CGMAX MANAGEMENT CASE STUDY MAY 2019 EXAM ANSWERS

Variant 2

Section 1

Core competences and resources to undertake the Vorsan Golf Resort proposal

Core competences are actions and processes that we are able to do that are very difficult or impossible for our competitors to copy. Importantly, core competences are the key to our competitive advantage. As you know, our competitive advantage is based on our skills in designing and manufacturing highly sustainable buildings, to the highest build quality, and in designing unique products for each customer. This is a clear specification laid out in the document outlining the Vorsan golf resort proposal. In this document it states that the hotel will be designed and built to the highest specification of quality and environmental sustainability. We clearly have core competencies here, in being the leading industry expert in the combination of glass and timber-framed construction to deliver maximum efficiency and lower energy consumption than our competitors.

The resource-based view of strategy argues that strategy should involve deciding what makes our business unique and building strategy on that, extending into any products or markets where it will work. This is clearly the approach we are taking in considering this proposal, and in undertaking the hotel construction in Saspa in 2016.
Our main concern is likely to be the level of resources required. This proposal is almost certainly likely to require significant investment in production technology and human resources, if our existing order book for the rest of 2019 and into 2020 is to remain unaffected. A 150-room hotel is likely to be equivalent to 30 or more 5-bedroomed houses (in terms of production capacity), which is an extra 30% on top of our existing order book.

This project would be significantly larger than the Saspa hotel construction and therefore, it is likely to be unfeasible to consider undertaking it, without necessary investment in additional resources. We have for several years, operated at full capacity, with a full order book, clearly demonstrating our ability to exploit our core competences, but this may be ineffective without investment in the necessary technology and manpower. We have a strong cash position that should help to ensure that an undertaking of this size could be supported, even though a certain amount of debt finance may well be needed as well. The absence of any current loans and a strong balance sheet should help to secure finance for the project. We have access to renewable sources of timber. The only concern here will be whether or not sufficient quantities could be obtained for such a large construction project.

Business Risks

There are several potential business risks of undertaking the first Phase of the Vorsan Golf Resort proposal. The first risk is the potential upside risk of being involved in such a high-profile proposal. The Vorsan Golf Resort is likely to attract a great deal of publicity due to the promotion of the hotel by its prospective owners during its construction. It is also likely to be seen on television coverage of major golf tournaments that are staged there.

There is a corresponding downside risk. Any delays or problems encountered during the construction will attract significant adverse publicity. Vorsan will be keen to open the hotel on time and to meet guest expectations following on from the publicity during construction. A major corporation such as Vorsan will have the means to cause as a major corporation, Vorsan will be exposed to bad publicity if it fails to open its hotel on time or to meet the advertised standard. Vorsan will have both the means and the motive to pass any blame onto Jord, which may damage our reputation amongst potential house buying customers.

The construction process will raise a variety of risks that are less of an issue for Jord when building homes. This is a major project that must be constructed at the edge of a luxury golf course. There may be issues associated with gaining access to the site in order to carry out the build, having cranes and other equipment on site during tournaments and at busy times when members wish to play without the noise and visual disturbance of a building site. Any slight delays could become much worse because of those factors.

There is a product risk in that our experience is in the construction of building domestic houses. A large hotel will have to withstand much greater wear and tear and will be subject to far more constraints in terms of building permits, fire safety and so on. Any omissions due to our lack of experience could reflect badly on the business as a whole, harming house sales in the process.

There are also potential operational risks associated with the delivery of this project. The transportation of large sub-assemblies to Malia and the construction over a significantly longer period of time than the usual 5-10 days on-site build phase brings with it the risks of more potential errors and delays which could lead to contract penalties.
There is also a price risk in that, because of the large quantities of timber required, if this then created a shortage of suitable materials, (this is already a medium risk in the risk register) then the price charged by the suppliers may well increase. An upside risk here is that, as we will be looking to buy timber in larger quantities, then we may well be able to negotiate a volume discount, bringing the unit cost down.

