global environment. First, the use of recycled materials reduces the consumption of the world's natural resources. Second, recycling waste avoids the over-use of landfill refuse sites, which in turn reduces the level of potential pollution or contamination. Additionally, manufacturing costs can be reduced, as energy savings of around 5% can be achieved when, for example, new cans are manufactured using recycled aluminium. Also, recycled aluminium cans may end up being manufactured into sheet metal for car or aeroplane bodies.

Glass recycling is very efficient because a glass container is 100% recyclable and can be recycled over and over again with no loss in quality or purity. The use of recycled glass is also not restricted to making new glass, as it can also be recycled into construction aggregate and abrasive material for blasting and also into garden paving slabs. Another significant area of recycling is paper. In Western Europeans' household waste, around 40% of it is paper waste, and paper is currently one of the fastest growing recycled products. Aside from waste reduction, paper recycling makes ecological sense as recycling around 17 pounds (which is less than 8kg) of paper can save one tree. Paper is usually recycled into new paper products, such as tissues, printing paper and chipboard.

More and more businesses are also seeing the sense in selling off their waste paper and many new companies are entering into, or expanding their own, recycling business. Additionally, in today's business world, a company's image is one of its most important assets. A company that has a positive environmental profile will attract quality customers, employees and suppliers. It can also command a share price premium, as corporate investors are increasingly aware of the demand for "green" investments. There is also increasing external pressure to demonstrate effective environmental practices and to recycle waste. It is likely that within the next decade there will be a statutory requirement for businesses within the European Union (EU) to adopt processes such as waste recycling. To assist companies to reduce and recycle their waste a large number of service companies have entered this growing market.

Over ten years ago, recycling companies were small and operated only within their home country, but with the freedom to operate across boundaries within the EU, many of the larger recycling companies have made acquisitions to strengthen their position and to expand into new markets. Additionally, many large multi-national organisations have become more aware of waste and "green" issues and have established their own recycling departments, which recycle waste materials from other parts of the company.

Most European governments have established a variety of ways in which both domestic and industrial waste can be minimised and materials recycled. To support the various government initiatives, a wide range of specialist companies has been able to increase the volumes of materials recycled. There are many companies of all sizes in the recycling industry, which is still in its early stages, and the recycled materials market is expanding rapidly.

Details follow on two recycling companies

This material gives details on two fictitious companies operating in the recycling industry, mainly in Europe. The two companies are Reuse Refuse (ReuseR) and No Waste (NOW). Details on both companies and their operational and financial data are shown below.

Reuse Refuse (ReuseR)

Reuse Refuse (which trades as ReuseR) is a quoted company operating in a northern European country, with subsidiary companies across Europe. The company collects waste and recycles a wide range of products, but its single largest recycled product, which is also one of its most profitable, is recycled glass. It currently supplies recycled glass to twelve customers spread over eight countries in Europe. It sources its recycled glass supplies from hundreds of sources, including its many contracts for the collection and recycling of domestic waste. ReuseR also recycles a range of other waste products, including wood, paper, metal, tyres and a number of other materials.

ReuseR has expanded its operations across Europe by the acquisition of many smaller recycling companies. Since 2000, with the pressure on governments and the general population to recycle waste materials, it has introduced several innovative ways in which various types of waste are collected for recycling and sold to a range of manufacturing companies.

Entrepreneur Kurt Finehart, who is the Chairman and Chief Executive, had acquired the company in the 1980's when it was small and operating only in one country. Kurt Finehart always had ambitious plans for the company and was ahead of his time, with his vision of recycling waste. In the late 1980's the company became listed and the current directors and employees collectively own over 53% of the shares. The rest of the shares are spread over a wide range of investors with no large shareholdings.

The key senior management team in ReuseR is as follows:

Kurt Finehart – Chairman and Chief Executive

Kurt Finehart is a very flamboyant 48 year old, who has strong Government connections in his home country. He is from a wealthy family, which helped him to acquire the company initially. He has proved himself to be a serious businessman, with close links with several of his key customers. He is a non-executive director of two other companies, one of which is a glass manufacturing and printing company, to which ReuseR sells some of its recycled glass and paper. Kurt Finehart is also actively involved in many global environmental groups and is highly respected in the recycling industry. His catch phrase, which the press repeats often, is "re-use, not refuse".

Jean-Paul Gamell – Finance Director

Jean-Paul Gamell joined ReuseR over ten years ago and has improved the company's financial strength and its ability to manage its increasingly complex business covering eight EU countries. He has a small, strong head office team and has established finance teams in each country where ReuseR operates. In each country in which ReuseR operates, a separate subsidiary company manages its operations and acts as an autonomous business unit. Communication between some of the finance teams in the subsidiaries and head office needs to be improved and it is a problem area that Jean-Paul Gamell is aware of and he has planned to concentrate on, but he has continually been under pressure with the many recent acquisitions that ReuseR has made.

