

CGMA AUGUST 2018 EXAM ANSWERS

Variant 4

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

Part 1

Evaluate the strategic fit of Mite-E Media

Suitability

Considering the recent consolidations in the newspaper publishing industry, the increased demand for digitally delivered news, and the need to engage with customers more directly, an acquisition of Mite-E Media would fit the current environmental trends. Also, this acquisition could build on FNG strengths. FNG has a strong reputation for focusing on local customers and therefore this acquisition should certainly bring more strength to our local focus. If we look at our strategy, then there appears to be a clear strategic fit if we were to go ahead and purchase Mite-E Media. As it is an internet-based news and events hosting business, this would clearly be something that would be relevant in the digital media age and is very much locally-focused. The fact that the Mite-E Media platform also has a focus on local event hosting should also help FNG to ensure that our local brands are relevant.

We would also need to consider if our portfolio will be balanced as a result of the acquisition. The answer would probably be yes, in that we will now have a more diversified portfolio with events hosting, which is a new but related product added to our current portfolio.

Acceptability

Is the acquisition acceptable to our stakeholders, both in terms of returns and risks? This will depend on each stakeholder group. The acquisition is likely to be welcomed by shareholders, who will be looking to diversify their own risks. Our external investors can always do this themselves by holding a diversified portfolio of shares but the 60% of family shareholders are likely to be supportive of diversification, as it will help manage the risks of the business. FNG staff may be appreciative of potential new skills and opportunities, but only if investment is made in sufficient training in events hosting, otherwise there could be resistance. Our customers are likely to welcome this acquisition, but it needs to be well publicised if it is to be successful. If our customers

appreciate more focused local news, and the events that we host in a variety of regions, then they will hopefully respond positively.

Feasibility

To evaluate the feasibility of a strategy, we must consider whether we have the resources. Firstly, without a price for Mite-E Media at this point in time, it is difficult to assess whether we have the financial resources to acquire Mite-E Media. Identifying a suitable price may be difficult, as it is a relatively new and unlisted internet business. In terms of resources, such as skills and knowledge, acquisition will require an investment in new resources, particularly event hosting. An increased focus on local news may also require more investment in local journalists.

A final consideration is the cultural integration of FNG and Mite-E Media. Cultural fit may be difficult, as integrating a new entrepreneurial internet-based business within a long-standing family-based business may prove challenging.

Part 2

Risks of operating our current portfolio

Our current business portfolio is quite narrow. We have a range of similar products (newspapers and websites) across the different regions of Borland. Each of these products is very similar (that is, focused on local news). However, we do have some geographical/ market diversification through operating across a number of geographical areas. We could also argue that we have a range of different product offerings, in terms of weekly and daily hardcopy newspapers and websites and apps, so to some extent, FNG does operate with some degree of product diversification.

However, there is a degree of risk in this current portfolio. The diversity of the products that we are currently offering is fairly limited, as it is based upon a limited and traditional narrow product range. Our advertising revenue (both print and digital) is significantly dependent on these products and, should the popularity of these products decline (as we are already witnessing in printed newspaper sales), then we are at risk from the loss of more advertising revenue. Therefore, having limited alternative products with which to generate alternative revenue is a risk to the business.

There is also a risk to our shareholders due to the lack of product diversification. However, an argument can be made that any shareholder concerned about lack of diversification can diversify risk themselves through managing their own share portfolio. However, our internal family shareholders may be less likely to diversify their portfolios than our external shareholders. Therefore, a lack of diversified portfolio may bring risks to family shareholders.

An upside risk of our current portfolio is that it is very stable, in that it has not changed for decades, and we know our products very well. Therefore, we have managed our risks effectively, because we have focused on a product portfolio in which we have great expertise and have offered for many years. This should help to reduce potential portfolio risks.

Diversification through the acquisition of Mite-E Media would help to counter these risks. For instance, an acquisition nearly always offers a faster way for gaining market share than organic growth, as there is a ready-made customer base for products that already exist.

