CGMA STRATEGIC CASE STUDY MAY 2019 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 – strategic fit

As a starting point, we might use the Johnson and Scholes "SAF" criteria.

The suitability criterion appears to apply to this proposal. Denby's primary area of business is the provision of healthcare and this new line of business is essentially an extension into the provision of services that are intended to improve quality of life and mental health. Denby's present business model focusses on the recruitment of professional staff and the management of consultations and treatment in attractive and comfortable premises. The only concern is that "clients" may be unwilling to use this service if Denby's brand as a provider of healthcare is interpreted as a suggestion that those using the Denby Lifestyle brand implies problems with mental health. The fact that the Board wishes to retain "Denby" as part of the brand name suggests that the association with hospitals is not viewed as a significant matter.

The proposal may be feasible, although it does not offer a great deal of synergy with the existing business. The service will have to be staffed by professionals from different backgrounds to those that Denby usually deals with and it will require new premises to be acquired and fitted out. Denby's background in recruiting and retaining medical professionals should assist it to attract professionals from related fields such as psychology and counselling. Hopefully, Denby's reputation as an employer will prove attractive. It is unfortunate that Denby will have to acquire and prepare new premises, but this is another area in which it has experience and expertise. Denby may not necessarily enjoy any huge advantage over potential competitors who wish to enter this market because it will have to create a viable business from the very start.

Acceptability is probably the criterion that will create the greatest difficulty. According to Robert Borr, Denby will have to create a significant business without having the opportunity to test the market through a low-key startup. That requires Denby to risk a significant amount of money on a venture that could fail. The potential upside is significant because it will open a whole new line of business, enabling Denby to offer treatments that are not restricted to clients who require medical attention. The downside is that the company will be left with significant investment in premises that may not be particularly easy to realise. It will also have recruited staff who may have to be made redundant.

©CIMA 2019. No reproduction without prior consent.

The SAF criteria are by no means the only benchmarks for this proposal. For example, Denby may struggle to obtain a sustainable competitive advantage even if it does establish a foothold in this market. Existing providers could argue that Denby has little relevant experience and that its background in dealing with physical health matters could impair its ability to offer a suitable service for those seeking counselling. New entrants may not be at a particular disadvantage to Denby because they may be able to observe Denby's business model and develop their own improvements. Competitors could also benefit from Denby's promotion of its service, which will inform the market about the value of counselling. Competitors can then tap into that market.

Requirement 2 – challenges

Denby's gearing is presently 32% (calculated as 550/(550+1,144)). That would increase to 38% ((550+150)/(550+150+1,144)). That is a significant increase in gearing, which might make the existing shareholders and lenders nervous, as well as potential lenders. If the stock market is nervous then Denby's share price might fall until the success of the venture has been established and that could put Denby's Board under some pressure to produce rapid results in order to restore the share price. It could also put existing lenders under some pressure to impose any penalties for slow or late payment.

There is a further difficulty arising from the fact that much of the cash raised will be invested in assets and outlays that will have little or no realisable value. Recruitment and promotional costs are necessary start-up costs, but Denby will have nothing to show from these that could be pledged as security. Similarly, the premises should retain their intrinsic value as property, but they will have to be fitted out to reflect Denby's requirements, decorated using the corporate colour scheme, and so on. Certainly, the project will not have the effect of providing its own security for the funds raised and that could force lenders to seek security against existing business assets such as hospitals.

Denby could respond to the first difficulty by developing a detailed and realistic business plan for this project. If shareholders can be persuaded that the investment is sound then the increased gearing will be less of a worry for the markets. Similarly, if lenders can see that the cash flow projections have been realistic and have erred on the side of caution then they may be more willing to tolerate the high gearing ratio on the grounds that they are unlikely to be forced to foreclose. Reassuring the sources of finance can be targeted at key stakeholders to avoid releasing commercially sensitive information. For example, briefing institutional investors and investment analysts should be sufficient to ensure that the stock market does not panic.

Denby could manage the launch in such a way that the project is made scalable, thereby delaying the investment of funds until the venture's success seems likely. For example, once premises have been acquired, Denby could decorate and furnish the reception area and only those consultation rooms that are necessary in the early stages. Denby could also pledge to draw on its cash reserves in the event that the business is slow to start and needs to be supported. The company has had a large cash surplus for a year, so it should be possible to apply those funds in an emergency.