Clement Weiss – Business Development Director

Clement Weiss joined ReuseR five years ago and has been the driving force behind many of the company's recent acquisitions. The recycling industry is very fragmented and many small, privately owned, local companies operate successfully and profitably. Clement Weiss believes that economies of scale can be achieved by building upon ReuseR's existing collection and distribution network that it operates in eight EU countries. Some of the small companies that ReuseR has acquired in the last two years handle a range of recycled products that ReuseR had not dealt with previously. ReuseR is currently recycling these additional materials, including electronic waste, old vehicles and plastics and is considering which of these recycled materials should be continued with a view to future expansion of its recycling business.

Allain Chambers – Operations Director

Allain Chambers, now 53 years old, had worked in the transportation business for over 20 years before joining ReuseR in 1994. He had previously managed his own small fleet of lorries, but when a large European logistics company had acquired his company, he felt that he wanted to stay in the industry, and personally felt strongly about recycling. The opportunity to manage the European operations and logistics at ReuseR was a challenge, but he felt he had a lot of experience to help ReuseR achieve its goals of cost reduction and improved operational safety and performance. He has been key in the selection and implementation of a €12 million IT project using satellite navigation technology that enables the company to track and monitor its large fleet of specialised vehicles.

During the early 1990's the company had experienced a few minor safety incidents, prior to his joining the company. The safety problems arose where employees had been involved with hazardous materials, which had resulted in personal injury claims. Allain Chambers feels strongly that the assets of the company are its staff, who should always be looked after as its first priority, and that a 100% safety record should be aimed for, despite the company's complex, and sometimes difficult, business.

Ellouise Matin – Human Resource Director

Ellouise Matin had joined ReuseR eight years ago after the unfortunate health and safety problems had occurred. She agreed with Allain Chambers that the staff should be better managed and safety procedures improved. These two directors have both put pressure on the Board to improve pay and conditions and to reduce working hours. In the past some staff had worked excessively long hours with large payments for overtime. Ellouise Matin considered that staff could not work effectively for long hours on a regular basis. She had initiated a recruitment drive to replace overtime with full and part-time employees. She is well respected by the ReuseR workforce for many of the Human Resources (HR) changes that have occurred.

The company has experienced problems with recruiting, and also retaining, employees, despite providing training, good rates of pay and allocation of free shares for staff after two years of employment. The company is still experiencing a high staff turnover in some countries and in certain sectors of the business. HR and operational management are looking at ways in which team building and more flexible working could improve staff retention and commitment to the company.

Cost control and international logistics in ReuseR

The ReuseR Board has asked Jean-Paul Gamell to investigate why the increased volumes and increased turnover has not resulted in corresponding increases in margins. At the December 2004 Board meeting Jean-Paul Gamell tabled an analysis of costs. This demonstrated that the current level of spend on improved IT facilities was one of the contributing causes of the lower than expected margins, together with training and recruitment costs of new staff, which he explained was an ongoing high cost as the company was continuing to expand.

The Board approved a new IT project in December 2004, which has been outsourced, following on from the successful implementation of the satellite navigation tracking system in 2003. This minor additional software solution will improve the reporting of waste materials collected and the location, and status, of recycled materials. The system will additionally incorporate the automatic production of legal paperwork for cross border deliveries. This IT project is forecast to cost a total of €1·5 million and to be operational before the end of 2005. The project is justified financially on the basis that it will eliminate delays due to incorrect or missing paperwork, and it will also speed up deliveries of recycled waste to ReuseR's customers.

Two of ReuseR's main costs are staff costs, in respect of the collection of waste, and secondly distribution costs associated with recycled materials. As the volume of waste collected has increased, the collection costs have reduced as a proportion of the volume of waste collected, due to economies of scale. However, ReuseR has identified that its distribution costs of recycled materials have increased significantly more than changes in volumes of materials handled would justify in recent years. Allain Chambers has led a project team to identify what costs are currently incurred and to benchmark the costs against other European recycling companies, as well as other European distribution companies.

It is planned that the investigation and report will be completed in March 2005 and that a report recommending changes will go to the ReuseR Board in April. Early findings are that transportation costs have increased significantly, while waste sorting and handling costs have fallen, mainly due to the introduction of new recycling plants in some countries. Allain Chambers has stated that the bulk of some types of recycled products, some of which have a low resale value, have contributed to the reduced margins that ReuseR has experienced in the last few years. He wants his team to identify which materials are not cost effective to transport and recycle, so that the company can take a strategic decision not to handle these products.

However, Clement Weiss has pointed out that ReuseR has won a number of long-term waste collection and recycling contracts (many with local government departments for the recycling of domestic waste) on the basis that over 80% of all materials collected will be recycled. He therefore argues that the company cannot renege on its contracts, some of which are 10 and 15 year contract periods, and that the company cannot change its strategy by selecting which materials it will, or will not, handle.

