CGMA STRATEGIC CASE STUDY MAY 2019 EXAM ANSWERS

Variant 2

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SECTION 1

Requirement 1 – reliance on KHS referrals

This argument forces some consideration of Denby's strategy. It could be argued that Denby's Board should have considered the possibility of a change in government attitudes towards referrals to private hospitals. The fact that private hospitals must make a profit, while providing superior accommodation and food, suggests that it will always cost more to refer a patient than it would be to offer the same treatment in a KHS hospital. Denby is probably well aware that the cost of referring patients is likely to be a controversial political issue that will lead to criticism of the KHS and Keeland's government. Denby's Board should be conducting constant scenario planning so that it has contingency plans in place for dealing with this threat.

One argument in support of Denby's Board is that there is a significant market for referrals and that it would be foolish not to accept these patients, provided they are generating profits as well as revenues. Even if this market cannot be expected to continue, it would be foolish to withdraw from it unless there is a more lucrative way to utilise those resources. It seems unlikely that this market will disappear soon in any case because the KHS would be unable to treat all its patients within the time limits set by government policy and relaxing those time limits would be unpopular with voters. While there is a threat in the long term, Denby's Board should work on the basis that there will be the potential to earn revenue for quite some time to come.

It could be argued that the facts do not support the suggestion that Denby has been complacent. Denby's total revenue has increased from 2017 to 2018, but revenue from KHS referrals has declined. KHS work still provides 29% of total revenue, but it was 32% previously. It is unclear whether that decrease reflects a deliberate policy to reduce Denby's reliance on KHS, but it does undermine the suggestion that Denby has been idle in accepting these referrals at the expense of other revenue streams. Denby appears to have been successful in increasing revenues from self-pay patients, which might be a direction that could be pursued even more aggressively in the future if the KHS referrals diminish. The gradual change of direction will be less likely to confuse potential patients or to alert competitors as to Denby's intentions.

Finally, it may be that there are no viable sources of revenue to replace the income from KHS referrals. Realistically, many of the patients treated by the KHS cannot afford either private health insurance or the cost of private medical treatment.

Accepting KHS referrals may be the only way in which Denby can generate income from this market segment. If referrals cease then it may be necessary for Denby to downsize rather than seek alternative revenue streams because there simply aren't any viable alternatives.

Requirement 2 – share price

The most important thing is to explain that the market's reaction reflects changing expectations of future cash flows. If the capital markets are efficient then the prices will reflect all available information in a logical and unbiased manner. We cannot necessarily explain why the market reaction was less severe for Denby than one would have expected, but there are possible explanations that can be explored and discussed with the Board. Paradoxically, the share price is set by the market forces created when individual participants make buy and sell decisions and so the resulting market price cannot necessarily be explained with any given certainty, other than to state that it reflects overall market beliefs.

Share prices fell by less than the proportion implied by this lost revenue. That could suggest that the market had already considered the possibility that referrals from the KHS would stop and that the share prices before the minister's announcement had already reflected some of that. Market analysts are constantly reviewing the business models of the companies and industries in which they specialise and there can be no doubt that they would have been aware that referrals from the KHS could come under threat. The minister's announcement could have been predicted by the market. For example, there could have been a leak from the government before the announcement or the market could have known that a press conference had been called and they might have guessed as to what the announcement might be. The limited reduction in share price could also reflect the possibility that the market does not believe that the KHS can cope without referrals to private hospitals. Market participants may not believe that the Minister can deliver the reduction implied by the announcement.

The fact that Denby's share price fell by less than implied by the potential loss of revenue could be explained by the possibility that the market does not believe that KHS referrals are particularly profitable. Bronty Health commented that private hospitals give the KHS significant discounts and so margins may be thin. Those thin margins will be further eroded by the competition between the major private health groups, because the KHS will be extremely price conscious in selecting hospitals for referrals. Market analysts will do their best to gather information about business models and so they may have quite deep insights into the impact that the loss of this business would have for Denby. They would not necessarily rely on crude percentages from the segmental report.

Denby's share price fell by a smaller percentage than those of its competitors. That could be due to several possibilities, or a combination of all. Firstly, Denby might not rely on KHS referrals to the same extent as its competitors, so the proportionate loss of revenue would be less severe. Or the market might believe that Denby was in a stronger position to retain KHS referrals and that more of the loss of business would be borne by its competitors. Conversely, the market might already have anticipated that Denby would lose this revenue, perhaps because it was the weakest company in this particular area of business. That concern would have meant that the share price would have fallen already. Or the market could have decided that Denby planned to make a strategic withdrawal from the KHS business in order to pursue other directions, again suggesting that the loss of KHS referrals had already been incorporated into Denby's share price.

