CGMA NOVEMBER 2017 EXAM ANSWERS

Variant 3

SECTION 1

Part 1

Ludno's proposal

Arguably, the traditional product portfolio tools such as the BCG matrix would classify Steelcast's products as being in the high market share, low growth segment, making them cash cows. The market for luxury watches is restricted by limited number of people who can afford the retail price and so the market is unlikely to grow consistently. Steelcast has a high share of that market, which further restricts the company's ability to grow. It would possibly have to develop new styles of luxury watch in order to compete with other manufacturers. These could be difficult to sell because of Steelcast's association with the rugged "sports" market. Opening up new lines of products would create an opportunity for Steelcast to grow, while using the revenues from the existing product range to underpin that venture.

It could be argued that this proposal could also be justified using Ansoff's product/market growth framework. These would essentially be new products aimed at what are effectively new markets as far as Steelcast is concerned. This suggests that Steelcast would be following a diversification strategy with regard to its product portfolio. It would enable the company to leave its existing product lines in place, which is desirable because they continue to sell well, while moving into new, but related, markets. This means that there would be some synergy between the new products and the existing range.

The critical success factor for this diversification strategy is whether the Steelcast brand can be stretched to encompass these new products. Whether this is the case or not will depend on the nature of the products being offered and whether they are consistent with the Steelcast brand image. For example, Steelcast watches are classic and understated, with an emphasis on function. Putting the Steelcast name and logo to a fragile and overly elaborate product would be potentially damaging to the brand itself and might do little to boost sales of the new product.

The other critical question is whether Steelcast has the necessary resources to be an effective collaborator in this venture. In this case, the only issue is the question of the management time required for the selection of suitable products. Ludno will carry out the initial effort required to identify potential partners who will pay to use the Steelcast brand. Presumably, the partners will undertake most of the design work, although Steelcast's design staff will have to make an input to ensure that the brand's values are being maintained. The only real question is whether Steelcast's board will wish to be selective so that the brand's exclusivity is not diluted by excessive use on too many products.

Part 2

Share price behaviour

The fact that the share price increased suggests that the capital markets regarded the possibility of these new products as good news. This does not necessarily mean that Steelcast should proceed because the market's immediate response will reflect the understanding of the proposal as at that time. The capital markets are regarded as efficient, which means that prices reflect all available information at any given time. This does not necessarily mean that the immediate response to good or bad news is necessarily valid and proportionate. The capital markets may regard a piece of information as positive in the first instance, but prices may settle down once the markets have had an opportunity to reflect.

Share price movements may be rational on the basis of the market's understanding, but the markets as a whole may not have sufficient knowledge to make a reasoned decision that the board should regard as persuasive. In this case, the markets responded to rumours that Steelcast may be collaborating with Philipe Pens, which is potentially beneficial in the short term. The markets do not know how much Philipe Pens will pay to Steelcast. It is possible that they will offer too little to make the venture worthwhile or less than the market has anticipated. There may also be issues that the market is unaware of that will make Steelcast's board reject the proposal. For example, Steelcast may have plans to launch its own range of pens in the medium term and so it may reject Philipe's offer.

The directors also need to be careful not to be misled about the reasons for the market reaction. The board may have inferred that the share price was responding to rumours about Philipe Pens when it is possible that the reaction was to some other news, such as a change in the currency or interest rates that was expected to benefit Steelcast. The markets may not regard some announcements as news because the information has already been made available in some other way. For example, the CEO of Philipe Pens may have voiced his interest in working with Steelcast on a previous occasion and so the markets may have already been aware of the possibility.

Even in an efficient market, share prices can react to speculative forces that need not be related to the future cash flows. A misunderstanding of the implications of an item of news could increase or decrease the share price without a good economic reason. If sufficient investors believe that the share price will increase then it will rise even if they are being illogical. Indeed, rational and informed investors may believe that a blip in the market should be exploited so that they can buy shares in anticipation of a short-lived increase before selling them at the top of that movement.

SECTION 2

Part 1

Strategic alliance

The most important issue is to identify and maximise synergies with our licensees. For example, it would be ideal if we could leave our products unchanged while our licensees develop products that capture the essence of the Steelcast brand. For example, Philipe Pens could develop writing instruments using materials that closely match those used in Steelcast watches that are polished to the same degree of finish. If our licensees use as many design features from our existing products as possible then their development costs will be minimised and ours will be close to zero.

We should attempt to position our respective products as effectively and efficiently as possible. For example, Steelcast might use opportunities to promote licensees' products alongside its own at sponsored events such as polo matches featuring the Steelcast team. It might also be possible to use existing distribution networks to sell suitable products alongside Steelcast's offerings. Customers buying a Steelcast watch may value the opportunity to buy, say, a pair of matching cufflinks from the same retailer.

There should be close cooperation so that the various parties can develop a bond of trust. For example, if Steelcast is making a significant change to an existing model or launching a new product then it should ensure that its licensees are able to adapt to keep pace with that change. We should do our utmost to avoid making a licensee's products obsolete or redundant without at least giving them a clear warning of the forthcoming changes. We might also seek inputs from the licensees so that we can develop products with their needs in mind.

Overall, we should aim for a win-win relationship that benefits both sides of every licensing agreement. Steelcast is permitting the use of its intellectual property and so it should charge a royalty or license fee. The charges should be reasonable and realistic for both parties. We should consider the licensees' interests when we are evaluating and managing risks. A successful collaboration will help to promote Steelcast.

