

MANAGEMENT CASE STUDY MARCH 2015 EXAM ANSWERS

Variant 2

<https://connect.cimaglobal.com/resources/management-case-study-exam/march-2015-management-level-case-study-exam---bild-variant-number-2>

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SECTION 1:

Errors in assumptions

The discount rate has been based on the cost of borrowing. While this development may be financed by borrowing, this borrowing is only possible because Bild also has equity. It would therefore be more correct to base the discount rate on WACC since the requirements of equity providers must also be met by projects undertaken. This would reduce the NPV. In the same vein, the discount rate should reflect the risks of the project and so even WACC may not be wholly appropriate.

No risk premium is added to the discount rate. Consideration should be given to the risks of this project – there are indications (uncertainty of degree of land contamination, lack of identification of potential purchaser) that this may be more risky than projects usually undertaken by the division. In which case it may be appropriate to add an additional percentage to the required rate of return to derive the discount rate. This would reduce the NPV.

The option cost has been included in the appraisal. The option has already been paid for and is a sunk cost. This should be omitted from the appraisal, which would increase the NPV.

Land clearance costs based on the most likely outcome may be too low. Higher cost outcomes are more likely than the lower cost. If the cost were calculated as a weighted average (expected value) then \$1,850,000 would be included, which would reduce the NPV. It would also be possible to re-run the calculation with different cost levels to test different scenarios.

The assumption that a buyer will be immediately found for the project may be optimistic. The calculations should be re-run showing a delay of say 6 months to a year before the building sale is completed. This will reduce the NPV.

The projected sale price may be too high. The assumption that a single high quality tenant can be found may not be realistic, particularly combined with the assumption that the sale will be rapid. A lower sale price will reduce the NPV.

No professional fees have been shown in connection with the sale of the building.

Apportioned administrative costs are not an incremental cash flow and should not be included.

Motivating the project manager

It may not be necessary to carry out the development right away. Constructmore's project will be blocked by Bild exercising their option to buy the land. Bild could add the land to its land bank and wait until a profitable development can be carried out, perhaps with a known end user. If the project lies dormant until a positive outcome can be anticipated then the manager will be happy to accept responsibility at that stage.

It may be possible to offer the project manager an additional incentive that is specifically linked to this project and which has a modified set of performance criteria. The danger is that doing so will send a message that bonuses are a matter of right and that they will be earned from all work. It is also possible that the bonus scheme offered will lead to some form of dysfunctional behaviour. It may be preferable to simply give an unconditional cash payment.

It may actually be appropriate to give the project to the most suitable manager and insist that he or she accepts the responsibility. It could become a disciplinary matter if the manager refuses to cooperate. That would have the advantage of retaining Bild's right to manage its properties.

The bonus system should be revisited if it has become such a powerful motivator that managers are refusing to do their jobs as assigned to them. Threatening to withdraw or restructure bonuses could serve to encourage managers to take on this new project.

Section 2

Share price and WACC

The share price is set by the capital markets and it reflects both expectations of future cash flows from dividends and perceived risk. These expectations and perceptions are not necessarily made in any formal or explicit manner. There won't be a formal net present value calculation showing the forecast dividends being discounted. Market forces lead to shareholder confidence expressing itself in terms of supply and demand for Bild's shares and the equilibrium price that is reached amounts to an estimate of net present value. Despite that, most valuation models that can be used to estimate the prices of unquoted shares are based on some variation of the net present value calculation.

The cost of equity is essentially the discount rate that would be applied to shares in any calculation. If shareholder confidence is weak then the future cash flows will be discounted at a higher rate and so the share price will decrease to the point where the required rate of return is being obtained. Thus, a decrease in the share price means that the cost of equity has increased.

The WACC calculation is simply the weighted average rate required by the markets from all of Bild's long term finance. The weighting is according to actual or estimated market values of each element. In Bild's case, roughly one third of long term funding comes from debt so equity is weighted by approximately two thirds. Any change in the cost of equity will have a fairly significant impact on Bild's WACC.

The cost of debt is determined by the risk of default and prevailing interest rates. Lenders tend to protect themselves against default by seeking debt covenants and so the cost of debt is largely outside of Bild's control because there is unlikely to be significant risk of default leaving lenders unpaid.

WACC and strategy

Many companies, including Bild, use WACC as the starting point in choosing investment projects. If WACC increases then fewer viable investment opportunities will be open to us. There is a potential opportunity cost in that Bild may have to forgo possible chances to expand through taking on additional business.

If building projects offer higher rates of return as a compensation for accepting risk, then it is reasonable to assume that seeking projects with a higher expected return will mean that Bild has to take on more risky projects. The threat is that accepting such opportunities may lead to a further perception that Bild is not an attractive investment and so it could become a vicious circle, with the higher risk profile further increasing WACC.