Section 2

Alternatives for funding the proposed new production technology

Fresh equity would be a consideration, but that might be difficult to arrange because, collectively, the members of the Larsson family control 60% of the company and so they may be nervous about diluting their control. There are only nine shareholders, in any case, and they may be reluctant to upset the company's stability by introducing new shareholders, who may wish to push the company in a different direction.
A rights issue would give existing shareholders the right to subscribe to new shares in proportion to their current shareholding. That would deal with concerns about dilution, but Jord is unlisted and it seems unlikely that the shareholders will be able to invest a further C$6 million between them. The Larsson family members would have to find C$3.6 million.

Debt may be a sensible option given Jord's financial history. There is no debt currently held by Jord and given its historic profitability there would be ample opportunity to borrow from a bank. This would also give the benefit of a 'tax shield' as our interest payments will be tax deductible. You should note however that this borrowing will cost interest charges and will need to be repaid out of operating cash flows over the next few years.

Alternatively, we could use our cash balance to fund this project, although this may require sacrificing dividends payable. In 2018 there is a cash balance of C$26 million but dividends payable are C$17 million and these are due to be paid in July which will reduce the cash balance significantly. These dividends are still, however, unpaid and could be used to fund the project effectively achieving the same result as a fully subscribed rights issue.

One possibility would be to lease the new technology. It would be possible to have a bank or leasing company acquire the new technology, as specified by us. They would then grant us the use of the assets for the term of the lease. Technically, the lessor would retain ownership of the leased assets and so there should be no need to lodge separate collateral in support of the lease liability. The lessor will be able to repossess the assets if we do not keep up with payments.

Leasing would have virtually the same implications as taking out debt. The lessor would be unlikely to buy specialised assets to our specification unless we committed ourselves to a lease term that made economic and commercial sense to both sides. It is unlikely that we could simply return the assets in the event that they became surplus to our requirements. We would probably have to maintain the lease payments even if Phase II of the project does not take place.

There would be no real advantage to leasing in terms of financial reporting. IFRS 16 *Leases* would require us to capitalise the present value of the lease payments and the assets themselves, based on the present value of the lease payments at the time the lease commences.

Leadership team actions to motivate on-site construction staff

It is clear that there were some motivational problems for the on-site construction team when we delivered the Saspa project. High levels of sickness, absenteeism and more worryingly, accidents, are strong indicators of poor morale, which is also likely to have impacted on the quality of the final delivery of the project.

We need to ensure that we strive to achieve and encourage high performing teams that have a clear purpose and objectives and a commitment to that purpose. One of the issues we may have encountered in the Saspa project, is the lack of clear purpose, due to this being a completely new type of construction for the on-site construction team. This may not have been caused by the overall lack of understanding of the needs of these team members by the leadership team.

Therefore, there are a number of possible actions that could be taken by the leadership team to improve motivation of the on-site construction team. Firstly, Jord's leadership team must communicate the goals and objectives of the project clearly to the team, prior to commencement. The construction team need to understand the importance of their role in the successful delivery of the project. Team building exercises may need to be carried out to develop a strong sense of team cohesion.

Jord's leaders must also develop a clear form of communication between the team so that any issues can be resolved quickly and efficiently. Communication, such as developing and encouraging problem solving exercises should be developed to build trust in the team and encourage team commitment. The leaders' visibility, availability and preparedness to discuss project related issues will have a significant positive impact on staff morale.

Sufficient training in health and safety may also need to be given to motivate staff in terms of their own personal safety whilst working overseas. Jord may also need to consider team rotation. Clearly, the length of time away from home was an issue with motivation previously and therefore a clearly defined plan should be set up whereby teams know in advance where and for how long they will be away. This should be communicated well in advance. We may need to consider incentivisation through some form of financial reward, such as bonus payments. Although financial rewards alone will not be motivating, they are means by which team members can feel more valued and committed to the project

We may want to consider social events and interactions between the individuals in the team to help to reduce any potential conflict and increase the cohesion of the group. In addition to formal teambuilding exercises, managers can attempt to reinforce the individual identity of the on-site construction team, strengthening team members' sense of belonging and improving the efficiency of the group. This can be accomplished by giving the team its own name or its own uniform.

Section 3

The time value of money and the project appraisal methods used

Incorporating the time value of money into an investment appraisal decision takes account of two factors. The first is that any investment involves committing funds that have been raised and on which the entity is incurring a cost of finance. It is generally appropriate to take that funding cost into account. These are relatively short term projects, so the cost of capital will have less of an impact on the evaluation than if they had a longer term, but it should also be borne in mind that Jord will be making a significant investment. C$7 million is a significant outlay.

