MANAGEMENT CASE STUDY AUGUST 2018 EXAM ANSWERS

Variant 2

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Section 1

Evaluation of acquisition

The NPV criterion is generally appropriate to most investment decisions, because it reflects the impact of the investment on shareholder wealth. Montel's shareholders will be diluting their equity in their company in return for the future cash flows that will be yielded through ownership and control of Gless.

The fact that no cash will be paid out in return for the shares in Gless does not invalidate the use of NPV. The impact on shareholder wealth will be exactly the same as if the new shares were sold at their market values and the resulting cash used to pay for the stake in Gless.

The application of NPV forces Montel's Board to justify the decision that has already been taken. This is an important aspect of the implementation of that decision, because it reduces the risk that Montel might overpay in the subsequent negotiations.

The most immediate challenge is in knowing what the future cash flows to Montel will be from this arrangement. Montel will not have free and open access to Gless' bookkeeping records until after the acquisition has been completed and so it may be difficult to establish exactly what benefits it will enjoy.

Montel will not necessarily be able to predict the extent to which its customers will specify Gless lenses in place of Montel. It may be that Montel's belief that customers specify Gless lenses is misplaced.

The acquisition of Gless could cost the company significant revenue if other camera manufacturers' customers stop buying Gless lenses. The benefits to be had from selling Gless lenses to the market as a whole may be overstated. Determining the NPV of this investment would require an appropriate cost of capital to be determined, one that takes account of the risks associated with acquiring Gless.

Fair value

IFRS 3 requires that the consideration should reflect the fair value as at the date of acquisition. In this case, it is complicated by the fact that the price was lower before the exchange was announced. That suggests that the fair value of Montel's shares was F$3.40 and that the F$3.90 reflects the company's value after it has announced its interest in Gless.

Despite these concerns, the market price as at the date of the acquisition should be used as the fair value because it is an objective and relevant measure. The danger is that basing the calculation on a different date could adjust the share price for factors that have nothing to do with the acquisition and could simply introduce a spurious element into the calculation. The question of what constitutes the fair value of a share will always be complicated when the share price is volatile. The fact that the price has remained constant at a certain level in the past does not mean that price movement is a temporary deviation from an underlying intrinsic value.

The former Gless shareholders will become shareholders in Montel and so they will be exposed to the risks and returns associated with the newly expanded Montel Group. Previously, they were collectively majority shareholders in Gless. Now they will be minority shareholders in Montel. That is unlikely to make a significant difference, because Gless was a quoted company and so it is unlikely that any individual shareholders had significant interests.

There could be a slight change in the wealth of the former Gless shareholders. There is a slight difference between the market value of every ten Gless shares exchanged for nine shares in Montel. If that difference persists then the Gless shareholders could benefit (or suffer) if they accept the offer. If the intrinsic values of the two companies are closer to their previous prices of F$3.40 and F$2.60 then the net effect on Gless' shareholders will change.

Section 2

Transfer pricing

The transfer pricing issue is that the Montel Group now makes both Zentar and FZ480 lenses that can be fitted to its Professional DSLRs and so those products are essentially mutually exclusive. If transfer prices are set correctly then intra-group orders will be set at a level that optimises overall group profitability by encouraging the Montel-branded shops to order either FZ480 or Zentar on the basis of the greater profit for Montel overall. Similarly, Gless will be encouraged to make sales internally or externally, with a view to maximising group profit.

The optimisation of Gless' output through transfer pricing should allow for the fact that the contribution per hour of technician time is much higher for Talos and Volar than for either FZ480 or Zentar. A shadow price could be built into the transfer price for Zentar lenses that allows for the contribution per hour that would be lost if resources are diverted away from Talos or Volar. That shadow price would be affected by demand for the more expensive lenses and so it could lead to some volatility in the transfer price.

It may be necessary for the Group to intervene by imposing a dual system, with different transfer prices recorded by the buyer and the seller. Montel's head office could determine the priorities in terms of managing production capacity. Both factories would sell to our shops at prices that achieved an optimal production schedule. The shops would recognise the costs of purchases at a different price that avoided the disruption of production by shop buying decisions. Montel's head office would make the necessary adjustments. Before making these decisions, there are some important commercial issues that need to be considered. For example, is Zentar under-priced in order to compete more readily with FZ480? Any possible increase in the selling price of Zentar should be allowed for in setting the transfer prices. In the same vein, there could be wider benefits to replacing FZ480 with Zentar if the Northern Factory could have some other use to the Montel Group.

Conflict

This appears to be a form of horizontal conflict, which has arisen because the workers in the FZ480 factory have become unsettled because of the acquisition of the Gless factory. The two factories produce broadly similar products, but Gless is larger and more advanced. There could be scope for resentment and uncertainty at the FZ480 factory.

It is not particularly surprising that this conflict has arisen. The FZ480 factory may become surplus to requirements in the event that the Gless factory is expanded and so jobs may be lost. The fact that priority is being given to Montel orders at Gless could be interpreted as implying that the FZ480 lens will be phased out in favour of Zentar, opening up the possibility that the Montel factory will close. Opportunities for promotion at the ZX480 factory could be filled by Gless staff, given the greater expertise at the Gless factory. Mainwaring suggests a number of strategies for managing conflict. In the short term, the “conflict suppression” approach could be necessary in order to address the immediate problems. If the staff are failing to meet production schedules, or the quality of output is slipping, then Montel may have to threaten disciplinary action in the short term. Alternatively, it could be made clear that the problem has been identified and that it will be addressed more fully in the immediate future.

