CGMA NOVEMBER 2017 EXAM ANSWERS

Variant 1

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SECTION 1

Part 1

Strategic options

The launch of a Steelcast smartwatch will open up a new market segment to the company. At present, Steelcast sells only traditional clockwork watches to a narrow market of wealthy customers who are prepared to pay a substantial amount for a traditional watch, which limits the potential for growth. This market segment is unlikely to expand and so Steelcast is unlikely to grow unless it can find a way to sell more watches to existing customers or open up a new market. It may be that existing customers would be interested in buying Steelcast smartwatches so that they could alternate between traditional and high-tech watches as they wished while continuing to be associated with a prestigious brand.

The creation of a smartwatch would actually be consistent with Steelcast's approach to product design and branding. The company's focus on chronographs shows that it has always been keen to make watches that offer additional functionality, other than simply telling the time. Building a smartwatch is arguably an extension of the Steelcast brand image, which should make it easier to convince customers that the watch fits into the product range. The challenge would be in ensuring that the new smartwatch was sufficiently attractive and robust to carry the Steelcast name.

A smartwatch would create an opportunity to develop relationships with phone manufacturers with a view to creating further commercial opportunities. A smartwatch is essentially an extension of a mobile phone and it may be worth investigating the creation of Steelcast models of existing phones. Steelcast could take a phone manufacturer's best featured phone and build a case to accommodate the electronics. Apart from the potential sales of the product itself, Steelcast would attract a great deal of positive publicity.

Looking forward, the creation of a successful electronic watch would create scope for gradually distancing Steelcast from the clockwork watch market. The smartwatch may prove unpopular, in which case it can be dismissed as a failed experiment and the company can revert to conventional watches. If it proves popular then the ability to sell

Steelcast watches with electronic movements will free the company from the need to train and retain skilled watchmakers. In the long-term, this move could lead to a significant change in the business model and could eliminate a major strategic risk.

Adding a smartwatch to the product range may enable Steelcast to persuade existing customers to buy a smartwatch to alternate with their traditional watch.

Part 2

Financial and non-financial objectives

While we do not have sufficient information to form any final conclusions or recommendations at this early stage, we can consider the likelihood and direction of any impact.

The principal financial objective is the maximisation of shareholder wealth. There is a danger that this new product will create some uncertainty in the minds of shareholders and so market capitalisation might decline. If the Smartwatch is viewed as an indication that Steelcast is no longer committed to its core product range then the market may be concerned that future revenues will decline and share prices will fall. That may prove to be a short-term phenomenon, though. If the Smartwatch subsequently proves itself as a source of revenues then reported earnings will lead to a correction in the market capitalisation and shareholder wealth will recover. In the short term, it is fair to imagine that the markets will impute an increase in Steelcast's total risk to this new product.

From a purely financial point of view, the new product may affect our profitability. In the short term we should be able to make a good profit from each watch sold. We can buy in the electronic movement, possibly adapting the software slightly to give the interface the appearance of our watch. The development costs will be restricted to adapting the design of our Brawn case to ensure that it can accommodate the electronic movement. The contribution per watch sold is likely to be significantly higher if we can sell the Smartwatch at the same price as the existing product. In the longer term, we will lose the potential for revenues from aftercare services such as servicing watches because the electronic watches will require no maintenance.

Non-financial objectives are wider and consider the implications for other stakeholders.

Steelcast's employees may feel threatened by this development because many of the skilled workers will be concerned that the company may not be committed to mechanical movements. In this case, staff morale could decline. This is a problem because the accuracy and reliability of each watch requires considerable attention to detail from each watchmaker involved in creating the movement. Workers may fear the loss of their jobs and so they may start to apply for posts with other watch companies. Steelcast's reputation as a caring and committed employer could be damaged by fears that these highly trained employees may find that their skills are no longer in demand.

