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MANAGEMENT CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 3

The November 2016 Exam can be viewed at

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SECTION 1

Evaluating benefits from market research

One problem is in knowing what difference the market research will make to our implementation of 5G. Arguably, the whole history of mobile phones has been that manufacturers such as Portafone have added features to their products and then convinced consumers that they would benefit from them. If we are confident that we can sell the feature set that we intend to introduce with 5G then there may be very little point in having the market researchers tell us what consumers presently think. It may be more important for us to be aware of the features that our competitors will have rather than knowing what consumers think about rumours or suggestions.

Big data can only draw patterns and trends out of data that already exist. In the context that we are talking about, we might get an idea of whether consumers are attracted by the idea of, say faster download speeds from 5G. That is not the same as actually knowing whether or not they will notice a difference when they first handle a 5G phone or whether they will actually pay more for that functionality. Companies such as Portafone are often instrumental in creating a demand for a feature that users did not realise they needed.

The market researchers may end up reporting consumers' summaries of the newspaper articles and television reports about the new technology. Consumers may be influenced by such experts when making a judgement about an abstract proposal for a new product line, but behave differently when they are actually able to buy it. New generations of mobile phones have tended to be popular with the mass market because this technology has captured the public's attention. It may be that it would be a waste of money to buy the market research because the reality is that customers will buy the new 5G phones simply because they are newer and faster.

Negotiating a deal with the networks

We might start by identifying the position that each of us is in. The network providers will be investing a great deal in the launch of the new service and will be keen to have consumers take it up. Part of the key to that launch being successful is that there will be suitable phones ready to demonstrate the superiority of 5G. The phone handsets and their facilities are the visible element of 5G and so there will be limited incentive to upgrade without our design work. The market's initial enthusiasm may dictate the success of the new frequency because there is a fashion aspect to mobile phones. Consumers will be less inclined to upgrade if no-one else does.

From the manufacturers' perspective, consumers buy new phones as a matter of routine anyway, to keep in touch with the latest development. The launch of 5G could see a huge demand for any new phones that are developed. If Portafone does not develop new handsets to take advantage of this opportunity, then we will lose ground to our competitors. The network providers might feel that there is little need to subsidise our design efforts.

The most practical compromise would be for us to identify functions that would add significant value to a 5G handset, but which would cost a great deal to develop. If we could approach the networks with a proposal that we could make 5G even more desirable, but the cost would be too much for Portafone to bear on its own, then we might be able to persuade them to contribute. It would help if we agreed to lock those handsets to just one network, so that new customers could be drawn in by this one feature. In that case, there would be a genuine synergy between ourselves and the network.

SECTION 2

Customer profitability

Julie's analysis makes a number of fundamental errors and we should interpret her table with care.

Firstly, the research and development expenses have been apportioned on the basis of revenues within each of the segments that she has identified. We spent almost F$5.8 billion on R&D last year, which was more than our total operating profit. We will probably spend just as much if we cease the sale of SIM-free phones and so we may find that those sales actually generated a contribution to overall profit, despite appearing to Julie to be loss-making. We may generate brand recognition through having our phones on display in settings such as duty free shops and upmarket department stores, so there are probably commercial benefits to us continuing those sales.

Julie's analysis also ignores what would appear to be structural differences between markets. Judging from our own figures, it would appear that Europeans tend to obtain their phones via the global network providers, while Asians use their national networks. Splitting our sales efforts in three between global networks, national networks and retailers would be unduly mechanistic and could see us lose business. We may be at risk of spending too little in some markets to have any effect at all and so part of our marketing spend would be wasted.

Julie also misses the fact that the cost of reaching different segments will vary significantly. For example, there are just four global networks and so we may not need to spend a third of our sales effort on reaching those four organisations. Conversely, there may be some segments that are difficult to reach and that might not be worth pursuing. For example, there may be many different national network providers across North, Central and South America and their collective operating profit is only F$65 million.

Sales force structure and motivation

Clearly, we need to take great care to target the global networks in a co-ordinated manner, so that they promote Portafone handsets across the world. There ought to be a dedicated sales team for each of those networks' corporate headquarters. The role of that team would be as much to collect feedback from those networks on ideas and proposals as to make sales of existing phones and part of the evaluation would be the extent to which the wishes of major customers were built into new products. These sales teams should be motivated by having them communicate directly with Julie herself, as Marketing Director. They should be paid good salaries that reflect their importance and the feedback would ensure that they continue to earn those substantial rewards.

It might make sense to target the rest of the market using national or regional sales teams. The emphasis in different markets can be tailored to suit the distribution channels. For example, it seems more important to deal with retailers in America than to target network providers. These teams can be evaluated on the basis of more traditional measures, such as sales orders or the number of customer visits. Rewards can then be linked to bonuses for meeting and exceeding sales targets or sales commissions.

