STRATEGIC CASE STUDY MAY 2015 EXAM ANSWERS

Variant 1

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Section 1

From: Finance Manager
To: William Seaton, Director of Finance
Subject: Email from CFO of Fouce Oil

Fouce's Board has made a thought-provoking proposal. This will require careful consideration.

Strategic perspective

The first thing to consider is whether this proposal is consistent with our mission statement. Slide's mission is to become the most successful oil exploration company. That mission is underpinned by strategic objectives that include a "focus on exploration-led growth".

We might argue that any strategic proposal should be consistent with our stated mission and goals. Abrupt changes will imply erratic leadership and adding lines of business will prove a distraction from the strategic focus.

Slide has always been an oil exploration company. We do not exist to extract and sell oil and gas. Our business model is to invest in a portfolio of exploration opportunities, to bring as many as possible to production and to sell the resulting wells in order to release resources with which to repeat the cycle.

We do implement our strategy with a degree of discretion. Our aim is to sell productive wells under conditions that favour Slide. We have generated almost K$ two billion from the sale of oil and gas in 2014, an increase of almost 30% on the previous year. We have demonstrated that we will hold and exploit a find until it can be sold at a realistic price. Prices are currently depressed because of low oil prices and so we have an accumulation of holdings.

Having said that, during the year ended 31 December 2014, we made a profit of K$189.7 million from the sale of exploration assets and that figure was artificially low because of depressed oil prices. In the previous year, we made a profit of $K 547.3 million, showing that we can trade-in finds effectively. Clearly, we do not give away the results of our activities. We sell them at a fair price that generates a return on our investment of time, money and skill.

Clearly, we should keep our strategy under constant review and should be prepared to adapt over time. However, it is unlikely that Slide would benefit from becoming an oil producer. We are a relatively small player in this market. Our competitors will have economies of scale in terms of distribution and marketing that we would struggle to match.

Selling finds at a profit creates equity with which to finance further exploration. The alternative would be to retain the assets and borrow in order to fund further exploration. That would leave us exposed to the risks associated with additional gearing, which could be disastrous if we had a run of unsuccessful exploration activities.

Informing the stock market

There is an argument that the stock market is efficient, which means that it will process all of the information that is available to it and correctly price our shares. In the long term, the new strategy will become apparent from our published results and will have its effect on the share price no matter what we announce or how we announce it.

In the short term, the stock market cannot react to information that it does not have. There are industry experts who devote their working lives to gathering information about the oil industry and who will study our behaviour as closely as they can. It is probably in our interests to brief those analysts so that any uncertainty can be minimised, otherwise the share price may be artificially depressed until the market sees evidence of success.

There is no guarantee that the stock market will agree with our predictions concerning the new strategy. The share price may not reflect our expectations of success because analysts could feel that we are mistaken, or they may believe that Slide is exaggerating the likelihood of success in order to manipulate the share price.

One way to reassure the market is to provide as much information as possible in the initial briefing. That has the advantage of reducing the uncertainty, but creates the risk of alerting competitors to our change of strategy.

We can probably afford to publicise the change quite extensively because we are not likely to provide our competitors with information that could be used against us. The oil business prices its products in terms of market prices that are set by market forces. Slide's activities will have no effect whatsoever on the price of oil and the product itself is an homogenous commodity, so crude oil buyers will care little whether they pay the market price to us or someone else. We might be in competition with regard to distribution and the actual sale and delivery of the crude to customers, but we have already established those relationships and they are already well known.

The market will be keen to know whether we will exploit our relationship with Fouce. One way to make this strategy cost effective would be for Fouce to buy our output at the market rate. That would give us a realistic profit from these sales and Fouce would receive the benefit when we were able to pay a larger dividend.

Any such announcement would have to clarify whether we might anticipate a takeover bid from Fouce.

Section 2

Finance Manager’s report on Fouce’s proposal

Political risks

The oil industry attracts a great deal of attention from governments and regulators. Oil is very much a strategic resource and access to reliable supplies is important to all governments. There are also significant revenues to be generated from oil royalties or other fees.

On the downside, there are also political risks associated with the threat of pollution and oil spillage. The oil industry has been blamed for threatening the destruction of natural habitats and disrupting the lives of local residents. There are national and international environmental activists who track the activities of oil companies and publish any findings concerning allegations of misbehaviour.

Oil companies frequently operate globally, but are generally viewed as “foreign”. That has been apparent in the aftermath of cases such as the environmental damage caused by the oil spill in the Gulf of Mexico, with the US press and US government viewing the company who owned the rig as a foreign investor who had harmed US citizens and damaged the local economy. Clearly, such an attitude will make it more difficult to defend any political interference.

Responses to political risks

Ideally, we should reinforce the oil security of our host nations as much as possible. Ideally, the host nation should feel secure that we cannot divert the oil or that we are not feeding it into a network that is controlled by other countries. There is very little that we can do beyond that, other than to lease assets so that the potential loss from any expropriation or nationalisation is minimised.

Environmentalists are unlikely ever to soften their stance on oil companies. The most realistic response for Slide is to stress the benefits that we create for the citizens of our host countries. Ideally, we will be able to offer jobs to local residents and so contribute to the local economy. We should use public relations campaigns to present the work that we do as a positive contribution to citizens’ lives.