Allain Chambers is therefore under pressure to identify which costs within the distribution and waste handling operations could be reduced. In some of the countries in which the company has only been operating recycling plants for a short period of time, ReuseR has not yet reached a critical mass, which would enable it to enjoy economies of scale. One additional factor is that recycled glass is currently sold to only twelve customers in Europe, whereas only three years before, ReuseR sold glass to over thirty companies. The company changed its customer profile to generate higher revenues. However, it now has higher transportation costs to move this bulky product to fewer customers over greater distances. Allain Chambers pointed out that ReuseR was able to secure longer-term contracts for the supply of recycled glass to its twelve main customers and that the contracts secured higher prices per tonne. However, the contracts stated that ReuseR would bear the transportation costs to customers' factories. Allain Chambers agreed to provide a detailed analysis of margins by recycled product for the next Board meeting.

ReuseR shareholdings, share price and earnings per share (EPS)

At the end of November 2004 there were 200 million authorised shares, with a nominal value of €0·20 per share, and 90 million shares were issued and fully paid up. The main shareholdings were as follows:

	Number of shares (000) at 30 November 2004	*% shareholding*
Kurt Finehart	20,500	22·8%
Jean-Paul Gamell	7,300	8·1%
Clement Weiss	5,900	6·6%
Allain Chambers	4,100	4·6%
Ellouise Matin	1,000	1·1%
Institutional and other investors	41,800	46·4%
Employee shares*	9,400	10·4%
Total number of shares issued	90,000	100·0%

* *Note:* Employee shares are purchased by ReuseR and issued to employees free of charge.

The share price of ReuseR had risen slowly during the 1980's and 1990's, and during 2004 ranged from €1·91 to €2·61. ReuseR has a current P/E ratio of 10. The industry average P/E ratio is 9. The company achieved EPS of €0·24 in 2004. The company plans to increase its EPS, in accordance with its five year plan, to €0·39 per share by 2009.

Appendix 2 shows an extract from the accounts for ReuseR.

Establishment of ReuseR's first recycling operations in the Middle East

ReuseR opened a recycling plant in October 2004 in a country in the Middle East. The move is to a stable country in the region, which has a very high record of recycling. This country is keen to establish itself as an example of high recycling levels to the rest of the world. ReuseR had wanted to establish a base in this country before the market for waste became too competitive and this would enable ReuseR to establish its name as a leading waste recycling company. However, it is forecast that this will result in operational losses for the first two years. The company has had many meetings with the large companies operating in this country and to date has signed two contracts for the recycling of waste.

Potential acquisitions by ReuseR

ReuseR has expanded its operations in the past mainly by acquisition, both by expanding into recycling different products and also into other countries. ReuseR is planning to make a number of further acquisitions to grow the business and also to give it access to new markets in other EU countries, and elsewhere, in which the company does not currently operate. The management of ReuseR believes that it has the business skills to recycle a range of materials, and that the company has existing customers who want these recycled materials. However, if recycled materials are transported back to existing customers in the EU, it is forecast that transportation costs could increase in the short term. However, within two years of ReuseR expanding its operations into a new country, it is forecast that ReuseR will have located new customers to which it could sell the recycled materials produced within that country.

The ReuseR Board has set the following criteria as a guideline for possible acquisitions:

- Gross margins (defined as sales less all direct costs, variable and fixed) must be similar or higher than achieved by ReuseR (ReuseR gross margin is over 50%);
- Sales revenue of between €10 – €30 million per annum;

- Must be a stand alone company, rather than a recycling division of a larger company. ReuseR has historically found it quite difficult to manage the merger of operations post acquisition, when it has acquired the recycling division only of a larger company;
- Must be willing to be acquired (for cash or share exchange), as ReuseR's management do not want to pursue a hostile take-over.

The business development department of ReuseR, headed by Clement Weiss, had identified a list of thirty possible targets for acquisition, of which most are operating in EU countries. However, some potential acquisitions are operating in countries in which ReuseR does not currently operate, as well as some countries outside of Europe. From this initial list, Clement Weiss has eliminated fifteen companies as unsuitable for acquisition and he has selected three companies that he considers would be particularly suitable for ReuseR to acquire.

Clement Weiss has requested his managers in the business development department to prepare further detailed reports on a few of the other potential acquisitions from the original thirty that had been identified, and to continue to identify new companies that are emerging in this growing marketplace. Depending on the size of the company and the price required, and whether shares or cash are used, ReuseR, is planning to acquire as many as eight companies over the next eighteen months.

Jean-Paul Gamell has been in negotiations with a leading European bank to secure loan financing of €40 million in order to fund ReuseR's aggressive acquisition plans. **Appendix 1** shows an extract of the news report about the announcement of ReuseR's new financing plans agreed with this European bank.

ReuseR Board meeting in February 2005

Following on from strategic planning meetings attended by ReuseR senior managers during January 2005, a proposal was put to the Board meeting in February 2005 to agree to three proposed acquisitions. All three companies are privately owned companies.

