# STRATEGIC CASE STUDY MARCH 2015 EXAM ANSWERS

## Variant 2

### THE MAY 2015 EXAM CAN BE VIEWED AT

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**Section 1**

**From: Finance Manager**
**To: William Seaton, Director of Finance**
**Subject: News article**

**Implications for Board decision making**

As a Board, our focus is on maximising shareholder wealth. In principle, it should make no difference as to whether the shares are widely held or concentrated in the hands of a small number of investors. Provided no shareholder has a controlling interest, we should regard ourselves as free to manage the company to the best of our ability.

It is debatable whether we will ever act with such freedom because it is clear that Fouce will feel obliged to monitor our behaviour as closely as possible. It has invested a great deal in our company and so it cannot really afford to simply permit us to take care of its investment. It will be accountable to its own shareholders if we should fail to deliver a sound performance.

This shareholding means that we cannot aim to maximise the collective wealth of the shareholders without also considering Fouce's interests. Some of the strategic decisions that we might take will have synergies for Fouce, even as a minority shareholder.

Ultimately, that creates an incentive for us to deliver steady growth with no visible risk. We may feel inclined to take the safer option in our decision-making, albeit at a subconscious level, because we will believe that Fouce will not tolerate any risky behaviour on our part. We cannot afford to lose the confidence of Fouce's Board because it would not be particularly difficult for them to remove us from Slide's Board. That pressure may operate at a subconscious level, without us being particularly aware of it or making any overt changes to our behaviour in response to it.

Our decision-making may be further complicated by the fact that Fouce is essentially a competitor in some respects. We have a duty to act in the best interests of Slide and its shareholders as a body, so we shouldn't ever forego any opportunities to leave them open to Fouce. However, the non-executive directors may provide it with advance notice of our plans and so it may be better equipped to bid against us.

The presence of Fouce's nominated non-executive directors means that there is a great deal of transparency in our decision making, which can work in contradictory ways.

The fact that the non-executives are likely to report back to Fouce means that they will reassure it that positive action is being developed in response to any problems. Thus, we do not have to deliver short-term solutions to problems that might be better addressed in the longer term. That will give us a little more freedom of movement. Reassuring Fouce should also send a signal to the rest of the stock market, which should protect our share price.

Transparency could also be a problem because we have lost the ability to address a problem quietly and in private if the facts are not known to the shareholder. We may have to devote time to addressing emerging problems before the facts are fully known, simply to prevent Fouce from losing confidence because of our inactivity.

**Implications for the share price**

The capital markets will be constantly weighing up Fouce's intentions.

Fouce could decide to sell shares, which would probably be interpreted as a costly signal by the capital markets. The sale could be viewed as implying that there is some bad news in the future and so the markets could remain unsettled for quite some time. Fouce will be perceived as a source of news, regardless of whether it is aware of Slide's detailed operations. At some point, Fouce may decide that it wishes to sell in order to release cash or for some other strategic purpose, so the sale need not be due to news about Slide. On a day to day basis, the fact that one shareholder could choose to sell a large block of shares could create some speculative pressure on price.

Conversely, Fouce may stimulate the share price because of the possibility that it could mount a bid for a controlling interest in Slide. It has stated that it has no interest in doing so, but such intentions can change and Fouce is not under any formal obligation to refrain from bidding. The other shareholders know that they will be able to sell their shares at a premium because Fouce will be prepared to pay more than the market price to acquire control.

The market will weigh up the possibility that Fouce's actions will drive the share price.

Fouce's shareholding will also serve to make the share price a little more volatile even if it makes no move to buy or sell. Fouce and the Jones family control a total of 43% of the issued shares. Any investor who has fresh insights into the company will be forced to buy or sell from the remaining 57% of the shares, which could mean that anyone purchasing a block of shares could push the price up by more than if the shares were freely traded.

As a major institution in our industry, it is very likely that Fouce will be able to influence our other shareholders to a significant degree. If Fouce remains steady in the face of price-sensitive news then the rest of the market may feel that Fouce's directors are in possession of deeper insights and so the market's reactions could be moderated. The markets are, however, aware that Fouce has its nominees on the Board, which could constrain Fouce from buying or selling because Fouce is likely to be in possession of inside information at any given time.