SECTION 2

Requirement 1 – Big Data analytics

Social media would make a good starting point in order to establish the priorities that potential clients might attach to different services. Denby could identify media sites that tend to attract the well-paid professionals who might be willing to invest in the new service. The sites could then be searched for references to life experiences, such as depression or addiction that might form the basis of a service that could be offered by Denby Lifestyle. The search could be assisted by a psychologist, who might assist Denby to develop algorithms that could help pick up on nuances in posts that would not require a specific reference to “depression”.

Denby could search the business press and management publications to establish whether there are any emerging trends that could be of interest. For example, industries that are in transition or companies that are in difficulty could create opportunities to sell counselling or other support services. Professional journals could also be scanned to establish whether they offer suggestions that a particular occupation is changing, thereby creating the need for members of those professions to be resilient. Trends in job vacancies could also identify occupation groups whose skills may be in shorter supply.

The analysis could review local economic factors, such as regional changes in house prices. Declining house prices could suggest that employment is falling in some areas of Keeland and that could indicate an opportunity to sell advisory services. If prices are rising elsewhere then there could be a need to help business people to rank and manage their life priorities, perhaps choosing between moving for the sake of promotion and avoiding disruption for their families. Areas that show declining wealth could be in greater need of coaching services paid for by employers to assist with the transition in employment.

There could be correlations between economic, social or geographical factors and the number of counselling and other services that are on offer. Plotting the locations of specialist counsellors, drawing on information provided on their websites, could give an indication of the factors that imply success, such as proximity to certain types of industry. These websites could also be analysed to determine the extent to which they appear to be directed at employers or employees, because that could have implications for the scale of the market and the manner in which Denby Lifestyle should be promoted. Any figures published by professional bodies for revenues and numbers of members engaged in these services could also be incorporated into this analysis.

Requirement 2 – executive director

The first advantage is that Denby Lifestyle could benefit from the input of a suitably experienced executive director who might be able to offer insights into the market for Denby Lifestyle. The Board presently includes a medical director, who is a qualified physician. The CFO has a background in the KHS and the non-executive chairman is a retired physician. The emphasis on traditional medicine could make it difficult for the senior managers responsible for Denby Lifestyle to communicate with the Board and also for the Board to provide suitable strategic direction. Senior managers might also be reluctant to work for Denby Lifestyle if they feel that Denby’s Board will not take them seriously.

The new Board member may not necessarily come from a counselling background and could add valuable skills to the existing Board. The CEO’s background is in marketing and the Commercial Director has a human resources background, but that leaves gaps in terms of logistics and IT. The new director need not necessarily be a qualified counsellor or life coach, but could be capable of learning about that industry. In the meantime, the new appointment could offer strategic leadership in one of the areas in which the Board is presently deficient.

It may be difficult to justify a new director to be responsible for Denby Lifestyle because the new business will be a relatively small part of the Denby Group. The proposed investment in Denby Lifestyle is less than one tenth the book value of Denby's existing non-current assets. The new Board member will feel obliged to establish a presence and also to argue for the need to keep Denby Lifestyle under review, so the Board may struggle to retain focus on the far larger issue, which is managing the private hospitals. It could be argued that some of the medical specialisms within Denby are larger than Denby Lifestyle in terms of assets and staffing and yet they will not have separate representation on the Board.

The new director may also have an incentive to mislead the Board with regard to any problems encountered by Denby Lifestyle. This is a new business and it may run into difficulties. The director may be unwilling to have the Board informed of such problems in case that reflects badly upon his or her leadership. In an extreme case, the new director will have an incentive to resist any proposals to downsize or even close Denby Lifestyle. That could lead to the Board being misinformed about problems until it is too late to address them.

