STRATEGIC CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 3

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

Requirement 1 – risk mitigation

The Board can only be blamed if it failed to identify and implement any realistic mitigation strategies that would have been available for addressing this risk. If the pods cannot be patented and they can be sold as "S/D compatible" without breaching trademark restrictions then we would have had no legal basis to prevent them. It was also inevitable that our pods could be easily reverse engineered and copied because they are simply plastic containers with aluminium lids.

The Board should have been aware of the possibility of such a duplicate product being launched and it should have had a contingency plan ready. There is a huge barrier to entry to this market for vendors who wish to establish their own coffee systems because consumers have to be prepared to buy a compatible machine. Making pods that are compatible with S/D machines will be much easier and cheaper and will enable the vendor to be associated with the S/D brand.

It may be that the most effective mitigation for this risk is already in place. By maintaining its brand image, it is pre-empting the entry of a rival company. S/D invests heavily in maintaining quality, buying good quality coffee beans. Its capsules are well made and feel as if they are of good quality. It advertises heavily and promotes its brand image through its association with a major film star.

The impact of this risk has still to be determined and so it may be too soon to criticise the Board. The rival product has only just been launched and so it is still unknown whether it will affect S/D's revenues. S/D possibly needed to wait for the inevitable attempt to enter this market in order to establish how best to respond. The fact that Valyoumart is competing on price rather than quality may require a different mitigation than an attempted entry by a rival who claimed to be making better quality pods.

Requirement 2 – retail sales

At present, S/D has a coherent business model. It distributes its pods online, asking consumers to buy them in relatively large quantities. That approach encourages consumers to hold inventory and so effectively has the effect of accelerating consumer sales. Customers pay at the time of sale, which is good for S/D's cash flows. Fulfilment is handled by third-party couriers, which simplifies the processing and delivery of

©CIMA 2020. No reproduction without prior consent.

orders. Opening up a retail sales line would threaten these benefits by encouraging consumers to switch to purchasing in small quantities from supermarkets.

Selling through supermarkets would force S/D to upgrade its logistics system to handle bulk deliveries to business customers. S/D would be forced to invest in the administrative systems required to support such sales, including accounts receivable staff and account executives to maintain ongoing sales. Time would be spent in negotiating discounts and managing relationships with major customers. The end result might simply be to divert existing sales from online to supermarkets and so there would be no additional sales volume.

Before selling through supermarkets, S/D will have to conduct market research in order to establish whether doing so might attract new customers to their brand. Customers are already being asked to make significant investment in a machine, so asking them to buy a large quantity of pods to go with that could discourage them from trying it at all. The need to buy a machine might, in itself, be sufficient to discourage customers from trying this style of coffee and so there would be no advantage in making it possible to buy a single sleeve of pods for trial purposes. This will always be a high-risk strategy because it will harm S/D's reputation if it launches in supermarkets and that proves to be a failure. The supermarkets will only give shelf space if sales are healthy.

Selling through supermarkets now might appear as an acknowledgement that Valyoumart's business model is superior. Even if supermarket sales were under consideration for other reasons, S/D will appear to be following Valyoumart and it may lose credibility in the process. S/D may struggle to enter this market because Valyoumart may not wish to sell S/D pods in direct competition to its own, or it may simply stock them in order to display them alongside its own pods in order to promote their superior value for money. Other supermarkets may be reluctant to stock S/D pods until the impact of Valyoumart's entry into the market has been clarified. They may even wish to consider offering their own brand of S/D compatible pods and would not wish to encourage S/D to establish itself in retail outlets.

S/D would lose the competitive advantage associated with the fact that its customers are presently forced to buy in relatively large quantities, which might discourage them from buying other brands of pods sold through supermarkets. S/D's existing customers may have sufficient coffee pods to last for weeks and so may not rush out to buy Valyoumart's new line. By the time they are running out of S/D pods they may have forgotten the initial excitement associated with Valyoumart's launch. Selling through supermarkets would enable S/D's customers to buy and hold pods in much smaller quantities and so make it more convenient for them to try different brands.