In the event of bad news, the market may be deterred from overreacting because of Fouce's holding. In the event that the share price falls dramatically, Fouce could be in a position to increase its holding to a controlling interest at a bargain price. Paradoxically, shareholders might be reluctant to sell because the falling share price could give Fouce the impetus to buy these shares. The market will bear that possibility in mind and so any fall in the price could be curtailed by the speculative forces created by Fouce.

**Section 2**

**From: Finance Manager**
**To: William Seaton, Director of Finance**
**Subject: Memorandum of understanding**

Hi William,

Please find my thoughts detailed below:

**Suitability for Slide**

Ignoring the strategic risks, which will be discussed below, this appears to be a positive proposal for Slide.

Our principal skill is in exploration and this proposal plays to that strength. We will effectively have the opportunity to expand our exploration activities using resources that will be provided by Fouce. It will provide us with control over its professional exploration staff, which will enable us to conduct far more investigations than would otherwise be possible on our own.

One concern may be that we could be distracted by this arrangement because we will effectively be agreeing to retrain Fouce's geologists. We may struggle to achieve the expected increase in productivity. We will also have to consider the implications of staff morale at Fouce because geologists from the larger company may resent being placed under the control of Slide's staff.

The financial arrangements mean that we will have to pay only 45% of the cost of any exploration activities, in return for a 50% return from any success.

The terms of the contract suggest that we will not be forced into a long-term commitment to production. The agreement is that Fouce will buy us out for 50% of each well's agreed value.

**Strategic interests**

In principle, both parties are keen to explore for oil and locate sizeable discoveries. Both companies are effectively in the same industry to begin with and their business models do overlap.

Slide has a particular focus on the exploration of marginal opportunities that are potentially overlooked by the bigger oil companies. Fouce is likely to be more interested in the mainstream production areas because it is a larger company and it needs productive wells to keep its downstream activities resourced. There could be conflict over the basic approach to oil exploration if Slide is trying to buy cheaper exploration rights with a view to profiting from exploration success and Fouce is keen to buy more expensive rights in more promising areas with a view to profiting from the oil itself.

There is a danger that the need for high volume discoveries will force Fouce to press for exploration in geological structures that differ from those in which Slide's technical staff specialise. Slide could be deprived of its strategic advantage in exploration because of the conflict with Fouce's needs.

Fouce is clearly a much larger company and its existing exploration activities are likely to be significantly greater than Slide's. Slide may struggle to keep up with the pace if Fouce is pushing to invest in more exploration activities than Slide can consider funding, even at 45% of the total cost.

**Strategic risks**

The biggest risk is that Fouce will spend the next five years studying every aspect of Slide's operations before allowing the agreement to lapse. That could then mean that Fouce will be free to use the knowledge gained from working with Slide to compete directly for the exploration rights that Slide seems to enjoy partly through a lack of interest by the bigger oil companies. Fouce has a greater appetite for oil and greater financial resources, so it could price Slide out of its market.

Fouce will spend the next five years working closely with Slide's technical staff and will be in a position to learn their individual strengths and weaknesses. It will be in a very strong position to headhunt Slide's best people, possibly even during the five year period if the contract does not specify otherwise. In the worst possible case, Slide could lose most of its key personnel.

Involving Fouce with its other collaborative ventures could alienate companies with which Slide has enjoyed useful collaboration in the past. If Fouce's involvement makes it difficult for Slide to reach decisions on the joint work then the counterparty may choose not to work with Slide on future ventures.

**Communication with stock market**

Hopefully, the stock market will view the collaboration as a positive sign that would result in an increase in the share price. The two companies should work on a joint press release for the business press so that there is clarity as to the proposal.

The nature of the proposal is speculative and so the tone of the press briefing should be positive without implying unrealistic expectations. There is no guarantee that the two companies will find any more oil than they did when working together.