Jean-Paul Gamell announced to the Board that financing plans had been finalised for the loan of €40 million over eight years, at a variable interest rate of 2·15% above European lending rate, repayable in 2013. ReuseR will now have loans totalling €60 million.

The Board agreed in principle to the three acquisitions, of RED, KLL and MER. Details of these companies are shown in **Appendix 4**. The basis for ReuseR's proposed acquisitions is as follows:

1. Acquisition of RED on the basis that ReuseR does not have any recycling operations in this Eastern European country (now in the EU) and wishes to expand its geographical coverage. All investigations have shown that RED's operations are efficient and the company is operating profitably. However, it has not invested in advanced recycling plants and much capital expenditure on equipment, plant and vehicles will be necessary post acquisition.

2. Acquisition of KLL on the basis that this will help consolidate operations in a northern European country where ReuseR already has established recycling operations and has a growing customer base. This will enable it to acquire a larger customer base and better utilise the new recycling facilities that it has opened in two regions of this country to achieve operating synergies.

3. Acquisition of MER, which was one of the first recycling companies operating in the same Middle East country in which ReuseR set up a recycling plant in October 2004. The country has seen recycling rates increase rapidly and the ReuseR Board agreed that there is huge potential in this country. Additionally, ReuseR considers that this privately owned company would benefit from ReuseR's experience and expertise.

No Waste Recycling Services Ltd (NOW)

No Waste Recycling Services Ltd (which trades as NOW) recycles a range of products and has established long-term relationships with a number of its larger customers from whom it collects waste materials. Some of these customers are local government departments and divisions of multi-national companies. NOW is highly regarded as a leader in waste management and it provides its customers a high level of customer service.

NOW is a privately owned company whose shares were originally owned by two families, who ran a transportation company. However, after over 20 years in the transportation business, and increasing wage costs and competition, the company changed its trading name to NOW in 1996 and decided to enter the growing business of recycling waste. NOW handles a number of recycled products, but its two dominant business areas, which together account for almost 50% of its sales revenue are the recycling of waste paper and wooden pallets. The next most profitable sector of its recycling business is recycled glass, which accounts for almost 20% of the company's sales revenue.

When NOW first started in the recycling industry, it was able to establish very good links with a number of companies, and commenced with recycling these companies' waste paper. It soon established a high reputation as a recycling company and it has been able to forge strong links with several European wide manufacturers, to whom it sells recycled products.

The shareholders and management team of NOW at the end of 2004 are detailed below.

Imran Patel – Chairman

When his parents, who started the family's transportation business, retired, Imran Patel took over as Chairman, in 1996. As a shrewd businessman, Imran Patel, then 38 years old, saw the gap in the market for companies requiring recycled products and for their need for a specialised waste disposal and recycling service. He had worked in the transportation business all of his career and understood logistics and the need to provide customers with a quality service. Imran Patel strongly believed that the company could rapidly gain a good reputation in the growing recycling industry by exceeding customers' expectations, both in service quality and price. He is a perfectionist and very hard working, which has helped NOW maintain a high growth in turnover.

Ernst Heist – Chief Executive

Ernst Heist, now aged 48, had identified a gap in the market for recycling domestic waste and he had established quite a reputation for himself and the media dubbed him the "the man who made gold out of rubbish". Fifteen years ago he had worked as an adviser to Government departments and had close political links with central government in his home country in northern Europe. Then he founded his own recycling company and was its Managing Director, until NOW acquired it in 1999. This acquisition enabled NOW to expand geographically in Europe and also to almost double its turnover. For the past five years Ernst Heist has held the role of Chief Executive of NOW.

NOW's acquisition of Ernst Heist's previous company had given NOW the opportunity to expand its operations into neighbouring countries, which are all operating profitably. By 2001 the company decided to expand its recycling facilities and to commence handling certain waste materials from local industries. With the help of a government grant and bank loans the recycling facilities were quickly operating at almost maximum capacity.

Peri Patel – Operations Director

Peri Patel, who is Imran Patel's younger brother by 3 years, had not previously worked in the family's transportation company. He was the first member of the family that had graduated from university (with a degree in marketing management), and he then joined an international shipping company. Later he moved to an electrical manufacturing company. When his brother

took over the family business in 1996, Peri agreed to join the company and to head up marketing and operations. Since the company has grown, a new marketing director has been recruited and Peri Patel has concentrated on operations. Peri Patel has sound management knowledge and experience and he has been the driving force behind the professionalism that NOW has established within the company. Together with his brother's demand for high quality service, they make a formidable team.

Val Rines – Sales and Marketing Director

Val Rines, then 33 years old, joined NOW in 2000 as Sales and Marketing Director. Initially she had no equity interest, but has since invested €0·9 million (financed by a personal loan secured on her family property) in the company. Val Rines had previously worked in a local government department responsible for refuse and recycling and then as the sales director for a small competitor in the recycling industry. She has much knowledge of recycling and had graduated with a degree in environmental studies.