SECTION 2

Requirement 1 – shareholders

The shareholders will see the growth in revenue and the increased investment in assets when the financial statements are published but will be unable to explain this in terms of the specific strategy that is being pursued. The impact on the figures overall may prove confusing, with a declining gross profit % amongst other things, and could leave the shareholders uncertain as to the strategy that is being pursued. It is important to offer an explanation for any such changes, even if the connection with Dolsav must be kept confidential, because S/D's shareholders could believe that their company is becoming less efficient and is slipping back behind competitors such as Caffham. S/D could explain this by stating that it had entered new markets, without

being too specific, and stating that these are still under development. The shareholders will, hopefully, accept that the figures are improving, even if they do not understand that strategy.

The fact that S/D has been making sales on credit will be apparent from the increase in trade receivables. The shareholders will be aware that S/D has been making business-to-business sales, even though no announcement has been made. S/D should pre-empt this by announcing in advance that it had entered into some profitable trading relationships with third parties. S/D could phrase this carefully, avoiding offering any explanation that might lead shareholders in the direction of a supermarket.

The biggest concern is that S/D's ROCE may decline because production capacity is increasing, but the profitability of sales made based on that investment will be reduced. The directors may appear to be inefficient and the shareholders may be concerned that the company is entering a decline. The directors will have to ensure that the expansion is completed as efficiently as possible to minimise the risk of a negative impact. S/D should consider increasing its dividend to highlight the fact that its profit has increased in absolute terms, even if it has declined relative to capital employed.

There may be rumours about S/D being the source of Dolsav's new line, either because someone talks or because the changing accounting figures will coincide with the new sales by Dolsav. The shareholders may be concerned that S/D is undermining its own competitive position by making pods that will be sold in competition with those carrying the S/D brand. In the event that such rumours emerge, S/D should argue that they agreed to this deal in order to prevent Dolsav from opening up in competition and costing S/D the opportunity to create any added value. If the sales are profitable, then S/D will be generating further contribution and so benefitting.

Requirement 2 – financing

The funding decision should take full account of S/D's present funding arrangements. The company currently has debt of M$942 million and equity of M$2,167 million, which gives a gearing ratio of 942/(942+2,167) = 30%. S/D might raise funds through an equity issue, which would reduce the gearing ratio to 942/(942+2,617) = 26%. The alternative would be to borrow, which would increase gearing to 1,392/(1,392+2,167) = 39%. Equity would slightly reduce the gearing ratio, which would make the group appear slightly less risky, while debt would increase gearing substantially to a level that many companies would regard as unacceptably high.

Before going any further, S/D should establish whether it has any debt covenants in place that might prevent it from borrowing further. It is possible that it has agreed to restrict its gearing ratio to, say, 40%. In that case it would be reckless to borrow up to 39% because it would leave no further flexibility for borrowing in the future. It could also mean that any losses that reduced equity could put the company in technical breach of its covenants. In the event that S/D is close to its borrowing limit, it would clearly be necessary to seek equity in order to raise this finance.

If debt cannot be raised, then it could be argued that the funding requirement is for 450/2,167 = 21% of S/D's equity. That is enough to justify a rights issue to provide sufficient equity finance to meet the funding requirement. S/D would, however, have to bear significant costs in terms of professional and other fees in order to raise that sum. It would also be necessary to persuade the shareholders to increase their stake in the company by a substantial amount while being unable to explain fully the arrangements that S/D has made with Dolsav.

Overall, it would be cheaper and probably simpler to seek debt, provided S/D has sufficient debt capacity. The company is planning to invest in plant and equipment that will, hopefully, provide security to reassure the lender. The cost of debt is generally cheaper than the cost of equity. S/D will get tax relief on debt, but there is no tax benefit to be had from equity finance.