Also, the products and services offered by Mite-E Media seem to be innovative and are likely to be market-leading so should give us an opportunity of gaining some

advantage over our competitors. Although diversification strategies can be risky in themselves, this would be a case of related diversification, as we already understand the media industry. It is just the technology that would be new to us. This wouldn't be as risky as acquiring a totally unrelated business, such as a property development company, for instance.

Overall, it may be prudent to consider diversifying our product portfolio through the acquisition of Mite-E Media, which will offer us a new product/ market opportunity, thus spreading the risk across our portfolio. Should we acquire Mite-E Media, this would be related diversification and, as such, is likely to be far less risky than an unrelated diversification (that is, in a completely new market or new product which we are not familiar with).

The local news element of Mite-E Media is something which we can exploit and build upon using our current skills set and resources. Event hosting is a new product offering, but is related to local news and is something that could complement our existing products. Therefore, I believe that overall this acquisition could help to reduce the risk in our current portfolio.

SECTION 2

Part 1

Valuing Mite-E Media

The traditional business valuation methods, such as asset-based or earnings-based methods, are unlikely to be wholly applicable in valuing this relatively new internet-based business. Firstly, there are likely to be few assets to value in this business (apart from any assets required to host events, but these are likely to be hired for each event rather than owned). Therefore, the usual starting point of using an asset-based valuation method is not likely to be helpful and is likely to significantly under-value the business. Secondly, as Mite-E Media is an unquoted business, it will be difficult to use some of the more obvious valuation methods such as Price Earnings and the Earnings Yield methods, although a proxy P/E ratio for a similar business could be sought.

However, this situation does offer us a degree of negotiation and flexibility in the valuation methods we use and therefore, the main issue is how to come to an agreed price between ourselves and Joe Blindt. The advice offered by KTS should be considered, as the guidance in the slide you forwarded to me highlights some potential tools we could adapt to assist us in the valuation process.

The use of recent stock market performance trends could be used to assess the overall performance of internet-based businesses, but this is only very general and should only be used as a potential starting point to give us an indicator of where Mite-E Media may be performing, if it were listed. However, internet-based businesses can cover a wide range of industries and activities and, therefore, there is no real reliability of past general stock market performance as an indicator of the future performance of Mite E Media. Similarly use of an average stock market P/E ratio could be used, together with an assessment of Mite-E Media's earnings, but this may not give a true picture of the unique performance of this business, as sales and earnings growth forecasts are likely to be limited.

An interesting method we could investigate is to prepare a similar framework of relevant questions for Mite E Media to come to a price multiple on earnings to assist us in valuation. Obviously, we would likely need further assistance from KTS with how this

would operate in order to ascertain the most appropriate questions and how to model these into an appropriate price multiple. However, a multiple of between 2 and 3 times earnings could be a starting point for negotiations.

One of the most thorough ways to value a business is through a discounted cashflow method, which involves forecasting the free cash flows of the acquisition target and discounting them with a predetermined discount rate, usually the weighted average cost of capital. A DCF would be highly appropriate if we were evaluating a mature, stable business with predictable cashflows. Unfortunately, those pre-requisites are not satisfied with Mite-E Media. A difficulty may also lie in ascertaining an appropriate discount rate.

Clearly, placing a reliable, fair and objective value on Mite-E Media is not going to be easy and we may need to identify a range of potential valuations on which to base our negotiations with Joe Blindt. Overall, it will be based on our own perception of the future value of Mite-E Media to our business.

Part 2

Performance Measurement for Mite-E Media

Should the acquisition of Mite-E Media proceed, FNG will need to identify and monitor a range of performance measures to measure the success of the acquisition in terms of its impact in the achievement of FNG's overall strategy. The achievement of our overall strategy of 'delivering relevant local brands through exploiting the latest technology to build a diversified and sustainable product portfolio' needs to be assessed. Therefore, we need to identify key metrics for Mite-E Media in assisting us in achieving our strategy.