The announcement is likely to create rumours that Fouce is planning to take Slide over or to merge. This question should be pre-empted to prevent harmful conjecture that could lead to share price volatility.

Once the venture is under way, both companies should keep their respective shareholders informed through disclosures in the annual report. Any successes attributable to the collaboration should be reported as such.

## Section 3

**Report by Finance Manager**
**Implementation of collaboration scheme with Fouce**

### Formal coaching and mentoring scheme

The question of whether there should be a formal coaching and mentoring scheme is complicated.

The senior staff at Fouce may resent the creation of such a scheme because it will signal the dominance of Slide. That may help to make the scheme more effective because there will be no doubt. But it could also be counter-productive if Fouce's staff are disillusioned. It could even lead to some choosing to leave Fouce altogether in order to work for a competitor.

A formal scheme would inform the Board of Fouce that its technical staff were receiving the opportunity to learn. Less formal arrangements might lead to very little being learned.

It may be difficult to offer such training and mentoring to senior managers who have clearly been successful to date in their own career progression and in finding oil for Fouce. It may undermine the mutual trust and respect that will be necessary for the two companies' experts to work together on live exploration projects.

The training scheme could become a distraction for Slide's technical staff. Time spent writing and delivering training programmes will be time away from prospecting and organising exploration.

### Formal scheme

The best approach might be to deliver practical training in conjunction with actual exploration. Teams with all of the necessary skills could be made up using staff from both companies, with a degree of duplication from both sides. The team lead could come from either company, but the expectation would be that Slide's experts would provide input at all stages.

Planning meetings could be used to emphasise how Slide would proceed. If Fouce would use a different approach then the reasons for doing things differently should be discussed. There is no guarantee that Slide's approach will be superior in every respect and so there should be room for mutual learning and exchange.

Mentoring could take the form of a number of exchanges based around the idea of a work shadow. Fouce staff could be assigned to Slide's offices and tasked to work alongside a counterpart from Slide. This relationship could then continue after the expert returns to Fouce, with regular contact by email or video link.

### Business relationship

The basis of the relationship should be that there is only one exploration department that serves both companies. The members of the exploration department should, ideally, not think of themselves as belonging to either Slide or Fouce. The creation of exchange schemes whereby staff could be encouraged and even rewarded for spending time at their counterparts' offices would help to create a bond.

If possible, reward structures should be as similar as possible to avoid bad feeling between staff from the two companies. There could also be dysfunctional behaviour arising from staff suffering different personal risks from the success or failure of operational decisions.

The direct business relationship may be assisted by the creation of as many centralised or shared facilities as possible. For example, it would be ideal if all geologists used the same software so that they could share files more easily. There could be a shared server so that those files were equally accessible.

Any recommendations issued by the exploration department should be agreed because it would undermine the project's credibility if geologists were issuing contradictory recommendations to their employers. In the event that there is a disagreement between Slide and Fouce staff there should be an expectation that they will consult and discuss for as long as is necessary to arrive at a consensus.

**Decision making**

The biggest difficulty is the fact that exploration is very expensive and so it is likely that it will be necessary to seek authorisation from the Board for many of the decisions taken by the exploration department. The merging of the two departments will complicate the decision making process because two Boards will have to agree on, say, the acquisition of exploration rights in a particular field.

Both Boards will have to agree at the earliest stage that they will treat the recommendations from the merged exploration department with the same respect as they would have when dealing with their own in-house experts. Any disagreement over implementing a recommendation could undermine the confidence of the exploration department's management.

The decision will also have significant financial implications. If both companies are to be expected to contribute to all projects then they will both have to have sufficient liquidity. Slide may have to raise additional finance in order to meet its commitments. It may be necessary to agree that either party can agree that the other should proceed with a project alone if funding is an issue.

The final concern is that the value of a recommendation may be judged by whether it results in the discovery of oil or gas. The danger is that managers could be nervous about recommending an investment if they will be criticised for a failed investment. It will have to be accepted that such investments will always carry such a risk and that the failure to find oil does not necessarily mean that the project should not have been recommended.