The other fact that the time value of money allows for is risk. Apart from the cost of the funds, the entity is also incurring a risk that the project may fail. Evaluating the project using the time value of money gives an insight into whether the expected returns are sufficient to justify the risks that are being taken.

The principal measure based on the time value of money is net present value (NPV), which has the advantage of linking the project's anticipated outcome to the impact of the project on shareholder wealth. On the basis of the table, accepting Phase 1 of the project will increase shareholder wealth by C$2.501 million, taking account of both the cost of capital and the risk.

IRR measures the return that is being earned on the funds invested in the project. Any project that has an IRR that exceeds the required rate of return will have a positive NPV. That means that Jord should accept Phase 1 if it can because it is delivering a 35% return on investment, while the company requires only 10% in order to cover the cost of capital and the risk. The prospect of such a high return on investment may also help the shareholders to understand the merits of accepting this risky project.

Discounted payback is more difficult to evaluate. In principle, it tells us that Jord will be tying up funds for 1.5 years if it proceeds with Phase 1. That could be of some interest in making strategic forecasts of cash flows, allowing for the need to raise finance for other projects or generally for expansion.

Accounting treatment of the Vorsan project

You quite correctly noted that 'revenues' are not specifically mentioned in the spreadsheet presented by Carla. These are in fact included within the 'Cash inflow' category.

Jord's normal business of building pre-fabricated houses for individual customers is in keeping with the activities of most businesses in that our costs and revenues are posted to the statement of profit and loss as and when they occur. However, with this project, an alternative treatment is likely to be required. This is because the costs and revenues will not always be occurring within the same accounting period.

In terms of accounting for the delivery of the Vorsan project, we would need to consider the application of IFRS 15 – Revenues from Contracts with Customers (formerly covered by IAS 18), to determine how we account for the revenues received in the Vorsan Golf Resort project, to ensure that the financial statements reflect a position that is as close to reality as possible, leading with the matching concept.

The nature of this project may be different from most of our bespoke house building projects because it will span more than one accounting period. In most cases, when we deliver a bespoke manufactured home, we will take a down payment when the contract is signed as a security, which will be recorded at that point as liability in the statement of financial position. Costs and revenues will then be recorded in the period they occur. To some extent, this revenue recognition issue currently occurs with our manufacturing of homes but it is to a much lesser extent than this contract.

The accounting issue for the Vorsan project is therefore when the revenue and costs associated with a longer-term contract should be recognised. In terms of the accounting treatment of the Vorsan project, if we can estimate the outcome of the contract reliably, then the revenues and costs should be recognised in the income statement by reference to the stage of completion of the contract activity at the reporting date. However, to satisfy this we must make sure that the following criteria are met: firstly, the amount of revenue can be measured reliably; secondly, it is probable that the economic benefits will flow to us; thirdly, the stage of completion at the balance sheet date can be measured reliably; and fourthly, the costs incurred, or to be incurred, in respect of the project can be measured reliably.

Phase I is likely to cause less difficulty for us and we should be able to simply account for Revenue as Total contract revenue × % complete', cost of sales as 'Total expected contract costs × % complete' and Gross profit as 'Total expected profit × % complete'. This should help to ensure that the current profitability of the project is reflected fairly in the financial statements.

Currently, Phase II is contingent on factors outside of our control and therefore it would be prudent to not recognise this Phase of the project at all until there is certainty that this will occur.

Section 4

Real options for the Vorsan Golf Resort project

Real options refer to the actual choices or opportunities which we can take advantage of or realize. The real options for Jord are whether to in fact abandon our involvement in Phase I of the project, continue with our involvement in Phase I and then decide on our involvement in Phase II, should the Champion's Trophy be awarded to Vorsan. However, we must take into account that by factoring in real options into the decision-making process, this will affect the valuation of potential investments. Therefore, we may need to consider using real options value analysis (ROV), to estimate the opportunity cost of continuing or abandoning our involvement in the project and make a decision accordingly. For example, investing in a new manufacturing facility may provide us with a real option of introducing new products, or increasing the output of our bespoke houses.