Part 2

Currency risks

We need to consider the extent to which this arrangement will be subject to economic risk. We will receive a royalty, so our economic risk will be determined by the extent to which changes in the C$ affect sales of Philipe Pens and Velosci Cars. Presumably both companies will have significant sales in Centralia and so currency movements will have relatively little impact. The biggest issue will be created by the cost of any imported materials or parts that increase the cost of making the companies' products which have to be passed on to customers, thereby reducing demand.

Economic risk could be an issue with regard to export sales made by Philipe Pens and Velosci Cars. Those risks may be self-mitigating to some extent because a strengthening of the C$ may lead to a decrease in export sales made by the two companies, but there should be a corresponding increase in the value of the C$ when they are remitted to Steelcast. Steelcast should also consider the interaction between royalties and watch sales. If the C$ strengthens then it will be cheaper for customers in Centralia to buy Steelcast's watches and so there could be some natural hedging between revenues from royalties and the primary business.

The other issue is the problem of transaction risk. The cash value of the C$ owed to Steelcast may change in value. This could be a serious problem because it is likely that Centralia will be a major market for Steelcast watches. Therefore, C$ receivables from Philipe Pens and Velosci Cars will combine with receivables from Steelcast's stockists to increase Steelcast's exposure to a decrease in the C$. One response would be to use suitable financial instruments such as forward sales and options to hedge movements in the C$. The extent of the overall exposure might justify the cost of doing so in terms of fees and also management time.

There may be some natural hedging techniques available to Steelcast, such as fixing as many costs in C$ as possible. For example, Steelcast spends heavily on magazine advertising in international magazines. If the advertising could be ordered and priced in C$ then inflows and outflows will cancel one another to some extent. It would also be desirable to have the royalties paid as frequently as possible so that balances are exposed to currency movements for the shortest possible time.

SECTION 3

Part 1

CSR coverage

The GRI's Guidelines set out a number of principles that could inform this decision.

The first principle is stakeholder inclusiveness. Steelcast should consider its stakeholders and respond to their reasonable expectations. For example, some ethical investors would not wish to hold shares in a company that led to them profiting from the sale of such a vehicle.

The report should present the company's performance in the overall context of sustainability, so that Steelcast can ensure that it is transparent and open with regard to its stakeholders. It could be argued that helping to promote the sale of a fast car, which is likely to consume a great deal of fuel and other resources, is unsustainable.

The principle of materiality requires Steelcast to consider whether its involvement with Velosci could be considered a material fact. All that Steelcast is doing is lending its name and some styling details to a product that would undoubtedly sell to more or less the same extent without its association with Steelcast.

The principle of completeness would require us to identify any and all significant environmental impacts. Stakeholders are likely to feel that the car itself has a significant environmental impact and that Steelcast's role should be disclosed in the CSR report.

Part 2

50% discount

From a purely financial point of view this purchase is potentially a positive net present value investment because it will help to promote the Steelcast brand. Steelcast watches have an association with racing and aviation and having a fast car as a promotional device can only help. The CEO is likely to be photographed arriving at meetings and again, his use of this car will promote the idea of Steelcast as a brand that is associated with sport and performance. Even if the cars were expensive, they probably cost relatively little in comparison to their commercial value.

From a governance point of view, it might be argued that the chairman should not be authorising transactions in this manner. The chairman is a non-executive, whose role is to oversee the management of the board. Having said that, using one of the cars as a company car for the CEO may be viewed as an extravagant perk and the chairman is probably the only person who could be seen to authorise the purchase of such a lavish company car. The decision could raise wider questions about Steelcast's governance, which may undermine shareholder confidence.

Part 3

Impact on share price

In theory the share price could increase slightly because buyers and sellers may factor the value of the discounts into the share price. That would only apply to individuals buying shares because it is unlikely that a corporate investor would be able to justify buying a sports car, a pen or a watch even at a discounted price. Most shares are held by institutions and so the number of individual shareholders may be too few to have much impact on the share price. There could even be a negative impact if institutions are deterred from investing in Steelcast in case stakeholders suspect their management teams of using their funds to take advantage of discounts.

The other issue is the question of the materiality of the benefit even to an individual. Presumably there is a minimum number of shares in order to qualify for a discount and a maximum number of discount claims, otherwise individuals would buy a single Steelcast share and would then purchase large numbers of discounted watches, pens and cars, perhaps for immediate resale. The prospect of an H$400 discount on a $2,000 pen will only be appealing to someone who can afford to spend H$1,600 on a pen, which further diminishes the appeal. It is also possible that non-shareholders will be able to negotiate these discounts with retailers even if they do not hold shares. For example, car dealerships often give small discounts in order to secure a sale.

Part 4

Ethical arguments

The most immediate concern is whether there could be a risk to the reputation of Steelcast and of its board. If the shareholders believe that the acceptance of such a lavish gift implies a lack of professional behaviour then it might be better to refuse the gift. Having said that, if the pens are being given without any conditions or expectation of more favourable treatment then the threat is diminished. The pens are also expensive, but it is debatable whether H$2,000 is such a significant value to a board member of a quoted company.

From the perspective of integrity, it could be argued that this gift is simply enabling the board of Steelcast to become better acquainted with this licensed product that bears the company name. The directors can make full disclosure of the gifts and they may even make the shareholders aware. Their use of the pens will help to promote the product and will, hopefully, stimulate sales to some extent. Presumably, the board members will be unlikely to risk perceptions that their personal integrity has been compromised and thus is unlikely to be an issue.