Customers may also feel that their association with the Steelcast brand has been impaired by the decision to launch a watch with an electronic movement. Past customers have invested heavily in the brand on the basis that it epitomises luxury watches. The expense is primarily driven by the skilled labour associated with making the movement by hand. The proposal to launch an electronic watch may create the impression that Steelcast is no longer a premium watchmaker because its watches are effectively just expensive cases with very ordinary quartz movements. Iconic brands that threaten to make changes are often heavily criticised on social media and that may lead to a decline in the appeal of all of Steelcast’s watches, both traditional and Smartwatch.

SECTION 2

Part 1

IT and barriers to entry

The most immediate barrier to entry is that concierge services employ experienced facilitators and also have contacts with potential suppliers. Steelcast will have neither of these, which could make it difficult to establish a worthwhile service, even ignoring the significant cost of doing so. Steelcast's app-based service negates the need to employ facilitators, thereby dispensing with a significant barrier to entry. The key will be to create sufficient content to attract users to this service. It may be possible to persuade restaurants and other attractions to grant privileges to members of the Steelcast Smartwatch Concierge Service because they are likely to be relatively wealthy individuals.

One possible strategy for using IT would be to enter into a collaborative relationship with a similar online booking service. Steelcast could simply create a separate website to act as the front end of the other company's system. This would create the impression that Steelcast's customers had an exclusive service. It would reduce the initial setting up costs to a minimal level and would offer a broad range of suppliers from the outset. The collaborator would be responsible for keeping the site up to date. The operating costs would be minimal, although it would mean that Steelcast customers might pay more to use the service when they could simply sign on to the host site directly.

Linking the exclusive membership to the use of the online approach could enable Steelcast to add value by providing statistics and review facilities to members. Members may find it useful to know, for example, that a large number of their fellow members have eaten in a particular restaurant in the past six months. A member looking for a restaurant in a particular city might find it useful to see how many Steelcast customers made bookings at each of the options on offer. It might also be possible to offer the ability to make comments about the restaurant, provided they have been booked through the Steelcast site. This would make the comments far more credible because it can be verified that the commentator had actually been a paying customer.

Steelcast is also creating a fairly effective barrier to entry to potential competitors who wish to emulate their approach. The Steelcast service is restricted to those individuals who can afford an expensive watch, which lends a sense of exclusivity. The app is available only to those who buy this watch and is, hopefully, of value because of exclusive privileges granted to Steelcast customers. Anyone wishing to link their competing service to a similar product will be forced to take second place in their dealings with suppliers and in promoting their venture.

Part 2

Ethical issues

The most immediate ethical issue is whether this is really a concierge service. Customers could claim that they are being misled into paying for a very limited service. Generally, concierge services charge a fee and in return they permit customers to make quite complicated requests that might otherwise be difficult to resolve. All the customer really gets is exclusive access to a service that could be easily replicated using an ordinary internet search engine. This could be viewed as a breach of the principle of integrity, which requires us to be straightforward and honest in all business relationships.

The easiest way to resolve this concern would be to change the name to the Steelcast Smartwatch Booking Service, or any other name that avoided the impression that a full concierge service is on offer. The target audience for a concierge service would comprise busy people who had little time to read documents in great detail and so the name of the service should reflect what the service actually provides. If the name is to be left unchanged then the next best thing would be to have a clear and brief description of the service that is to be provided, with a tick box for the customer to indicate that the message has been read and understood. This would ensure that the customer's attention was drawn to the box and that any further entries were properly informed.

The proposed service may also be a breach of the principle of professional behaviour. Customers are being offered lifetime membership of a free service. In fact, they are being invited to use a booking service that is potentially more expensive than the booking services that are already freely available. Over the course of a year, anyone using this service to pay for bookings could spend significantly more than the fee for a full concierge service. The fact that the service is accessed through a mobile phone rather than a device with a larger screen may also discourage customers from shopping around.

One response to this would be to offer greater transparency in the operation of the service. If the 10% commission was shown clearly on the screen before the customer paid then the cost of the service would be apparent. Customers might be willing to pay this if they feel that the convenience of the service and associated ease of payment justified the cost. It would also be helpful if Steelcast could have a response to any accusation of over-pricing. Ideally, the company will be able to explain how it adds value in return for the additional 10% charged.