The best way to overcome a sense of foreign control is to work with local partners. We could seek finance from local banks, so that we are making a contribution to the local economy. We could enter into joint venture arrangements with local oil companies so that there are local names on our production facilities alongside our own.

Changes in the global economy

The global economy will affect the demand for oil because a decrease in economic activity will mean that there is less manufacturing and so industry will need less energy. There will always be a significant need for oil to provide domestic energy and for transportation.

Supply is largely a matter of an economic response by the major oil producing nations because they have the scope to increase or decrease the rate of extraction from their fields. Reducing the world supply of oil increases the global price per barrel and turning up production reduces the unit price.

The expected movements in the oil price will be difficult to predict because they require an understanding of the political and economic environments in the major oil producing countries. The market price of a productive well will take account of expectations concerning future commodity prices.

Clearly, retaining oil wells leaves Slide exposed to the risk that it will become uneconomic to continue production in the future. Selling the wells gives a guaranteed outcome, but there could be an opportunity cost if the selling price is too low. Given that Slide is a relatively small player in the oil production industry, there is likely to be an information asymmetry over the ownership of the best economic forecasts and so potential buyers may well be able to persuade Slide to sell for less than the wells are actually worth.

Management team

Slide does have some managers who are experienced at operating oil extraction facilities and they may provide the core of the management team. These individuals may not necessarily wish to accept such a role because there is a difference between taking temporary charge of a production facility and being expected to manage it into the indefinite future. For example, some sites may be regarded as hardship postings that are acceptable for a few months until a buyer can be found, but would be regarded as unacceptable as a permanent posting.

Managers may regard Slide's culture as being to promote geologists and to reward oil exploration. The engineers who take charge of oil extraction may feel that they have little prospect of future promotion and that they would be better off in a more traditional oil company. This perception will be difficult to address until the passage of time reveals whether there is, indeed, a career structure for these managers.

Many suitable candidates will already work for Slide's competitors, who may be unwilling to see Slide's new venture succeed. They may go to great lengths to retain staff simply to prevent them from working for Slide.

Section 3

From: Finance Manager
To: William Seaton, Director of Finance
Re: Yesterday’s Board meeting

Hi William,

I think that you were right to be suspicious of the suggestions being made.

Tax matters

Most countries insist that all transactions be priced at their fair, open-market values. Oil is simply a commodity which has a readily observable market price and very few governments would tolerate the return of tax computations that were based on revenues set at less than the market price per barrel.

Sales between the production subsidiaries and any Slide trading subsidiaries will attract particular scrutiny from the tax authorities. The revenue authorities in the producing country will refuse to accept that sales are being made to another customer at cost price, especially if this is an intra-group sale. Such tax avoidance schemes have attracted significant adverse publicity around the world and most governments will be keen to avoid being presented as ineffective at protecting tax revenues.

The artificial arrangement involving Fouce is likely to be just as visible to the tax authorities. The manipulation of these transfer prices may also prove extremely complex to administer, thereby offsetting the tax benefits. It is debatable whether we could supply oil in sufficient quantity and at a sufficient saving to make it worthwhile for Fouce to risk its reputation in this way. There is also the risk that significant amounts of management time and effort will be consumed in arguing this scheme through the tax authorities’ scrutiny.

Decision making

This is actually quite an interesting proposal.

“All or nothing” offers clarity over our strategy. If we strike oil then the stock market knows that our production will increase by the capacity of the new well.

There is, however, no need for us to commit to selling every single well. There could be cases where we feel that a particular find has been undervalued because additional work could start to yield more oil. We might wish to sell some wells to release cash or to rationalise our holdings. We could, for example, feel that we are over-exposed in one country and that any further discoveries should be sold.

The danger is that if we do not have a consistent strategy, we may find that we revert back to the present approach to managing our assets.

Driving performance

The management teams in charge of each aspect of the business will require some indication of their performance and so it would make sense to separate production from exploration. The danger is that if we do it incorrectly, we will create unhelpful divisions and lose synergies. For example, engineering staff may have a role to play in both exploration and extraction. A separate divisional structure might mean that engineers cannot be easily sent to where they are needed without clearance from divisional managers.

EVA may have a dysfunctional effect on the managers in charge of production. They are not responsible for the investment base attributed to their division and so they are being held accountable for decisions to which they have had very little input. Also, the revenue streams are not directly within the managers' control because they have no control over global oil prices. They may even be unable to set production levels for themselves if the host government is a member of OPEC and decides to scale back output.

Alternatives

Balanced scorecard

There will be merit in making managers in charge of production responsible for a variety of factors that are within their control. A balanced scorecard approach will make performance in these areas transparent without creating the dangers associated with a single financial performance measure. This approach could be scaled up or down so that managers at different levels are held accountable.

Matrix management

There could be situations in which we might wish to take the emphasis away from separate divisions. It could be desirable to look at overall performance in a particular country or region with respect to both exploration and production. In some cases, it may be preferable to move exploration resources to another country in order to balance out the pressure on infrastructure.