Rik Mal – Finance Director

Rik Mal, then 45, joined NOW in 1997 shortly after the company started in the recycling business and he bought shares in NOW during 2001. He is a steady, reserved character and has a close bond with the Patel brothers who respect his conservative attitude to business. They fully appreciate that Rik Mal has managed to keep the company's finances under control, given the company's rapid expansion over the last nine years.

NOW shareholdings

NOW has 20 million authorised shares, at a nominal value of €0·50 each, of which 10,620,000 shares have been issued and are fully paid up. The main shareholdings are as follows:

	Number of shares (000) at 31 December 2004	*% shareholding*
Imran Patel	4,000	37·7%
Ernst Heist	2,500	23·5%
Peri Patel	1,700	16·0%
Val Rines	320	3·0%
Rik Mal	300	2·8%
Employee shares*	1,800	17·0%
Total number of shares issued	10,620	100·0%

* *Note:* The employee shares have been given to employees free of charge.

Appendix 3 shows an extract from the accounts for NOW.

Growth of NOW since 1996

NOW had grown the recycling business rapidly since 1996 and has expanded its operations into six European countries. The business has always been a strong cash generator and the company has reinvested much of the cash generated from operations into expansion. It has also invested in a number of recycling plants, many of them small plants, which are located close to the main cities in which it operates waste collection services. This gives the company flexibility and reduces transportation costs.

The company has also embraced the use of IT in the business, which enables its customers that it collects waste from, to monitor volumes collected as well as collection dates and times. Its IT systems also enable customers who purchase recycled materials to place their orders and get immediate confirmation of delivery dates and volumes.

During early 2004, one of Ernst Heist's innovative plans came to fruition with the introduction of new recycling containers at over 800 large shopping centres in several countries. Previously most of the domestic waste that was recycled relied on the continued social pressure to recycle goods and the increased publicity of environmental problems caused by landfill sites. Ernst Heist's new plan was to pay cash to the members of the public for each and every item recycled The new recycling containers that NOW had designed paid cash for each item of waste that was recycled, based on weight or type of waste, for example per glass bottle. Therefore, the public could now recycle paper, clothes, glass, batteries and certain other items and the new recycling containers weighed or measured the input and reimbursed coins. These newly-designed recycling containers had the added advantage that waste collected was also pre-sorted, which reduces labour costs at recycling depots.

Following a month's trial at 30 sites during 2003, the level of recycled goods had increased dramatically. The financial justification of these new "recycle for cash" containers was that if the level of recycled goods increased by more than 70%, then this would cover the increased costs, primarily the cash payments, and the higher costs for logistics for emptying the recycling containers and filling up the cash payment machines. At one site during the trial, one of the containers filled up within one day and the cash payment machine was empty, whereas the old containers were usually less than half full when they were emptied weekly. Therefore daily emptying of the 30 trial sites proved necessary to maintain public confidence in the scheme.

At the end of the one-month trial, the overall level of recycling had increased much more than the required 70%, with some sites achieving 300+% higher recycling rates. This proved that cash payments do appeal to the public. NOW decided to invest in these new "recycle for cash" recycling containers for over 800 sites. This involved an investment of over €3 million. However, it was decided that the company would move the existing, old style, recycling containers (which had no payment mechanism) from these sites, when the new "recycle for cash" containers were installed, to other sites.

After monitoring the ongoing volumes of recycled goods, which generate increased turnover for NOW, most sites showed a substantial increase over previously experienced recycling levels. Overall the level of recycled goods at "recycle for cash" sites was increased by over 180% (that is the recycled goods volume had almost trebled).

However, it has since been established that collection of domestic waste (by NOW's regular weekly collection that NOW operates on behalf of local government departments) has seen a decline in volumes recycled. Therefore NOW's management has reached the conclusion that some of the waste that it used to collect as part of the local government contract for domestic waste recycling, NOW is collecting via the "recycle for cash" containers, and is having to pay for. Therefore the increased volume is not entirely due to customers recycling more goods, or even new customers recycling goods for the first time, but is due to astute customers who are now recycling their waste using a different method and getting paid for recycling it.

During 2003 and the start of 2004, the company consolidated its position after a period of three years during which several acquisitions had been made. Peri Patel, the Operations Director, ensured that all of the sites that had been acquired were rationalised, and some waste storage sites were closed. Additionally, in some of the businesses that NOW had acquired, it was decided to cease handling some waste materials. NOW had no plans to be involved with liquid waste treatment and this had formed a small part of one of its recent acquisitions. NOW has been able to sell some areas of recycled waste that it did not wish to be involved with, to other waste recycling companies. NOW decided that it wanted to concentrate on its core strengths, which are the collection and processing of paper waste and reselling of the pulp to manufacturers of paper products; the recycling of wood products and glass recycling.