SECTION 2

Requirement 1 – CSFs and KPIs

Robert has identified two objectives for this team: to protect the business of KHS referrals and to maximise Denby's share of any work that continues to be referred. There could be some conflict between the two because the first might benefit from cooperation with competitors, while the second could put us in conflict with them.

One critical success factor would be our ability to lobby for the continuation of referrals of KHS patients, even if the number of referrals must be reduced for political reasons. Denby's Board must ensure that the members of the KHS Liaison Team have the skills and knowledge required to promote the argument that patients will suffer longer waiting times or poorer care if the KHS can no longer refer them for treatment.

A second critical success factor would be our ability to negotiate a response to the Minister's wishes that enables Denby to make the best use of whatever referrals remain. For example, if the Minister is seeking a reduction in the number of patients referred to private hospitals then our team might encourage the KHS to refer only complex and costly procedures that have high margins.

As far as maximising Denby's share of the remaining business is concerned, the most important thing is for Denby to maintain good relations with those KHS hospitals that refer lots of work. If hospital managers are confident that Denby will treat patients efficiently and effectively then they will be keen to continue to use Denby's hospitals.

Denby will also have to take care to maintain its reputation for clinical excellence. KHS hospital managers will be reluctant to refer patients to private providers whose standards are too low. They will also have to treat patients for any problems arising from negligence or malpractice while they were under Denby's care.

The KPIs should ideally measure progress towards achieving these CSFs.

Measuring performance with regard to putting the KHS under pressure to continue with referrals could be achieved by quantifying negative responses to the proposed curtailment of referrals. For example, the number of column inches in newspapers that criticise the comments or the number of posts in support of referrals on social media.

Progress towards establishing how any new policy will be implemented and measured might be measured by observables such as the secondment of Denby or other private health provider staff to working parties. It would be too late to simply wait until the policy had been determined because Denby will need to plan and, hopefully, influence the policy while it is under development.

Maintaining good relations with KHS hospital managers might be measured through quantifying the number of contacts with relevant decision makers. Denby should have designated staff who are responsible for staying in contact and ensuring that they are aware of the potential referrals so that capacity can be checked and committed.

Denby's clinical excellence should be measured for all hospitals and all patients, but in this context, the focus should be on areas that could discourage future referrals. For example, Denby will have to ensure that infection control is of the highest possible standard so that there are no adverse news stories about patients suffering from post-operative infections.

Requirement 2 – ethical issues

There are a number of threats that might undermine the ethical behaviour of the staff involved in Robert's proposed team.

There is a clear self-interest threat arising from the fact that the Team's remit is to work closely with government and the KHS in an advisory capacity, while aiming to minimise the loss of revenue to Denby. That suggests that Denby's team members could be motivated by their employer's best interests when offering any advice to the KHS. The KHS and the Minister of Health may be keen to liaise with Denby and other private hospital groups in order to liaise over the implementation issues that will arise from this proposal. They may be seriously misled over any misstated or distorted advice if Denby's team present it as if they are genuinely trying to help.

There could also be a familiarity threat, both from Denby's managers are the KHS and government decision makers. Denby has been taking referrals for years and its management team may struggle to think objectively about the prospect of the KHS managing waiting lists in any other way. Any advice offered to the KHS and ministry of Health could be distorted by the Team's inability to recognise that waiting lists might be managed differently. The KHS staff involved in this process may also be struggling with thinking beyond the familiar arrangements that are in place and the Denby participants will have no reason to assist them to think about alternatives.

The self-interest threat might be dealt with by instructing the team members to act with integrity, which would require them to be straightforward, honest and truthful. It would be redundant to declare an interest in everything that they say during discussions, but they should be clear if they are pressing for a choice that would benefit Denby, even if that same choice would also be advantageous to the KHS. The team members should also be truthful at all times. Their counterparts may trust them to report facts honestly and could be misled by any lies about the effects of any decisions on KHS patients. Ensuring that as much information as possible is shared in writing, with any meetings properly minuted, will reduce the risk of Denby's team members lying.

The familiarity threat might be addressed by acting with professional competence and due care, which would require the team members to develop the necessary knowledge and skill to at least understand what they might contribute. The easiest way to develop this would be for Denby to conduct its own review as to how the KHS might best manage its waiting lists, both on the basis of limited reliance on referrals and even after eliminating referrals altogether. This study could be conducted in private and without necessarily sharing the results in full with the KHS. At the very least, that would give Denby's team a clearer understanding of the advice that they could offer in order to assist the KHS to reduce its reliance on referrals to private hospitals.

SECTION 3

Requirement 1 – evaluating project

The biggest challenge will be to predict the cash flows associated with this project.

