MANAGEMENT CASE STUDY AUGUST 2016 EXAM ANSWERS

Variant 5

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SECTION 1

Requirement 1

There appears to be very little work available to SparkSpace. This contract would have covered running costs for a reasonable period, thereby enabling the company to retain its position. Charging labour out at cost reduces the need to make staff redundant for the duration of the contract.

The contract would have attracted positive publicity. Millitech's success has been hailed in the business press. High profile contracts could make the company more visible to the market place, even if they do not generate any profit in and of themselves.

The contract requires the purchase of 10,000 units from a hardware vendor. Such a large order would have enabled SparkSpace to maintain its relationship with an important supplier. SparkSpace could have combined this order with orders for other contracts and might have generated an even better discount rate, thereby improving the profit on other contracts even if this one yielded nothing.

The contract would have created a relationship with a major customer. Westland Gas may have other large contracts for other systems and the winner of this contract would have been well placed to benefit. It may be logical to undertake such business on the basis of possible future work, even if no profit is generated.

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Requirement 2

Arguably, the Sales Department's primary function is to make sales. That being the case, it makes sense to focus on sales as the key performance measure in evaluating the Sales Department's performance. Identifying a clear priority should help the sales staff to appreciate what they need to do in order to best serve SparkServe.

There is a risk that undue emphasis on revenue could be dangerous because sales staff have discretion over pricing. That could lead to significant discounts being offered in order to make sales quickly. It could also encourage sales staff to set prices that are essentially uneconomic, simply in order to boost reported revenue.

That is not necessarily a problem for SparkSpace because the company's business model involves signing large contracts on which expected margins are low. There are sufficiently few major sales that it is possible to hold a weekly meeting of senior managers to discuss the previous week's business. The company's senior management is well placed to ensure that contracts make commercial sense.

There does have to be a wider range of criteria in evaluating performance, but the fact that the Sales Dircetor takes an active role in bidding for major contracts offers some reassurance that the wider business issues are being taken care of. Having a board member consider the wider issues means that there is less risk in granting the sales team autonomy and a single focus.

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SECTION 2

Requirement 1

The shareholders will be primarily concerned with SparkSpace's ability to generate wealth by adding value to the goods and services that it buys in. That wealth can then be used to pay dividends and so reward the shareholders for providing finance and risking their investment in the process. Low margins need not directly affect the shareholders if, for example, the low margins are linked to high volumes of business.

Over time, the market for servers has changed and companies such as SparkSpace have had to adapt in order to survive. The shareholders may have to bear that in mind when evaluating SparkSpace's performance, focussing on whether management are confident in the company's future rather than past changes. The key question is whether SparkSpace has the necessary skills to push costs down further or whether it might be able to push further towards the HPC market in order to adapt.

The fact that margins are in decline, as indicated in the business press, changes matters. The low margins suggest that companies in this industry face stiff competition and are struggling to differentiate themselves. That could make it necessary for SparkSpace to take drastic action, such as downsizing or even winding up.

In the short to medium term, SparkSpace can survive on low margin contracts because they will cover cash flows. In the longer term, the lack of profit will create significant problems when the time comes to pay dividends or even maintain the business. It is the wealth created through profits that enables a business to maintain its operating capacity and renew itself.

Requirement 2

Paul's suggestion may lead to cost savings because we will have fewer sales staff to pay and support. Even if they receive a generous bonus, they will only be rewarded when they actually make sales and so the cost of the sales force will be reduced. Given that we have to compete on price, anything that we do to reduce costs will only help to make us more competitive.

The proposal will cost us a great deal of expertise in the process. For example, having sales staff who specialise in government contracts means that we can develop an understanding of budgetary cycles and ways in which we might structure contracts that have most chance of being accepted in that setting. Our specialist staff will also be able to develop long-term relationships that could be valuable given the level of competition.

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The reorganisation may prompt a degree of customer analysis that enables us to identify sectors that are more profitable. We could, for example, establish that we tend to make very little profit from our banking customers and so ceasing to actively sell to that market may not be a bad thing. Having said that, we could have that benefit without going to Paul's extreme position.

The biggest danger is that we might create direct competition between sales teams. Customers might realise that they can contract with different sales managers within SparkSpace and play one off against the other in order to drive prices down. We might also lose business because potentially lucrative customers might be irritated if we have more than one sales team trying to do business with them.

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SECTION 3

Requirement 1

This is an opportunity to merge with a major competitor, the only other company in our industry that is quoted on the Westland Stock Exchange. This merger will effectively eliminate a large and high-profile competitor from the market. We might be in a position to increase the margin on bids very slightly.

Our controlling interest in Techrunn will give us access to their patented power supply. We might be able to use that to differentiate our products by offering clients lower running costs. Techrunn would have very little incentive to licence out this technology in the absence of a takeover because it might cost them a competitive advantage.