SECTION 3

Requirement 1 – loan

In this case, the International Fisher Effect, an economic model, suggests that the C$ will strengthen against the K$ over the ten-year term of the loan. If the model holds true then the value of the C$ borrowed will increase by just enough to offset the lower nominal rate charged on the loan. International Fisher cannot guarantee that the anticipated increase will occur or predict the amount of the change. There are, however, economic indicators that can be observed and that are generally viewed as offering unbiased forecasts. It is, of course, possible that the First Bank of Centralia will charge a premium so that the 2.5% rate on C$ will actually be more expensive than 4.5% on K$.

It seems unlikely that a foreign banking group would be prepared to offer debt finance at a lower cost than funds that we could borrow locally from banks with whom Denby already has a relationship. It seems more likely that expectations concerning currency movements will offset the apparent advantage of borrowing from overseas. Foreign banks will know less about Denby than Keeland's and it may prove more difficult for a foreign bank to enforce the terms of its loan against the borrower. It is clearly possible that a potential lender would make a mistake and underprice its loan, but such a possibility is unlikely to occur in practice.

Requirement 2 – hedging

The only way in which Denby could have a 2.5% real rate of interest would be for all of the C$ payments to be made in servicing the loan interest and repayments to be at today's exchange rate between the two currencies. Again, it would be difficult to imagine how such a hedge could be created without paying someone else to bear the risks associated with any movements. The transaction costs associated with paying someone else to bear the risk will undoubtedly increase the effective rate to something approaching 4.5%. Even some form of currency swap would be unlikely to fix the rate at 2.5%. There are unlikely to be any counterparties to such a swap that would be able to afford to enable Denby to service the loan at 2.5%.

In the long term, currency risks can often be hedged using natural hedging techniques. It might be possible for Denby to manage some of the risks that the real cost of borrowing will exceed 2.5%, but that would involve Denby having some revenues that are priced in C$. In the event that the C$ strengthens, that would make it more expensive for, say, Centralian patients to travel to Keeland for treatment and that would reduce the strength of the hedge. The only way in which Denby might obtain this funding at a true cost of 2.5% would be to take the huge risk that all of the economic forecasts that inform the market turn out to be incorrect and that exchange rates fluctuate in a very narrow band around the current spot rate.

Requirement 3 – betas

We need to consider this matter from the perspective of properly diversified shareholders. Beta coefficients have little or no useful purpose when evaluating an investment unless it is part of a portfolio. Shareholders are primarily interested in the geared beta, because that reflects the risks arising from the business itself (the ungeared beta) and the additional risk arising because of debt. Denby's geared beta is less than 1.0, which means that its systematic risks are less than the average for the stock market as a whole. Arguably, this is a low risk investment and so Denby's cost of equity will also be relatively low in comparison to other entities.

Pantor's geared beta is greater than 1.0 and so it is more volatile than the market as a whole. The betas of the two companies can be combined as a simple weighted average to give a geared beat for the expanded Denby Group of ((10/110 x 1.08)+(100/100 x 0.62) = 0.66. That increase in Denby's beta will slightly increase its cost of equity. Hopefully, the future profits from Pantor will be sufficient to increase the share price and so increase shareholder wealth, despite the impact on the cost of equity.

A narrative explanation of the impact of beta on cost of equity would be perfectly acceptable, as would weighting the betas 90% and 10% as a rough approximation.

Requirement 4 – synergies

It is a good sign that Pantor's Board is cooperative, although it may prove reluctant to stay on in the capacity of subsidiary directors having had the freedom associated with managing a quoted company. The loss of key Board members could make it more difficult to manage the new acquisition with a view to it achieving its full potential.

The fact that Denby is considering retraining or replacing coaches and counsellors could be a problem because that suggests that Pantor's services do not necessarily match those that Denby needs to offer in pursuit of its strategy. If the main reason for acquiring Pantor is a desire to acquire premises then there may have been relatively little synergy for Denby in the first place.

The reorganisation could lead to the loss of coaches and counsellors whom Denby would have wished to retain. The staff could view the Pantor Board members' willingness to cooperate with Denby as a sign that they wish to benefit themselves, particularly if they leave during or immediately after the acquisition.

The question of branding is important because Denby could lose brand recognition if it changes the name of the business from Pantor Wellbeing to Denby Lifestyle. It could, of course, retain the Pantor name, but that would cost any benefits associated with having a visible link to the Denby Group.