A real option available to us is to abandon our own involvement in both phases of the proposal. As of yet, we are still in final negotiations with Mr. Alvez and a contract has not been signed and therefore we have the option not to take part in Phase I of the proposal at all. As you say, no significant financial commitments have yet been made. Alternatively, we could make the decision to only commit to Phase I and abandon our involvement in Phase II, even if Vorsan actually win the Champions Trophy bid. One interesting piece of information from the news article was the point that, often, the losing bidder will in fact win the Champions trophy in the next round of voting, that is, for the 2026 tournament. Therefore, there is a potential real option for Vorsan, and also ourselves, to consider delaying Phase II of the proposal for two years. This would be dependent on an assurance from Vorsan that they would indeed bid for the 2026 tournament if they were to lose the 2024 bid. The consequences of abandoning at this stage would include the writing off of costs incurred so far in getting to this stage, as we would be passing up on the opportunity of the potential profit that could have been earned from the project. However, if we choose to abandon either Phase of the project part way through, the consequences are likely to be far greater, as it is almost certain that the contract will include punitive financial repercussions of us not seeing the project through to completion.

One real option which is not available to us is the option to delay/defer Phase I or Phase II of the project, as the delivery of Phase I and II is time contingent and therefore any delay at this point will mean the loss of the opportunity on both project phases. One real option to consider, is the option to redeploy the new technology, should we decide to abandon Phase II. We know that the new technology is flexible enough to allow us to manufacture any type of prefabricated building and therefore it could be possible to use the new technology for the manufacture of more high-quality bespoke houses. As we have a waiting list of 12 months, this could free up this waiting list and allow us the opportunity to expand production. However, we need to seriously consider this, as this may impact on quality standards and the reputation we have established in the market for exclusivity.

Maintaining our ethical stance

At all times we must maintain the highest standards of ethical behaviour in this decision -making process. This means following the ethical and behavioural standards we have set for ourselves and by following the ethical codes of conduct expected of ethical organisations.

The main threat to this is Jose Alvez's offer to the Board of all expenses paid holidays to the golf resort, should we commit to undertaking the project. This is clearly an inducement to sway our decision to undertake the project and therefore challenges our integrity and objectivity. We must ensure that, at no point must we accept such offers, and this must be communicated immediately to Mr. Alvez. He must be informed that, should we indeed decide to proceed, we are not the type of business that will act unethically in any way. We need to set the tone of the business relationship from the very start.

In terms of reassessing our position in regard to the whole project, we are not acting unethically. This is a business decision which needs to be made rationally and with due professional competence. The fact that we are intending to evaluate all of our potential options proves to all of the related stakeholders that we are using our full professional judgement in making this decision.

Theo's insistence to keep the discussions confidential could be viewed either way. He has every right to insist that the decisions are made confidentially by the Board, and there is indeed no need to involve Mr. Alvez. However, it could be argued that, should we decide to withdraw at this late stage, it could be seen as unethical, in that it would leave the Vorsan Golf resort with no one to deliver the contract.

Communication to key stakeholders

Therefore, it would be ethical to inform Mr. Alvez of our considerable concerns in relation to our commitment to the project in advance of our Board discussions and let him know that we may be re-considering our position. Once we have made our final decision, we must immediately inform Mr. Alvez. This would probably be best achieved in a face to face meeting or phone conversation with Theo.

We also need to inform our shareholders of our decision. As many of our shareholders are family investors and employees then we should be able to communicate this internally, through either email or some face to face communications. Any decision must be clearly explained in terms of its impact on the shareholders' investment and on the business itself.

We will also need to consider staff. We are committed to involving our staff in the decision-making process which we did early on in this proposal. They will be expecting a decision sometime soon and therefore we must inform them as soon as possible, especially those staff directly affected, such as production staff and on-site construction staff. Communication should be open and honest and involve two-way communication between senior managers and staff.

We are likely to have been talking with some of our key suppliers to see if they would be willing and able to supply the timber, for instance. This is likely to involve very large order quantities and so, whatever decision we reach, we need to let these suppliers know that either we will need those extra quantities or not, as this could have a significant impact on their businesses.