SECTION 3

Part 1

Market analysts

The efficient markets hypothesis suggests that market prices always accurately reflect all relevant information relating to future cash flows. Before information can be incorporated into the share price it must be collected, interpreted and communicated, which is where market analysts become important. Market analysts tend to specialise in particular segments of the market, possibly one industry, perhaps narrowed further geographically. Those analysts have an incentive to process all news quickly, offering a realistic recommendation as to whether the news is “good” or “bad”. Their views will then drive the share price.

The analysts can push the market in more decisive ways because they have the ability to persuade institutional investors as well as many individuals. Market prices are set by the laws of supply and demand, with transactions pushing the share price in different directions. If an influential analyst makes a sell recommendation then the supply of shares available in the open market will increase and the market price will fall. Individual investors may not always agree with the analysts, but their opinions are rarely supported by sufficient quantities of shares to actually move the market price.

Part 2

Risks of attempting to persuade analysts

Arguably, the analysts are unlikely to be open to persuasion over matters of interpretation or understanding of the future. They are experts in the industry and in the capital markets and may resent any attempt by Steelcast’s board to persuade them to change their recommendations. Indeed, there have been a number of major scandals that have involved company boards pressuring analysts into distorting the market and any attempt to influence the analysts could be misinterpreted as an attempt to lie to the shareholders.

The analysts are unlikely to be open to persuasion unless the directors provide them with additional information that is not yet available to the public. Clearly, the analysts would then be obliged to reconsider their views in the light of this additional information and the share price could only increase if the information adds support to the case for the new service.

The downside is that briefing the analysts with new information could have the effect of giving competitors advance warning of the approach that Steelcast plans to take to this new service. The share price might increase, but the long-term impact could be negative if competitors are able to restrict Steelcast’s access or if new competition enters the market very quickly.

The final problem is that Steelcast’s board and the analysts have to be extremely careful about the possibility of accusations of insider trading. It would be illegal for the analysts to trade if they were in possession of price sensitive information that is not generally available to the market as a whole.

Part 3

Cost of capital

The first question is whether short-term fluctuations in the share price mean a change in the cost of equity. It could be argued that the share price is the present value of future cash flows, as determined by the market as a whole. If the share price decreases then it might be argued that the capital markets perceive higher risk and so are applying a higher cost of equity.

Share prices fluctuate almost constantly and some of those movements are due to rational expectations of short-term speculative movements, so they may not reflect the ongoing cost of equity. It would make more sense to look at share price movements in the longer term and to relate the share price to dividends or to profits in order to establish the cost of equity.

The second question is whether Steelcast's cost of equity is a realistic basis for the evaluation of this project in any case. The Smartwatch product and the concierge service are both very different, with different risk profiles. It would make more sense to evaluate each on the basis of some other external benchmark rather than Steelcast itself.

The fact that the share price has fallen does, however, suggest that the analysts have reason to believe that this is a bad move for Steelcast to be taking. At the very least, it suggests that the project is risky and should be evaluated using a higher cost of capital than we have used for other projects.

Part 4

Conflict

Shareholder wealth is measured largely in terms of the company's market capitalisation. If the share price increases then shareholder wealth has effectively increased also. That increase is a reflection of the future net cash inflows that the company will generate, which is created mainly through trading at a profit. New projects can decrease profits in the short term because of conservatism in accounting treatment and also because of the manner in which projects must be funded and costs incurred before any revenues are generated. The shareholders may also have only a very limited knowledge of a project and its expected returns because the directors may not wish to release too much because of commercial confidentiality.

In the case of a project such as this, the shareholders are faced with the certainty that funds are being tied up in investments that may not yield an adequate return. The outcome of the investment will only be seen with any certainty once time passes and the effects can be seen in the statement of profit or loss. The Smartwatch may generate a profit fairly quickly, but the concierge service may require a year or two to reach a critical mass of customers. In either case, the shareholders will have to be patient until they can see their investment generating a meaningful return and accept that such short term performance figures may be part of the process of generating an increase in their wealth.