If we obtain a 70% shareholding then we might be unable to fully benefit from this acquisition. We would certainly have to offer Techrunn's non-controlling shareholders some assurances that we were not compromising their investment by running Techrunn in a manner that benefitted the SparkSpace group. This could prove a distraction if, for example, the Techrunn shareholders believed that we were underpaying for the rights to the patented power supply.

This acquisition will effectively increase our production capacity in a market that appears to be saturated. We will be responsible for two sets of running costs and two groups of employees. If we take drastic action in downsizing either or both companies after the acquisition then we may appear ruthless.

Requirement 2

The fair value of the consideration has to be determined. That should be relatively straightforward because SparkSpace is a quoted company and so there will be an observable share price. We will need to establish the date on which the price is to be taken for the sake of valuing SparkSpace's investment in Techrunn.

If we plan to use full goodwill then we will have to establish the fair value of the non-controlling interest at the date of acquisition. We can use Techrunn's quoted share price as a starting point, but we will need to consider the possible effects of the non-controlling shareholders' ability to influence our management of their company. We may have to add a premium to determine the value of the concessions that we may have to make to keep the non-controlling shareholders satisfied.

The property, plant and equipment will have to be valued. That may be complicated by the nature of the business and the state of the industry. We should establish whether the buildings can be repurposed, in which case they probably have a defensible market price. The assembly equipment may be too specialised to have much of a market, especially given the low margins offered in this industry. We may have to assume that the equipment has very little value.

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The intangible assets include the patent for the power supplies. That could be a significant asset, but there is unlikely to be an observable market. The fact that Techrunn's margins are low implies that the power supply has had very little impact on sales and so it may not be particularly valuable. We might estimate the fair value in terms of the potential sales that we might attract into SparkSpace because of this product advantage. There will be wider complications because SparkSpace will have to attach a value to all of the intangible assets that it acquires through the purchase of Techrunn, which will be a complicated undertaking on its own.

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SECTION 4

Requirement 1

The figures suggest that keeping both assembly plants has the highest expected value, but expected value adopts a neutral position with regard to the evaluation of risk. The problem with the assumption of risk neutrality is that demand will either increase or not. If we keep the Techrunn plant then we will generate either W$850m or W$4,000m, and will never obtain the expected value of W$1,480m.

Retaining Techrunn is attractive because that gives us the means to derive the greatest benefit in the event that demand picks up. Having two assembly plants means that we will have the greatest capacity in order to boost sales. Unfortunately, keeping both plants also creates the possibility that we will have a poor return of only W$850m in the event that demand remains constant.

We can see from the decision tree that we can eliminate the option of closing the Techrunn plant and disposing of the power supply equipment. The additional revenues from being able to offer the improved servers will generate additional cash inflows under both market conditions. We can, therefore, make a direct comparison of closure with relocation against retention of both plants. If we close Techrunn then we will have an 80% probability of W$1,200m – 50m – 60m = W$1,090m and a 20% probability of W$2,100m – 50m – 60m = W$1,990m. That compares with W$850m and W$4,000m respectively. It could be argued that the worst possible case of keeping both plants is not that much worse than that of closing with relocation. However, the upside potential is significantly greater. The board should, therefore, consider that the figures do support retention of both plants, but not from the perspective of expected value.

It would be worth conducting some sensitivity analysis to support these arguments. For example, the best possible cases differ almost certainly largely because the SparkSpace plant on its own cannot handle the potential demand in the optimistic outcome. We might review market forecasts to establish the likelihood that we will see demand improve to that level and beyond. The directors may also wish to retain the prospect of capitalising on a serious increase in demand, even if such an increase is relatively unlikely.

Requirement 2

The relocation may create fear and uncertainty at both plants. The SparkSpace staff who install power supplies may feel that the incoming staff will replace them and so they will be hostile to the new employees. The incoming Techrunn staff may be unsure about the merits of disrupting their lives to change employer rather than simply accepting a redundancy package.

The other main issue is the timing of the dismantling and relocation of the equipment. The removal of this equipment may have an impact on the Techrunn plant's ability to complete any contracts that are in progress and the installation of the equipment may also disrupt

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production at SparkSpace. Given the size of individual contracts, any disruption that put SparkSpace in default of completion dates could be unacceptable to clients.

Communication is the key to addressing the personnel issues. We need to address the possibility of changes to the working conditions of the existing SparkSpace staff and if those remain undecided then we should offer a timeframe within which the decision will be made. We also need to be clear in our dealings with Techrunn staff as to the eligibility criteria for transfer and the compensation that will be paid for any relocation or additional travel costs. That information may also be shared with the SparkSpace employees to reduce the possibility of ill-feeling if they believe that their new colleagues are receiving some preferential treatment.

The first step to planning the dismantling of equipment will be to review production schedules at both plants. Presumably, we will wish to complete assembly of the work in progress at Techrunn and avoid starting any new jobs that cannot be completed before the closure date. We may have to consider rescheduling some work, taking account of deadlines and penalty clauses for delays. It may be possible to plan for some Techrunn contracts to be built at SparkSpace's plant once the necessary equipment has been installed .

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