Mainwaring suggests that a longer-term solution would be “conflict resolution”. In this case, that would involve gaining a fuller understanding of the sources of the conflict and eliminating those. For example, Montel might be able to offer clear and specific assurances about the concerns that prompted the conflict. If there are no plans to cut jobs in the foreseeable future, then the technicians could be told that is the case, eliminating the uncertainty that fostered the conflict.

Section 3

Target costing

The first challenge is in knowing the target selling price for this new lens. We do not necessarily know how much customers will pay for a lens that sits somewhere between the Montel FZ480 and the Gless Talos in terms of quality. If we do not have a target selling price, then it is difficult to tell what the target cost has to be.

Offering different combinations of cost and quality will be complicated by the fact that there comes a point where the additional quality of a lens will be difficult to evaluate. It might be difficult for Montel to gauge customer reactions to, say, a lens that had six coating operations, rather than the four of an FZ480 or the ten of a Talos. Customers might struggle to see the difference, unless they had the opportunity to make heavy use of a prototype, and they may struggle to decide how much the additional quality would be worth paying for.

The costings may be difficult to determine if the new lens is to be made in Montel's factory. The technicians there have experience of making the FZ480, but there could be a significant learning curve to moving up to a better-quality lens. If we cannot estimate the time taken to apply additional coatings, or to work with finer abrasives, then we may understate the cost of making the new lens.

The lack of experience in working to this standard is also a concern, because virtually all of the additional costs are driven by additional labour and/or grinding time. The whole target costing exercise is a matter of establishing how much time and effort will be required to achieve the required finish. Even relatively small errors in establishing just how much time these finishes will take to achieve could lead to a significant error in costing.

Competitive advantage

The lens could help Montel to demonstrate that it has made good use of its acquisition of Gless to develop improved products. Even if the lens itself does not sell particularly well, the fact that it has been developed will create positive publicity and will underscore Montel's technical excellence.

There is a risk that Montel will undermine the claims of the Gless Talos range of lenses. The new lens will be sold as an improvement over the Montel FZ480. Customers may decide that the new lens is good enough to avoid the need to buy a Gless lens.

Perhaps the key question will be whether the new lens offers a better price/quality combination than the premium lenses sold by other manufacturers. The special offer suggests that the sale of Talos at a discount attracted a great deal of interest and so customers may be keen to buy something better than the FZ480, but cheaper than Talos.

The design team should not be granted the authority to set the trade-off between price and quality, because that is really a marketing decision rather than a technical design question. At most, the design team should be given a target cost and told to design the best lens that they can for that price. If the new lens is significantly better than FZ480, but only a little more expensive then it may simply divert sales from both FZ480 and Talos without necessarily enhancing Montel's performance.

Too much discretion could lead to dysfunctional behaviour by the design team. For example, they could set out to design the very best lens that they can because they enjoy the engineering challenge of doing so. Or they could waste time and money on completing a design, rather than admitting that they cannot achieve a significant improvement over the existing products.

Section 4

Ratio analysis

The most significant impact will be on Montel's profitability ratios, particularly the return on capital employed. The group will be acquiring additional equipment before the year end, which will increase capital employed. The investment will not yield any profits before the year end, so return will – at best – be unaffected while capital employed will decrease and the percentage will decline.

Production costs will also increase because of additional wages and depreciation on the new equipment, which will reduce gross profit because there will be no additional revenue until next year. If the gross profit percentage appears to be reduced then the group will appear to be less profitable and the company may start to appear uncompetitive. The profit for the year will be further reduced if Montel has had to borrow to fund the project and the company has incurred interest before any revenues have been generated.

The funding for the new equipment will also affect the gearing ratio. Presumably the company has had to borrow in order to raise the cost of the additional equipment. That would obviously increase gearing. The overall effect would be to make Montel appear more risky.

The preparation for the new year will lead to an outflow of cash, with greater investment in inventory. That will make Montel appear to be less liquid because of the outflow and increase in trade payables. It will also lengthen the working capital cycle because it will appear as if inventory is taking longer to turn over.

Operational risks

The most immediate risk is that the expansion will impair product quality. New staff are being trained for complex and skilled work. Even if the staff are trained and well supervised, they may struggle to achieve the standards that define Montel's products.

The intention appears to be that there will be a major launch of the new product and so Montel is creating plenty of inventory to support such a launch. Even though inventory is being created well in advance, there could be delays because of training or quality problems. That could mean that Montel will miss its launch deadline, which could undermine confidence in the product.

Having a Gless engineer to oversee the project could help with the implementation process. The engineer will have experience of working to the greater tolerances required by more advanced lenses. There may be practical suggestions concerning layout or process that will help with the creation of the new facility. The engineer may also have a better appreciation of the aspects of grinding and polishing that might affect quality.

One danger is that the engineer will alienate the technicians, particularly the supervisors, already employed by Montel. There could be an implication that the engineer had to be brought in because Montel's senior management did not believe that the staff at the FZ480 factory had the necessary expertise. It is also possible that an engineer who knows the factory and the local workforce already will be better equipped to implement the project because of a better understanding of the extent of the changes that are being made.