There are other strategic issues. The cost of equity reflects the shareholders' satisfaction with the company and its leadership. The directors may be concerned that they have to strive to increase the share price in order to reduce WACC. In principle, that makes sense but in reality the directors would have to exceed market expectations in order to raise the share price. It is very difficult to outperform market expectations because market participants will always have a financial incentive to evaluate expectations in a realistic and rational manner.

A reduced share price will also heighten the directors' concerns about their own careers. They may become worried that they could have their bonuses reduced or even face removal from office. That could lead to the temptation to pursue dysfunctional strategies. It could also create the threat of an unwelcome takeover or forced merger if a third party could convince the shareholders that Bild is underperforming.

Section 3

Advantages

The biggest advantage is that IT Company will be responsible for providing services and so they will accept the risks. Bild has complicated IT needs that are always changing. Bild's IT systems have to operate in challenging environments. The company needs to establish a suitable IT infrastructure for each new project. Any problems arising from particular sites will become IT Company's responsibility, so that Bild can concentrate on the things that it does well and that add value.

IT Company specialises in the provision of systems and so can maintain a higher level of expertise than Bild. It may not be cost-effective for Bild to employ the very best IT experts or to train them in all of the latest techniques and technologies.

Disadvantages

It could be more expensive to use a specialist company than to maintain in-house expertise. If IT Company does not deliver an appreciable increase in service then the additional outlay on IT will add no value. It will be very difficult for Bild to know in advance what additional functionality IT Company will bring to its operations.

Bild's IT staff will be keen to ensure that the systems that are put in place are as good as they could possibly be. IT Company may aim to achieve an acceptable standard of service and may then stop pressing for further improvement because its fees are unlikely to be any higher.

Bild's needs are so unusual that IT Company may not fully understand the challenge. It may be that IT Company will make promises on which it cannot deliver.

Partnership agreement

The agreement should be win-win. Bild should not attempt to extract every last cent out of IT Company in the interest of getting the cheapest possible deal.

There should be clarity concerning the responsibilities of both sides. There should be as many meetings and discussions as necessary to ensure that IT Company fully understands all of Bild's needs and expectations. This should happen before the contract is signed so that the information can be brought into the contract negotiation.

There should be a formal agreement in the form of a service level agreement. This would set out the respective responsibilities of both parties. It would also act as the starting point in maintaining the relationship.

There should be ongoing monitoring of the quality of service that Bild receives and this should be fed back to IT Company. Hopefully, IT Company will use this to ensure that they are fulfilling their obligations to the best of their ability so that Bild receives the best possible service.

Any problems should be addressed and, hopefully, resolved in a constructive manner. Bild should not necessarily seek compensation or invoke penalties in the first instance provided we can see that IT Company is doing its best to resolve any difficulties.

Section 4

Communication

The need for communication skills arises from the fact that our supervisory staff are engaged in a constantly changing environment. They deal with new people on a constant basis. They have to deal with complex scenarios that require mutual understanding.

Our supervisors must be capable of making their expectations clearly understood so that work is properly coordinated and managed. Any breakdown in communication could lead to wasted resources, as well as delaying projects and possibly even exposing staff to health and safety risks.

There is also a risk that our managers may misunderstand the messages that they are receiving. Communication is also about understanding incoming information. Our supervisors must be able to be certain that they have received a clear and unambiguous message whenever they deal with a project-related matter and that their counterparty has not been ambiguous. That is important in Bild's case because any deliberate ambiguity over, say, a completion date could be exploited to pass on any blame to Bild's staff.

Team building

A typical project brings together subcontractors, each of whom has a specific responsibility. Construction work requires some mutual support and cooperation, otherwise the work may not be completed on time and on budget. The different people on site will have a specific loyalty to their own employer and may care little for the overall aims of the project.

If our supervisors are experts in team building then they will be better equipped to facilitate collaboration between the different subcontractors and construction workers on site. This may reduce the likelihood of conflict and could mean that problems are pre-empted and defused before they arise. Each subcontractor may have a responsibility that is potentially in conflict with another's. There may be little incentive to cooperate because any two parties may never have to work together again and so there may be no incentive to make concessions. Very few teams will see the project all the way through to its final conclusion and so they may have little regard for the overall plan of work.

Driving performance

Some aspects of Bild's work are easy to measure, for example the completion of basic tasks such as digging foundations. Other work may be more difficult to measure because faults may not become apparent at the time. For example, it may be impossible to fully test completed drainage works until the building has been completed and it is occupied.

Performance measurement is a key objective for supervisors because a building project is a vast collection of small tasks, each of which may have an effect on others. A delay in completing a task may mean very little to a subcontractor, but it could throw out the remainder of the schedule.

Subcontractors may measure performance in different ways. It may be acceptable to complete a designated task in the time allowed and without exceeding the cost implied by Bild's fee. Bild's supervisors must be capable of monitoring and insisting on acceptable standards of performance because Bild will suffer if every subcontractor works to the lowest acceptable standard. Defects in a completed project will be blamed on Bild and not on the subcontractor.