As Joe Blindt claims that Mite-E Media makes 75% of its revenue from event hosting, then clearly, we would need to predominantly focus our measurements of performance on this aspect of the business, as it is a means by which we can achieve a diversified portfolio.

Therefore, I would recommend the following performance measured as a starting point:

1. Revenue generated from event hosting as a percentage of Total Revenue (month on month comparisons)
2. Revenue and Profit generated per event
3. Number of events hosted per month
4. Percentage of attendants per event who are referrals from the website
5. Customer satisfaction ratings per event

These first two measures should give us an understanding of the revenue generating potential of the events hosted and importantly, the profits they generate for the business. As the acquiring business, it should be our focus to manage costs carefully, to ensure that we optimise the returns on our investment through optimising the most profitable events.

It will be important to not only manage how many events are undertaken, but to establish also the number of events hosted by type (such as award ceremonies, food festivals, sporting events) and the potential that each type has to generate profit. Some events may be highly lucrative and areas we should pursue further, whereas we may discover that some event types are unprofitable and should be reviewed.

This type of business activity is likely to rely heavily on word-of-mouth recommendations and referrals. Therefore, it would be useful to measure the

performance of Mite-E Media in these terms. If possible, it would be useful to measure the percentage of attendees per event who came through the website and the percentage that attended via word-of-mouth recommendations. Some form of customer survey could be undertaken at each event to determine where they heard about the event and would they attend further events hosted by Mite-E Media. This should also include a satisfaction rating for each event to understand which events are most popular with attendees. If event hosting is something we intend to continue to develop and expand further throughout FNG's business regions, then understanding what customers want and why will be critical to its successful development.

We may also wish to set up some performance measures to evaluate the local news delivery aspect of the Mite-E Media website. These might include:

1. Number of unique users per month (year on year comparisons)
2. Clicks per story/ clicks per advert
3. Advertising revenue per month

Understanding and measuring the traffic on our website should assist us in understanding how it is used and the popularity of stories and/or adverts. This should assist us in understanding how our users use the Mite-E Media website and, thus, assist us in providing a more focused website in the future to ensure its success in our overall portfolio.

Note: A range of possible answer formats could be used to answer this question, including the Balanced Scorecard

SECTION 3

Part 1

Corporate Governance and appointing a Director

Operating a system of sound corporate governance is a key aspect in helping to achieve our objectives and assists in risk reduction. Part of good corporate governance is having a procedure in place to appoint directors to the business. Using the example of the UK Corporate Governance Code (2010), this requires that there should be formal, rigorous and transparent procedures for the appointment of new directors to the board. My first recommendation would be to appoint a nominations committee, which would be responsible for identifying and nominating (for the approval by the board), candidates to fill board vacancies as and when they arise.

In this particular board appointment, it is recommended that the starting point would be for the nominations committee to decide on firstly, whether a new appointment is in fact required at this point in time. If so, it would then need to prepare a full description of the role and capabilities required for this board appointment. We must ensure that this review is independent of the Operating Board and we should ensure that we don't make a "knee-jerk" reaction of appointing someone without ensuring that they are the best fit for the business. For instance, it would be very tempting for us to simply appoint Joe Blindt, because of his knowledge and experience of setting up Mite-E Media. It is important that the nominations committee acts objectively and does not consider creating a board position merely to prevent Joe Blindt from leaving FNG. Any decision made by the nominations committee must be independent and for the benefit of our shareholders.

If we were to make Joe Blindt a director without following the proper nominations procedure, the board may risk being seen as not acting objectively and in the interests of the business. Our reputation in the eyes of stakeholders as a trusted, ethical organisation may be damaged.

Part 2

Benefits of a Management Audit

A management audit aims to identify existing and potential management weaknesses and recommend ways to rectify them. The focus of a management audit should be on improving the effectiveness of management support tools, such as effective management procedures, reporting and communication tools and training.

