MANAGEMENT CASE STUDY AUGUST 2018 EXAM ANSWERS

Variant 5

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Section 1

Lifecycle costing

Ideally, lifecycle costing would have been introduced at a much earlier stage so that Montel could design costs out of its CSC camera range. Montel should, however, allow for the need to update and upgrade its CSC cameras in order to maintain market share and should aim to design costs out of that process. Montel could, for example, aim to develop upgrades that can be applied to all CSC cameras, so that the whole range can be refreshed on the basis of the same piece of development work. Montel should also keep the feedback from users under constant review, in case there are any features that could be eliminated at the next update because they add very little perceived value. Lifecycle costing involves minimising the time to market. It may be that Montel should aim to focus the resources that are presently applied to bridge cameras to CSC instead. Bridge cameras still yield more in terms of both revenue and profit than CSC, but the market is clearly in decline. The danger is that Montel's competitors may attempt to dominate the CSC market while market tastes are in transition. It may be worth considering ceasing the production of bridge cameras in order to, hopefully, double output and sales of CSC. That would force Montel to market its CSC range aggressively and that should help establish the range.

Finally, Montel should aim to maximise the length of the lifecycle of its CSC cameras, albeit while updating its range for new technologies as they become available. The fact that the lenses are removable means that it may be possible to offer existing customers an upgrade route, perhaps by selling upgraded lenses that might then be used with an existing camera. If bridge cameras were popular because of their wide range of zoom settings, then it may be possible to sell reasonably priced lenses that would capture the extremes of the ranges.

The aim should be to rationalise on DSLR for customers who need the best quality and CSC for the medium range.

Segmental information

Making sense of the segmental information requires an understanding of the underlying business model. The shareholders can see that revenues and gross profits have declined, both in total and for bridge and compact cameras (the two largest segments). The shareholders would have to understand the industry to know that the decline is partly due to structural changes, such as CSC replacing bridge cameras and compact cameras being phased out altogether.

There is a further problem in that Montel incurred significant costs in the form of "Selling, general and administrative expenses". The shareholders do not know how those costs are broken down between segments and so they cannot necessarily tell how profitable the different product ranges really are. It is, for example, possible that selling costs associated with Professional DSLR cameras exceed the gross profit shown in the segmental report. Gross profit shown in the segmental report.
It is generally helpful for companies to provide their shareholders with a narrative explanation of performance. Even informed and expert shareholders would prefer to hear an evaluation of the figures from the company's management, in the hope that it might confirm or inform their own insights. Montel could offer a wider perspective on the figures themselves, informed by the Board's understanding of the market and expectations based on future plans.

There would be ethical issues associated with distorting the impression given by the financial statements. A "favourable" interpretation would distort the impression created by the figures and would mislead the shareholders, which would breach the concept of objectivity. Depending on the presentation, it might even be possible that the interpretation was not published as part of the audited accounts and so would not be subject to any review, which would possibly further mislead the shareholders if they assumed that the interpretation had been checked.

Section 2

Competitive advantage

The first implication is that Montel would be able to remain in the market for compact cameras. It would be able to introduce a new model that was an improvement over its existing range without incurring any development costs. Having compact cameras bearing the Montel branding will protect the company's reputation for offering a comprehensive range of cameras across all price points.

The launch of the new camera will generate positive publicity for Montel, even if it is simply an increase in brand recognition. The terms of the launch will have to be agreed, but it would be reasonable to expect Lemm to promote the new camera, given that it is Lemm's product. We would generate revenues from every camera sold without risking any cash of our own.

There could be risks to our overall competitive advantage. Montel trades on quality and on offering the best cameras in any given sector of the market. Lemm's design uses generic parts that would enable any competitor to make a technically superior camera by using slightly better generic parts. The fact that Lemm's prototypes are only slightly better than Montel's existing compact cameras means that the market might be disappointed that the new product is not a significant upgrade and so Montel may appear to be losing its edge. We will have no control over the manufacturing process and so the cameras that are actually sold might not even match the quality of the prototypes that we have examined.

It is almost inevitable that Lemm's relationship with this product will become public knowledge. Reviewers and competitors will dismantle the camera in order to determine the specification and the internal workings may give a clue. Apart from undermining confidence in the compact camera range, the knowledge that Montel is prepared to license out its name could undermine confidence in the company's other products.

Pricing

At present, Montel sells on the basis of quality and sets retail prices that reflect that. The higher price supports the overall perception that Montel cameras are technically superior and reassures customers when they make a buying decision. That suggests that a premium pricing strategy could be consistent with Montel's strategy on existing models and would support the idea that the new compact cameras continue the tradition of high quality products.

A premium pricing strategy might also yield a higher royalty for Montel because Montel's royalty is based on the absolute value of retail sales. Ideally, Montel will benefit from a selling price that is large enough to give a reasonable royalty for every camera sold, provided that does not unduly reduce sales volume.

Hopefully, the association with the Montel brand will mean that sales are not particularly price-elastic and so a higher selling price will not reduce volume. Having said that, the market may discover that their Montel-branded compact cameras are actually made by a different manufacturer and they may feel cheated if they are asked to pay the full price associated with Montel. Competitors may find it easy to undercut these cameras on price, while matching or exceeding them in terms of quality. The cameras are not a significant improvement over existing Montel compact cameras and they may not really command a premium price given the improvements in current technology.

It may be possible for Montel and Lemm to compromise by skimming the market initially with a premium price to attract customers who are prepared to pay more for a Montel-branded camera. In the event that strategy starts to falter, perhaps in response to competition, the selling price could be discounted to a point where the camera regains its competitive edge. Montel will still receive a royalty, which is effectively marginal revenue, even if prices have to decrease.