There ought to be a worldwide sales and marketing effort, with a separate sales team being responsible for managing advertising and other sales promotion in support of the direct sales activities. For example, the global network providers will be encouraged if we advertise our brand aggressively in their key markets because that will support their efforts in having new customers sign up for phone contracts. These activities can be measured on the basis of market research indicators, such as brand recognition. Rewards could be linked to success in achieving a positive brand image.

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SECTION 3

Earnings per share

The importance of EPS is underpinned by the fact that it is the subject of IAS 33 Earnings Per Share. A rights issue requires shareholders to buy freshly issued shares, which have to be issued at a discount to the present market price, otherwise the issue will fail. IAS 33 essentially splits the rights issue into two elements: the funds raised from the issue are treated as having been for new shares that were issued at their full market price. We deal with that element by basing EPS on the weighted average of the shares in issue throughout the year. For example, if we had 1,000 shares at the start of the year and issued a further 200 shares at full market price on day 120 of the year, then the weighted average would be (1,000x120/365)+(1,200x245/365) = 1,134. In theory, that gives a valid basis for EPS because we had the additional funds from the issue available to make profits for the latter 245 days of the financial year.

The second element of the rights issue is treated as a bonus issue. Effectively, we are diluting the shares in issue by giving those shares away free of charge. We deal with that element by restating last year's comparative EPS on the assumption that the bonus issue had taken place at the beginning of that year. We also assume that the shares had been in issue throughout the present year. If the rights issue in the previous example had issued a further 100 shares on a bonus issue basis, then we would recalculate the comparative EPS on the basis of 1,100 shares and the present year on the basis of 1,234 shares.

The rights issue will almost certainly reduce our EPS and we may have to be prepared to reassure the shareholders. The newly issued shares are unlikely to generate significant returns, if any, straight away and so earnings are unlikely to increase in line with the number of shares. The bonus element will definitely dilute EPS and the shareholders may base their comparison on last year's reported figure rather than the comparative published this year. The extent of this dilution will be related to the size of the issue and the extent of the discount implied by the issue price.

Research and development

Technically, the proposal is that Lucy will be made head of an investment centre. She will have the authority to invest in projects that will, hopefully, yield a positive NPV. The investment centre should be organised by setting realistic limits on Lucy's authority. For example, we might permit her to spend up to F$1 million on any given project, with an upper limit of F$20 million in what she can spend in any given year. The board would have to authorise anything more than that.

There will have to be a thorough appraisal process before Lucy can authorise a project. The project lead should prepare a detailed budget to indicate the costs that will be incurred. The proposal will also have to indicate the objectives of the study and their potential value to Portafone. There should be regular updates once the project is underway to establish whether expenditure is within budget and progress is being made towards the targets. It would be desirable to evaluate Lucy on the basis of the number of commercially successful projects completed, but that is unlikely to be realistic. For example, a study might be intended to lay the groundwork for future designs, perhaps by developing potential improvements that could be incorporated into all of Portafone's designs. We might evaluate Lucy on the basis of the number of projects started and also those completed on time. We could also keep a running score of the successful changes that have been brought about using the results of her department's activities.

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SECTION 4

Emergent approach

It is debatable whether Portfone truly follows the emergent strategy. Arguably, the company has a very clear strategic direction: to develop mobile phones that are attractive to the market and that will sell consistently and at a profit. The announcement that the 5G frequency will be given over to mobile phones around the world is clearly an opportunity that creates strategic opportunities. In that sense, we are responding to an opportunity that was not entirely of our own making.

Regardless of the label that is attached to our strategic approach, we are behaving in a reasonably proactive manner. We are tracking developments in our industry and in the wider regulatory environment in order to identify strategic opportunities. As a major manufacturer, we were undoubtedly aware of the possibility that this new bandwidth would be opened up and of the possibilities for new products. We certainly should have been involved in any industry consultation and lobbying of governments.

The emergent approach would require us to be constantly aware of possibilities and have plans in place for development as those possibilities emerge and develop. We need to be aware of the point at which it is time to start investing in development work to underpin the new strategies that might offer themselves. We need to have a realistic view of likely outcomes, otherwise we will face constant distractions in the face of remote possibilities or possibilities that offer little commercial opportunity. Tracking possible opportunities should not get in the way of managing and implementing current strategies.

Share price

The share price reaction lies at the very heart of the concept of net present value. In theory, the share price should respond to investments is positive NPV projects. The capital markets clearly see significant opportunities from 5G and our expenditure on R&D is clearly being interpreted as a healthy sign. The market's view is in line with the likelihood that many customers will replace their phones in order to benefit from the switch to 5G.

The crucial issue with respect to share price is the shareholders' understanding of our prospects. The markets need not agree with the board's expectations of a project. In this case, Julie appears to be concerned that the markets are more optimistic than we are about the potential of 5G. That may be due to short-term optimism while the markets form a view on the likely outcome.

Julie's concerns are well placed because the markets will expect to see this optimism reflected in outputs from these investments. We can expect to see the share price supported by the launch of prototypes on the announcements of successes from the development stage. In the event that the market starts to lose confidence then the share price will decline, possibly even more rapidly than it rose.