The most immediate question would be the determination of the cost of refurbishing the four hospitals. It is unlikely that even the KHS will have a comprehensive list of everything that is wrong with the hospitals. If the agreement is that the four hospitals must be updated or upgraded then the potential cost could be enormous. In the worst possible case, the building may have to be demolished and replaced with new hospitals if they are beyond economic repair. Denby may not have time to conduct a comprehensive survey before the KHS offers this proposal to Bronty or Postar. The cost will not be restricted to the physical refurbishment of the properties. The four hospitals may not have the necessary infrastructure to accommodate and support the latest medical equipment.

The revenues from this investment may be difficult to predict because they will depend on referrals from the KHS. Denby will have little control over the number of referrals or the nature of the treatments that will be requested. Local KHS managers may not always need to refer sufficient work to keep the refurbished hospitals fully occupied. There could also be questions concerning the potential profitability of providing this service at a 25% discount to Denby's normal rates because the refurbished hospitals may be less efficient than Denby's existing hospitals. There is a further complication arising from the fact that this investment will make Denby the KHS's preferred private hospital, which could be difficult to evaluate in terms of understanding the impact it will have on retaining revenues that might otherwise go to Bronty or Postar.

Requirement 2 – profit v wealth

If this is a positive NPV investment then it should increase shareholder wealth. If the refurbishment costs K$250 million as predicted then it will represent almost a 25% increase in Denby's property, plant and equipment. If the shareholders recognise that this is a bold investment and they agree with the Board's evaluation of net present value then the share price will increase and the additional wealth will be recognised immediately. If the shareholders do not fully share management's optimism then the share price may not increase to the extent envisaged by the Board's NPV calculation. It could even fall in the short term. If the project turns out to be as successful as hoped then the share price will increase gradually over time as the success of the investment is reflected in reported figures.

This project will almost certainly reduce profit in the short term. While much of the investment in refurbishing and re-equipping the hospitals will be capitalised, many of the setup costs will be written off as they are incurred. Denby will have to invest heavily in medical equipment that will have to be depreciated and that depreciation may be significant in comparison to revenues during the early stages of the project, leaving relatively little profit. There is a further concern that the profitability of this venture will differ from that of existing hospitals. The 25% discount may make the new venture appear less profitable than existing business. Denby may report increased revenues, but poorer return on capital employed. That may make it difficult to convince shareholders that their wealth is increasing.

Requirement 3 – dividend

The impact of the additional dividend will depend on the market's interpretation of the payment, which could be difficult to predict.

Denby's dividends for 2018 amounted to just over half the profit for the year, which suggests that shareholders are happy to accept dividends. If Denby was not in the habit of paying dividends then its shareholders might have gravitated towards the company in search of capital gains through the retention of profits to fund future growth. The tax implications for shareholders ought to be considered because they might otherwise have felt compelled to dispose of their shares before the dividend was paid, in the hope that there would be buyers whose tax circumstances favoured dividend income. Any volatility in share prices is potentially a matter of concern because it implies risk, which could offset the positive impact of the dividend payment on share prices.

There may be a concern that the additional dividend could be misinterpreted as a sign that future dividends will continue at that level, which could lead to an adverse reaction when dividends revert to normal levels. Hopefully, the markets will accept any announcement that the dividend is unlikely to be repeated in the foreseeable future, otherwise the share price could become quite volatile. Even so, there could be some speculative share trading around the time of any announcement that the share price is reverting to normal levels because some shareholders may take a naïve view of the dividend pattern. Paying the dividend may not have the desired effect of reassuring the shareholders and protecting the share price because it seems like a rather illogical act.

Requirement 4 – cash surplus

Dividends reduce both retained earnings and cash. It follows that any company must have sufficient cash reserves in order to pay a dividend unless it is planning to borrow and so increase gearing. Provided the “significant dividend” proposed by the board is less than the K$93 million that Denby has in the bank then it will not have a direct impact on gearing. In this case, however, Denby plans to invest in a project that will cost more than K$250 million and so it will have to raise funds from either debt or a share issue, even if the dividend is not paid. The justification for the use of these cash reserves to pay a dividend rather than partially funding the expansion will have to be explained carefully.

There is a further concern about the use of the cash surplus in this way. Denby has had a high bank balance since at least the beginning of the year and so the shareholders may have believed that the directors were working towards some long-term expansion strategy. Returning this cash as a dividend might be viewed as a sign that the Board could not find any positive NPV projects that could be funded using equity. That could undermine confidence in the Board’s stewardship and could lead to the shareholders questioning the logic of the expansion. The Board will have to be careful to ensure that the decision to pay a larger than usual dividend at a time when funds are needed for expansion is fully explained to the shareholders.