NOW's secure collection and pulping of waste paper for recycling

Another new development during 2003 was that NOW opened three new waste paper pulping plants which handle all of the waste paper collections in two of the Northern European countries in which it operates. By supplying paper pulp to several newspaper printers, rather than the waste paper itself, the transportation costs were reduced as the bulk being transported was reduced. Additionally, the revenue rate per tonne of pulped recycled paper was significantly more than the price achieved for waste paper that needed treatment and pulping. The company considered that this new change to the way in which it handled the paper side of its business could generate an additional 12% gross margin, on top of the 40% gross margin currently achieved in this recycled product sector, even after taking into account the direct incremental fixed costs of treatment and pulping.

NOW has also been innovative in the collection of waste paper and has been building up the number of companies to which it supplies a secure collection and destruction of waste paper service. It operates a fleet of purpose-designed vehicles that collect confidential waste paper and then pulps the paper on customers' premises. NOW then removes the pulped paper from customers' premises, which it then sells onto its customers who require recycled paper pulp. This service gives many companies the reassurance that all confidential material is being securely disposed of.

By the end of 2004, NOW had contracts with eight large international companies to dispose of their office waste paper securely on their premises, as well as a number of smaller customers. NOW has a contracted schedule to collect and pulp customers' waste paper. Generally it has met the agreed schedule. However, it has experienced a high staff turnover in this area of the business. To maintain the company standards, new recruits have undergone on-site training, which has slowed up the collection and pulping service even more. Recently there have been repeated instances where customers have been left without a collection. Customers are disappointed but so far have only complained. No contracts have been cancelled as NOW has been able to reassure customers and it is putting in place plans to ensure that agreed customer collections are met.

During January 2005, NOW secured two major new contracts; the first was from a local government department in a northern European country. This will generate turnover of €1·5 million per year and is for 6 years. Also, NOW is hopeful that securing this contract could lead to other contracts within that country. The other major contract was from a large international IT company to collect, pulp and recycle, in a secure manner, all of its waste paper. The IT company has appointed NOW for a trial period of two years in two European countries. If it is satisfied that NOW can meet its collection requirements within the contract terms, it may lead to a European-wide contract for waste paper collection and pulping, which could generate an additional turnover for NOW of over €5 million per year. NOW currently operates waste recycling plants in all of the European countries in which the IT company has offices, but it does not operate the specialised waste paper pulping vehicles in all countries. However, these could be purchased if NOW were to be awarded the European-wide contract in two years time.

NOW Board meeting to discuss future strategy

In January 2005, the quarterly NOW Board meeting had an item on its agenda concerning future growth strategies. During 2003 and part of 2004, NOW had not acquired any other smaller recycling companies, and Imran Patel considered that the time was right for further expansion, following a small acquisition in December 2004. He also felt that the company had a strong balance sheet and was generating cash from operations and that NOW should speed up its acquisition and expansion plans, so that economies of scale and synergies can be achieved. NOW had recently announced that it would be paying a final dividend of €0·245 per share to its shareholders.

Imran Patel stated at the meeting that NOW could not just sit back and continue to see cash being generated, as the company cannot control its destiny. In order to survive and grow it will have to continually balance its performance with its suppliers, customers, competitors and the

community in which it operates. He stated that this would not be an easy task as NOW is operating in several European countries.

As NOW has grown it has reviewed and changed its business structure. Only five years ago, each country operated as a stand-alone strategic business unit. Following a review of operating activities and a reassessment of the European market, the company changed its organisation structure to enable it to deliver better customer solutions. This also involved out-sourcing of some activities, which Ernst Heist felt the company did not have the correct skill mix to retain within the company. The treasury function was outsourced to its bankers and IT development and implementation work to a global IT company. The company now has one centralised finance department in its Europe-wide HQ building with small teams operating in a few offices around Europe. IT operations were also centralised in the HQ building following the review. NOW has established business units by type of recycled product, such as paper, wood or glass. This enabled line managers within each business to better serve its European customers.

After much discussion on alternative expansion plans, some of which are included in NOW's current five year plan, Imran Patel has requested Ernst Heist and Rik Mal to prepare an updated plan of future expansion for the next Board meeting in April 2005.

Pricing

NOW used to set its prices for recycled products based on the customers' ability to pay. However, with the increasing number of companies and governments involved in collecting and recycling a wide range of products, NOW has identified, in the last two years, a decline in the prices it can command for some recycled products, particularly with some of its major customers, who buy large quantities of recycled paper, wood, glass and metal.

Ernst Heist has requested Val Rines review prices and customer mix, and consider whether NOW should change its customer mix. He considers that if the company were to sell a lower quantity of recycled products to its few large customers, and more to smaller companies, it could achieve at least 15% more in sales revenue. Val Rines stated that NOW's larger customers had continued demand for its recycled materials and NOW should not put at risk its customers' loyalty, to achieve higher margins in the short term. Val Rines wants to set up long-term supply contracts so that its long-term waste collection contracts can be matched by region and by product type. Val Rines does not feel that the company should be looking to make short-term profits by selecting higher revenue generating customers, at the expense of long-term customer stability.