From his resignation letter, Joe has some concerns regarding our management approach, particularly lack of communication and clear leadership. A management audit could be undertaken to help us identify our management practices in terms of leadership styles and approach to leadership and delegation. The opinions of other managers in FNG needs to be sought to obtain a clearer understanding of any leadership weaknesses. Management communication processes should also be audited to evaluate how FNG's management communication tools are used and whether these are effective.

Delegation was also mentioned by Joe in his letter. We may use a management audit to consider whether our management style creates an unwillingness to delegate as a leadership team, particularly in cases where it would be in our interest to do so (as in this case, where Joe has far more experience of managing Mite-E Media and should be given the management freedom to do so.)

Without effective management processes and procedures, and without allowing managers to operate effectively, then it is unlikely that we will succeed with future acquisitions. Of course, it could be that Joe would find working for us impossible under whatever management style we adopted and whatever management freedom he was allowed. However, a management audit would assist in confirming or denying this.

Part 3

Cultural Integration issues

FNG is a long established, traditional business, built upon a family culture and strong values of trust and high standards. A business such as ours, based within a long-standing industry within Borland, inevitably has a particular culture, based on a more formalised approach to key elements of the cultural web, such as our control systems, power structure, organisational structure and routines and rituals. These have been developed and built upon over a 100 years and therefore, our culture is well-developed and likely to be formalised and structured.

Mite-E Media on the other hand, has only been operating for four years and has been managed and run by Joe Blindt, who clearly is a creative entrepreneur. The culture of Mite-E Media is going to be far less developed and structured than our own, due to both its relative newness and the fact that it is operating in the dynamic digital news and event hosting environment. Its organisational structure is far more flexible than our own and its management style and processes are based on creativity. Therefore, most of the elements of the cultural web of Mite-E Media are very different from our own.

However, these differences should not necessarily mean that the integration of Mite-E Media will not be successful in the long-term, but it does mean we will need to manage this aspect of the business appropriately. If we were to suddenly implement rigid control systems on its staff, such as rigid performance measures, this may hinder its creativity and dynamism and thus cause it to fail. Similarly, forcing our own routines and traditional structure on Mite-E Media is likely to hinder successful integration. Instead, we must analyse the culture of Mite-E Media to understand its differences with our own and to identify areas where there is cultural fit. We must not try to change the culture of this business without first understanding how this would impact on its future success. A difference in culture should not be a hindrance to the success of its long-term integration.

Part 4

Activities to enhance post-acquisition success

Firstly, I would recommend that we carry out a post-completion audit of the acquisition of Mite-E Media. This is essentially a review of a change process to see how well the processes were carried out and whether they could be improved upon for future acquisitions.

Importantly, it would be wise to have a post-acquisition integration strategy in place before the acquisition is finalised. This may overcome some of the issues we have encountered with Mite-E Media and Joe Blindt's resignation, six months after integration. If we are considering buying an entity in the future, we should review where synergies occur or cost savings can be made and where assets can either be sold or enhanced.

Also, we would need to evaluate the impact on the workforce and whether staff can be successfully integrated into our business (if so, what training will be required and at what cost) or whether redundancies need to be made. These need to be agreed before an acquisition takes place.

Part of our initial discussions relating to the acquisition of Mite-E Media was the impact of diversification on risk. This would be a key consideration in future acquisition strategies as diversification can assist in reducing risk and therefore add value to our business.

A further value-enhancing strategy to ensure future successful acquisitions would be to communicate post-acquisition intentions with the proposed acquired entity to prevent mistrust, demotivation and low morale, post-acquisition. Clearly, any risk of acquisition must be assessed thoroughly and evaluated both in the short-term and in the long term.

Importantly, we must also ensure that the corporate objectives of both entities are aligned and that there is a shared common core of unity.