CGMA FEBRUARY 2017 EXAM ANSWERS

Variant 2

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SECTION 1

Part 1

Strategic benefits

The acquisition of Evestar will create a degree of vertical integration for IndTV with regard to some of its programming needs. Commercial broadcasters depend on having programmes which attract advertisers and Evestar is responsible for the creation of one of IndTV's most popular programmes. Acquiring Evestar would give IndTV greater control over this resource. For example, it could ensure that Teeland Variety is not sold to a rival channel. IndTV could also work more closely with Evestar in developing new ideas for programmes, either as spin-offs from Teeland Variety or as purpose designed programmes. IndTV would be able to experiment with ideas that might otherwise be impossible to implement, such as having a new series of Teeland Variety every six months rather than once a year.

IndTV's profits may increase because it will essentially be acquiring programmes such as Teeland Variety at cost rather than the commercial price charged by Evestar. Evestar's business model is essentially to create programmes that are cheap to make but that can be sold at a profit because of the premium that can be added thanks to the creative talent employed by the company. IndTV's group profits are likely to increase because of this acquisition, even if that is at the cost of increasing capital employed. IndTV's share price may rise because of the potential for observable synergies after Evestar's acquisition.

Strategic risks

The anticipated synergies may be difficult to obtain because key staff may leave Evestar. In particular, Denny White may no longer wish to be associated with the company because he would no longer be in overall control and being accountable to a parent company board could interfere with his other activities. His loss would also cost Evestar its contacts in the music industry, which seem to have an impact on the success of programmes. IndTV's primary interest is likely to be the acquisition of our creative talent, and there are other career openings available to our programme makers.

Evestar could also find that it is unable to sell programmes to other channels, who may be reluctant to be seen to be buying their output from a rival company. The loss of major customers could make the investment in Evestar uneconomic and could outweigh any

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synergy benefits from the vertical integration. If IndTV feels obliged to compensate for this by buying more of Evestar's output then it could find itself compromising its primary business of broadcasting programmes that attract viewers and, therefore, advertisers. Too much pressure from IndTV could also impair the quality of Evestar's programming, thereby risking the loss of viewers.

Part 2

The basic ethical dilemma is that the directors ought to be acting to maximise shareholder wealth. They cannot tell whether this approach will be good or bad for their shareholders until they know how much IndTV is planning to offer for the shares. The offer is almost certainly going to exceed the present market price, so there is a strong probability that Evestar's shareholders will benefit. However, the acquisition could mean that Evestar's Board is effectively being demoted from running a quoted company to managing a subsidiary and so their personal interests could be harmed.

The directors are required to act with integrity, being straightforward and honest in their business relationships. If someone approaches them with a business proposition that could benefit the company then they should at least obtain sufficient information with which to evaluate the potential benefits. Refusing to engage with IndTV is an abuse of power in these circumstances and is anything but straightforward and honest. Refusing to meet with them to discuss the possibilities suggests that Denny is creating an artificial sense of "plausible deniability" whereby he can claim that he does not know that an attractive offer is available.

Rejecting the offer is a clear breach of objectivity because Evestar's directors should not permit their decisions to be biased. In this case, it is clear that there is a need to establish what IndTV is prepared to offer before considering whether to recommend the offer. The directors should inform the shareholders of the approach and declare the conflict of interest that has arisen. Then the shareholders would be able to obtain any advice and support they feel necessary before deciding on whether to accept the offer.

Professional competence and due care would require the directors to act with appropriate knowledge and skill. Choosing not to obtain the information required to evaluate an offer that would probably benefit the shareholders is a clear breach. At the very least, this refusal to gather information is reckless in the extreme. Due care might also imply maintaining a good relationship with IndTV, who are major customers of Evestar.

SECTION 2

Part 1

The negotiations should remain confidential because there are market participants who could attempt to profit from any information that is made public. Knowledge of the potential bid could encourage speculators to buy Evestar shares in the hope that IndTV will be forced to pay an inflated price in order to complete the takeover. This will make the acquisition more expensive and could even prevent it from happening altogether. The rumours could then have the effect of making Evestar's share price slump in the event that the bid is cancelled.

Evestar's employees may be intimidated by news of the acquisition. Acquisitions are often associated with reorganisations and redundancies and staff may start to consider leaving. In the short term, the uncertainty could be unsettling and productivity may suffer. Competitors may use this as an opportunity to head hunt our best employees.

The uncertainty could confuse Evestar's shareholders, who may be looking to the Board for leadership and advice. If nothing else, this could be a significant distraction and could interfere with the decision-making process. Evestar's directors may feel that they cannot make decisions until the acquisition has been completed or abandoned because the shareholders may feel that they should delay until after any acquisition has been completed. This could lead to further morale problems for staff.

Any breach of confidence from Evestar will undermine IndTV's confidence in our Board. This is clearly a confidential matter and any leak will imply that Evestar is willing to sabotage IndTV's attempt to acquire. It is important that a relationship of trust can be maintained between the two Boards and this is the first opportunity to establish exactly that. The two companies trade together in a competitive industry and so a failure to maintain confidence could lead IndTV to take any ideas or proposals elsewhere.