Appendix 1

European News

25th February 2005

Finehart secures loans of €40 million today with a leading European bank

Entrepreneur, Kurt Finehart, Chairman and Chief Executive of leading recycling company, ReuseR, today announced that loan financing had been secured to fund further European acquisitions of recycling companies, as well as expansion into the rapidly growing recycling industry in some of the Middle East countries.

Finance Director, Jean-Paul Gamell stated, "this loan will enable ReuseR to expand its operations to other European Union countries which will enable the company to benefit from further economies of scale. I am confident that ReuseR's planned growth strategy will have a long term positive effect on the company's share price".

Finehart stated "the financing package agreed is good for the company, good for the EU and good for the environment." He added, "With ReuseR handling higher volumes of waste for recycling throughout Europe, this will result in more materials being recycled and less waste and pollution".

The news was received positively in the market and ReuseR's share price rose 5·8% to €2·68 per share at the close of trading today.

It is believed that negotiations with possible companies that ReuseR is planning to acquire are well underway. The market expects that bid announcements will be made over the next few weeks.

Appendix 2

Note: All data in the Appendices are presented in International Financial Reporting format.

ReuseR

Balance Sheet	As at 30 November 2004 € million	€ million	As at 30 November 2003 € million	€ million
Non-current assets (net)		**131.9**		**123.3**
Current assets				
Inventory	20.8		19.9	
Trade receivables	46.5		39.1	
Cash and short term investments	6·4		4·1	
		73.7		**63.1**
Total assets		**205.6**		**186.4**
Equity and liabilities				
Equity				
Paid in share capital	18.0		18.0	
Share premium reserve	21.6		21.6	
Profit and loss reserve	109.8		95.1	
		149.4		**134.7**
Non-current liabilities				
7% Loan notes (redeemable in 2011)		**20.0**		**20.0**
Current liabilities				
Trade payables	22.5		19·6	
Tax	6.1		5·9	
Accruals	7.6		6·2	
		36.2		**31.7**
Total equity and liabilities		**205.6**		**186.4**

Note: Paid in share capital represents 90 million shares at €0·20 each

Income Statement	*Year ended 30 November 2004 € million*	*Year ended 30 November 2003 € million*
Revenue	214.2	184.0
Total operating costs	185.0	155.9
Operating profit	29.2	28.1
Finance costs	-1.4	-1.4
Tax expense (effective tax rate at 22% after allowances)	-6.1	-5.9
Profit for the period	**21.7**	**20.8**

Statement of changes in equity year ended 30 November 2004

	Share capital € million	*Share premium € million*	*Retained earnings € million*	*Total € million*
Balance at 30 November 2003	18.0	21.6	95.1	134.7
Profit for the period	-	-	21.7	21.7
Dividends paid	-	-	-7.0	-7.0
Balance at 30 November 2004	**18.0**	**21.6**	**109.8**	**149.4**

Appendix 3

Note: All data in the Appendices are presented in International Financial Reporting format.

NOW

Balance Sheet	As at 31 December 2004 € million	€ million	As at 31 December 2003 € million	€ million
Non-current assets (net)		**53.8**		**44.8**
Current assets				
Inventory	5.9		7.1	
Trade receivables	12.9		12.1	
Cash and short-term investments	2.3		0·4	
		21.1		**19.6**
Total assets		**74.9**		**64.4**
Equity and liabilities				
Equity				
Paid in share capital	5.3		5.2	
Share premium reserve	4.0		3.6	
Profit and loss reserve	44.4		34.7	
		53.7		**43.5**
Non-current liabilities				
Bank loan (repayable in 2005) at 10% interest per year		**0.0**		**2.5**
Bank loan (repayable in 2009) at 10% interest per year		**11.9**		**11.9**
Current liabilities				
Bank loan (repayable in 2005)	2.5		0.0	
Trade payables	3.3		3.2	
Tax	2.9		2.2	
Accruals	0.6		1.1	
		9.3		**6.5**
Total equity and liabilities		**74.9**		**64.4**

Note: Paid in share capital represents 10·62 million shares at €0·50 each at 31 December 2004

Income Statement	*Year ended 31 December 2004 € million*	*Year ended 31 December 2003 € million*
Revenue	55.8	48.3
Total operating costs	39.2	35.1
Operating profit	16.6	13.2
Finance costs	-1.4	-1.4
Tax expense (effective tax rate at 19% after allowances)	-2.9	-2.2
Profit for the period	12.3	9.6

Statement of changes in equity year ended 31 December 2004

	Share capital € million	*Share premium € million*	*Retained earnings € million*	*Total € million*
Balance at 31 December 2003	5.2	3.6	34.7	43.5
Shares issued during the period (to employees)	0.1	0·4	–	0.5
Profit for the period	–	–	12.3	12.3
Dividends paid	–	–	-2.6	-2.6
Balance at 31 December 2004	5.3	4.0	44.4	53.7