Section 3

Use of simulation

The purpose of any model is to simplify reality in the hope that it can be better understood. In this case, we wish to model the likely outcomes associated with two alternative decisions, so that we can decide which is preferable. The credibility of that model depends, firstly, on our ability to identify the areas where estimates and assumptions are required and to establish the links between those variables so that they can be modelled. For example, assumptions about economic variables such as inflation or interest rates will affect future manufacturing costs, but there could be some disagreement over the precise mechanism that will link, say, inflation to profits from continuing manufacture.

The simulation model will then require inputs in the form of estimates for the distribution of the variables that we have included in our model. Those estimates will affect the output from the model and so the credibility of the results will also be affected by the credibility and validity of the underlying assumptions about inputs. The credibility of the model also depends on our ability to understand how input variables might behave over the period of our simulation. These estimates may be disputed.

The simulation will impact on our decision making by helping us to understand the models that we have developed to predict the outcome from our competing alternatives. The models can and should reflect the complex interactions between the variables. For example, increasing interest rates could also increase costs and decrease consumer demand. Running the model frequently gives us a clear understanding of the interaction between those variables.

Reporting the average result, along with indications of the range and distribution of results, gives us a clearer understanding of the risks associated with our decision. We can adapt and adjust the model and run different versions to test sensitivity to, say, different expectations of how interest rates might move. Ideally, we will be able to be more confident in our expected outcome that if we simply prepared a simple calculation of the expected result.

Negotiation

The starting point for any successful negotiation is to establish what both sides need and to aim for a win-win outcome. The basic question that needs to be resolved by negotiation is the royalty per unit that would be paid by Lemm if the licensing agreement was completed. Montel would wish to argue that it needs more than F$30 per unit and, presumably, Lemm will argue that it should pay less.

Our starting point could be the fact that our estimates suggest that Montel will be exposed to a greater risk if it accepts F$30 per unit, rather than simply continuing to make its own range of compact cameras. We might argue that we should receive a higher royalty to compensate for the additional risk that we will incur if we enter into this agreement.

Montel could argue that it has more confidence in the estimates that are based on a continuation of the status quo. Past sales from the existing range of compact cameras are a known quantity and future trends can be predicted. The additional expected value from Lemm's offer will not necessarily be sufficient to compensate for the additional risk given the forecasting difficulties.

We could argue that Lemm is not exposed to the same degree of risk because the development costs of the new camera have already been incurred and, presumably, Lemm will launch the camera regardless of whether it licenses Montel's branding. Montel is bearing the remaining business risks associated with this launch, such as the reputational risk of putting its name to a camera produced by Lemm.

Lemm's risks will be reduced by its association with Montel because this is a good quality camera that will be more attractive to consumers if it carries the Montel brand. The fact that Lemm sought this agreement suggests that it is already aware that there is a risk that the launch will prove disappointing.

The problem is that the risks are not symmetrical. Lemm might believe that it is not in its interests to pay more for the use of Montel branding because it has already developed its camera and can, presumably, sell it under the Lemm brand name. Paying more for a royalty risks increasing Lemm's variable costs without necessarily increasing sales volume.

Section 4

Benchmarking

Given that we are aiming to protect our reputation, we need to aim to conduct functional benchmarking in order to compare Lemm's performance with Montel's. Ideally, we would wish to see evidence that Lemm is at least matching Montel's performance in all key areas that matter to our reputation. In this case, we will aim to feed back any areas where we feel that improvement is required in order to reach Montel's standard.

The most immediate issue in terms of selling Lemm's cameras through Montel's distribution network is Lemm's ability to deliver cameras on time. Delayed shipments could disrupt the supply chain and cost sales. We need to track the frequency of delayed or overdue deliveries to ensure that Lemm's logistics are at least as efficient as Montel's.

We should conduct our own quality control checks on samples of cameras received from Lemm, before they are shipped to retailers. We need to benchmark quality against that from Montel's production lines because any slippage will undermine Montel's reputation. Lemm should be provided with detailed feedback on any faults that are discovered because those cameras should already have passed through Lemm's quality control process.

We should establish a liaison between Montel and Lemm so that the results of these analyses are constantly fed back, both positive and negative. If we establish sound metrics for comparing Lemm's performance with our own, then we can discuss any apparent shortcomings openly. The feedback ought to be helpful because Lemm is moving into a different sector of the market and its management may appreciate the advice from Montel.

Bonds

A bond is essentially a loan to Montel from the investors who buy the bonds. Bonds are generally used to raise long-term finance. The bond instrument will carry a face value and a coupon rate. Montel will pay annual interest based on the face value and the coupon until the bond falls due for repayment.

Bonds are generally traded on the open market in the same manner as equity shares. They can be bought and sold and their market price will change, partly in response to interest rates, and partly due to the issuer's credit rating. If the market starts to become nervous about Montel's ability to repay its debt, then the value of the bonds will decline, although that will have no direct effect on the company itself.

Underwriters ensure that the bond issue is a success by agreeing to buy any unsold bonds that are left by the market. If the issue is not underwritten, then there would be a risk that Montel would raise insufficient funds to meet its needs. The underwriter may also be able to place some of the bonds with investors to reduce the need to rely on open market sales.

The underwriter will charge a fee for that service. Underwriters are experts in the workings of the bond markets and can offer valuable advice about the timing and organisation of the issue and the coupon rate to offer. They can assist with the significant administrative issues that arise, such as the creation of a prospectus document.