Part 2

In the absence of synergy, the combined value of the two companies should be T$1,075m + 8,742m = T$9,817m. In order to break even, Evestar's shareholders will need to have T$1,075m/9,817m = 10.95% of the merged entity. We need to know how many shares each company has in issue, but we need to ensure that the proportions on offer grant us at least this percentage after the acquisition. The shareholders will hardly be receiving a good deal if their wealth diminishes.

Ideally, both sets of shareholders should enjoy some of the benefit of any synergy so that they can see that there was some mutual interest being served. The extent to which both sides would do that is a matter for negotiation by both Boards. There is no particular reasons for the gains to be shared equally or in proportion to relative sizes. A realistic share would give some leeway in the event that potential gains did not materialise and so it would protect the shareholders.

The fact that this is a negotiation means that any share offered by IndTV's Board is likely to be a first offer. It may be a fair and reasonable offer, but it is not necessarily the best one that will be made. We should aim to negotiate further, starting with the initial offer and asking for a little more. The fact that it is a share for share exchange means that there is no cash outflow and so any requests will not leave the merged entity short of funds.

Evestar's share price will probably react to the announcement of the arrangements. Any increase will imply that the deal being offered is better than expected and the opposite will be true if the price falls. The price reaction does not necessarily mean that the deal being offered is good or bad, but a fall would certainly offer grounds for a renegotiation on our part. If Evestar's price is lower than when the bid was first announced then the deal is effectively being perceived as bad.

SECTION 3

Part 1

It could be argued that Evestar has been very successful in exploiting a particular niche in programme making. The fact that the company has been profitable is surely sufficient evidence that the approach has created wealth for its shareholders. Many companies have been hugely successful in making and selling products that have changed very little over many years. The crucial question is whether broadcasters are willing to pay for these programmes and whether advertisers will pay for slots.

It would probably be unwise to simply argue that nothing needs to be changed. We might respond that Evestar takes audience feedback very seriously. If satisfaction levels start to waver then we might change a programme or promote it a little more effectively. Arguably, viewers are not looking for innovation in this style of light entertainment. Revising the programme portfolio could actually risk alienating viewers and adversely affecting viewing statistics.

Part 2

The nature of a great deal of reality television is that it appears to rely on conflict and stress in order to generate entertainment. For example, filming the working lives of debt collectors and other occupation groups such as members of the emergency services will expose unhappy and potentially vulnerable individuals to public scrutiny. Evestar should establish the remit of any investigation that is under way and should act to distance itself from any programmes that are truly exploitative. Evestar could also argue that its programmes are very popular and that the government will lose a great deal of popularity if it deprives the public of its favourite Saturday-night programmes.

Evestar could also offer to develop its own standards in order to minimise the accusations of exploitation. All contestants in its shows are volunteers who know the nature of the programme in advance. All contestants could be offered the opportunity to see any extracts in which they will appear and to comment on whether they are willing to be shown in this manner. The contestants could then be asked to sign a formal release to indicate their consent.

Part 3

IndTV will have to focus on the factors that measure our contribution to their group profitability. The most obvious performance measure would be advertising revenues earned from slots sold during Evestar programmes. If advertising sales remain strong then Evestar is making a viable contribution. This might be investigated further by looking at statistics such as viewing figures and audience satisfaction ratings. These statistics would be an early warning sign of audience dissatisfaction and should be shown to have resulted in effective changes.

We might also measure productivity in terms of the number of programmes that we offer to IndTV and the number of hours filled by Evestar programmes. Now that we are part of the IndTV group, we may have greater freedom to develop new ideas in conjunction with our parent company. Our use of the resources and access to schedules could result in new programme ideas and extensions and revisions to our existing programmes. We might measure our performance in terms of new ideas that are offered for broadcast. We might even measure the number of programmes pitched, rather than just those that are actually made for broadcast.

Part 4

We need to introduce a safeguard against the threat that Evestar might pass commercially sensitive information to IndTV. We will need to discuss broadcasters' plans for particular broadcasting slots in order to offer them appropriate and tailored programme ideas. Potential buyers might be afraid that we will share that information with IndTV, who could then start to develop plans to counter any new ideas. For example, IndTV might reschedule a popular programme so that it conflicts with the competitor's new programme, thereby robbing it of potential viewers. Perhaps Evestar should offer to sign a non-disclosure agreement before entering into detailed discussions with potential third-party clients. This would be a formal declaration that we would not divulge any information about the potential buyer to IndTV (or anyone else). The agreement would both acknowledge our duty of confidence and would also set out the penalties for any breach. The very fact that we breached such an assurance would seriously damage Evestar's reputation, which ought to reassure potential customers.

A further safeguard would be for Evestar to maintain the appearance of independence from IndTV. Otherwise potential buyers might be concerned that any programme ideas will have been either rejected by IndTV before being offered to third parties or that the quality has been deliberately reduced to limit their ability to attract IndTV's viewers. At a more practical level, one safeguard would be for Evestar to retain its own premises rather than relocating to IndTV's offices, so that the appearance of independence from IndTV can be maintained. When pitching ideas to potential customers, Evestar should explain how they may be capable of attracting viewers from competing broadcasters, including IndTV. Any significant successes in capturing good audiences should be publicised, even if the programmes were broadcast in opposition to popular IndTV programmes.