Appendix 4

Data on ReuseR proposed acquisitions

All figures have been restated in € million for latest financial year	*RED*	*KLL*	*MER*
Geographic location	Eastern European EU	Northern European	Middle East
Turnover	12·0	18·0	28·0
Gross margin	6·1	10·1	18·2
Net profit (after tax)	1·0	2·0	7·6
Gross margin %	51%	56%	65%
Net margin %	8%	11%	27%
No of shares	10,000	6,000	38,800
Company status	Privately owned	One operating division of a privately owned company	Privately owned
Form of acquisition: cash or shares	Cash	Cash or ReuseR shares	Cash or ReuseR shares
No of employees:	96	220	292
Recycled products	Glass, tyres, industrial waste	Domestic recycled waste only	Glass, chemicals, paper and some other industrial waste
Other relevant data:	Local press reports state that company is struggling with a cash shortage and that it has been unable to secure further loans	This is a small competitor of ReuseR that has secured a number of government domestic waste recycling contracts by under-cutting ReuseR on price. ReuseR would like to eliminate this competitor before it grows larger and becomes more of a threat. It would also help ReuseR to achieve greater economies of scale in this country.	This would be ReuseR's first acquisition of a company operating outside of Europe. MER is operating in the same Middle East country in which ReuseR opened a recycling plant in October 2004. ReuseR's five-year plan had identified a number of regions globally that have an increasing recycling industry. The Middle East is achieving high levels of recycling and this company could provide ReuseR with a customer base in this country from which to increase trade.

May 2005 – Assessment Matrix for TOPCIMA – (Recycling – ReuseR and NOW)

Criterion	Marks	Clear Pass	Pass	Marginal Pass	Marginal Fail	Fail	Clear Fail
Technical	10	Thorough display of relevant technical knowledge. 9–10	Good display of relevant knowledge. 6–8	Some display of relevant technical knowledge. 5	Identification of some relevant knowledge, but lacking in depth. 3–4	Little knowledge displayed, or some misconceptions. 1–2	No evidence of knowledge displayed, or fundamental misconceptions. 0
Application	10	Knowledge clearly applied in an analytical and practical manner. 9–10	Knowledge applied to the context of the case. 6–8	Identification of some relevant knowledge, but not well applied. 5	Knowledge occasionally displayed without clear application. 3–4	Little attempt to apply knowledge to the context. 1–2	No application of knowledge displayed. 0
Diversity	10	Most knowledge areas identified, covering a wide range of views. 9–10	Some knowledge areas identified, covering a range of views. 6–8	A few knowledge areas identified, expressing a fairly limited scope. 5	Several important knowledge aspects omitted. 3–4	Many important knowledge aspects omitted. 1–2	Very few knowledge aspects considered. 0
Focus	10	Clearly distinguishes between relevant and irrelevant information. 9–10	Information used is mostly relevant. 6–8	Some relevant information ignored, or some less relevant information used. 5	Information used is sometimes irrelevant. 3–4	Little ability to distinguish between relevant and irrelevant information. 1–2	No ability to distinguish between relevant and irrelevant information. 0
Prioritisation	10	Issues clearly prioritised in a logical order and based on a clear rationale. 9–10	Issues prioritised with justification. 6–8	Evidence of issues being listed in order of importance, but rationale unclear. 5	Issues apparently in priority order, but without a logical justification or rationale. 3–4	Little attempt at prioritisation or justification or rationale. 1–2	No attempt at prioritisation or justification. 0
Judgement	10	Clearly recognises alternative solutions. Judgement exercised professionally. 9–10	Alternative solutions or options considered. Some judgement exercised. 6–8	A slightly limited range of solutions considered. Judgement occasionally weak. 5	A limited range of solutions considered. Judgement sometimes weak. 3–4	Few alternative solutions considered. Judgement often weak. 1–2	No alternative solutions considered. Judgement weak or absent. 0
Integration	10	Diverse areas of knowledge and skills integrated effectively. 9–10	Diverse areas of knowledge and skills integrated. 6–8	Knowledge areas and skills occasionally not integrated. 5	Knowledge areas and skills sometimes not integrated. 3–4	Knowledge areas and skills often not integrated. 1–2	Knowledge areas and skills not integrated. 0
Logic	20	Communication effective, recommendations realistic, concise and logical. 16–20	Communication mainly clear and logical. Recommendations occasionally weak. 11–15	Communication occasionally unclear, and/or recommendations occasionally illogical. 10	Communication sometimes weak. Some recommendations slightly unrealistic. 5–9	Communication weak. Some unclear or illogical recommendations, or few recommendations. 1–4	Very poor communication, and/or no recommendations offered. 0
Ethics	10	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. 9–10	Good evaluation of ethical aspects. Some appropriate advice offered. 6–8	Some evaluation of ethical aspects. Advice offered. 5	Weak evaluation of ethical aspects. Little advice offered. 3–4	Poor evaluation of ethical aspects. No advice offered. 1–2	No evaluation of ethical aspects. Unethical, or no, advice offered. 0
TOTAL	100						

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