SECTION 3

Requirement 1 – data security

The team members should be under strict instructions to prevent colleagues from looking at their screens at any time when they are accessing Dolsav files. Ideally, a section of the office could be set aside for the exclusive use of the Dolsav team and non-members should be discouraged from entering that area. Staff should not be permitted to leave their laptops unattended at any time. If they are away from their desks they should either take their laptops with them or lock them in a secure drawer. The staff should be required to sign non-disclosure agreements that deal with protecting files and documents in addition to refraining from communicating details of the contract with Dolsav.

Laptops should be secured by passwords and should always be switched off when not in use so that they cannot be used easily by any unauthorised user. The user names and passwords required to access Dolsav files should not be stored anywhere on the laptops, not even if encrypted or disguised as a phone number or whatever. Staff should access all files on the server and should not be permitted to store any data or file extracts on their laptop hard drives.

There should be a clear policy concerning working away from the office. If staff are permitted to work from home then they should be required to have their laptops in their possession at all times, except when they are locked away at home. Laptops should never be left in an unattended car for any reason or for any length of time.

Staff should be fully trained in computer security and they should be provided with anti-malware software. All anti-virus and firewall software should be active at all times and it should be kept up to date. The server should only ever be accessed through an internal network or via a secure VPN.

Requirement 2 – internal audit

Internal audit could be tasked to treat this as an area of priority in which the Dolsav team is reviewed every few months. Regular reviews will remind the team that the controls are important and that the company is expected to adhere to them. Care should be taken to prevent the reviews from becoming too frequent and intrusive, otherwise they may become counterproductive by demotivating the team.

The internal audit team could start by reviewing evidence that computer security training has been provided. Presumably that training would be provided by either an in-house or external expert, which would leave some form of record of the participants' involvement. If the training was provided online then hopefully there was a self-assessment quiz at the end of each module with a pass mark that had to be exceeded. The auditor could check that the training covered all relevant areas identified as necessary to ensure the security of access.

The internal audit team could review the behaviour of the team members with regard to security whenever they happen to be in the office. They would be looking for signs

that laptops are being locked when staff are away from their desks. This observation would have to be subtle, otherwise there is a risk that compliance will occur only when the internal auditor is in line of sight.

From time to time, perhaps annually, the internal auditor should conduct an unannounced inspect of the laptops. This would involve asking their users to demonstrate that a password is required to log in when switching the machine on. It would also be possible to check that any laptops that were not being used at the time of the inspection were switched off.

The internal auditor could then check that the software that should be in place to protect the laptops is running by inspecting the machines and checking that all updates have been applied. The internal auditor could attempt to access the server, in the hope that the machines had not been set to log in automatically. The content of the hard drive should be reviewed to check that it does not have any files that should not be present.

Requirement 3 – exit strategy and governance

It could be argued that S/D's Board has been negligent in waiting until now to consider the need for an exit strategy. This is a significant strategic relationship that could turn out to benefit Dolsav more than S/D. It may prove difficult for S/D to negotiate a break in the contract unless that is explicitly incorporated into the agreed terms from the very beginning.

Dolsav's Board members may view any request by S/D for a break as implying a lack of commitment to the trading relationship, which is potentially undesirable. They are, however, unlikely to view the insistence by S/D's Board to protect S/D's interests as weak. An exit strategy is a safeguard that mitigates against the risk that a business relationship may have some unforeseen and adverse consequences. It is hardly indecisive to mitigate against such risks.

The logical thing would be for the negotiation of the contract to have considered break points where either party could request a review or the cancellation of the arrangement. That would give each side a clear commitment from the other until the next break point, at which time both sides could seek whatever change is desired. The fact that this is built into the contract means that both sides will be motivated to treat the other side honestly.

If S/D has already signed a contract that does not allow for changes, it will become even more necessary to develop an exit strategy that will be available in the event that it becomes desirable. S/D may have to find a way to interpret and apply one or more terms in its contract that would encourage Dolsav to withdraw and agree to set the contract aside. That could create the possibility of escape, but it would also run the risk of alienating a potentially useful business contact and damaging S/D's reputation in the process.