CGMA STRATEGIC CASE STUDY FEBRUARY 2019 EXAM ANSWERS

Variant 1

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SECTION 1

How the competing views of stakeholders could influence strategy

In any organisation, each stakeholder group will have differing desires and needs and by putting those forward to management start to shape organisational strategy. The three groups under consideration by Vita have some competing aims as described below:

Shareholders

The focus of most shareholders is to obtain a return on their investment. This could be short term, in the form of regular dividends, or long term, in the form of an increase in the value of their holding due to the share price being higher when they sell their investment than it was when they bought it. In our case, we have not yet paid any dividends and have stated in the notes accompanying our financial statements that we have no current plans to change this policy. Therefore, the focus of our shareholders is in growing the value of their investment (which they may prefer to dividends dependent on their tax position) and, as you have indicated, switching our production from HJM to Dash should help this by growing our profits. This should also help to future proof our capacity requirements which will help with long term sustainability and, hence, help satisfy our shareholders' needs. Not changing supplier to protect HJM could be viewed as an emotional response rather than a commercial and strategic response. However, there are risks of switching if Dash fail to deliver on their promises and if reputation is damaged by deserting a supplier who has been such an integral partner in the past and helped us with extended credit terms and close collaborative working.

Suppliers

Suppliers' interests are very much built around getting a long-term commitment from us, with a regular avenue for supply, which is what Dash is looking for by offering a good price in return for us moving a large proportion of our production to it. Suppliers also look for prompt payment. If we do switch a large proportion of our production to Dash, it will have the power to hold us to prompt payment schedules.

However, we also have a commitment to our existing supplier, HJM, and by switching to Dash, it could be argued that we are going against the ethos of our stakeholder engagement policy to ensure that we look after our suppliers as much as they look after us. Not only that but switching could be a major risk. Dash has only traded for one year and, without a proven track record, a full switch could be disastrous, affecting customers in terms of quality and security of supply, and shareholders in terms of reducing profit and share value.

Customers

Customers will focus on being able to get the products that they want at a price that offers good value for money and with a satisfactory level of customer service, at a desired quality level and with no interruption in supply.

Moving to Dash could help ensure that stock-outs don't occur. We may be able to pass on to our customers some of the savings that we obtain from moving to Dash, which could encourage further sales and improve margins in the long term and this could also help improve our relations with our shareholders. However, if moving to Dash causes HJM to collapse as a business, customers may view us as 'heartless' and refuse to buy our products for ethical reasons.

There are often conflicts arising when trying to keep one stakeholder happy at the expense of another. Customers may be unhappy at first if there are teething problems caused by the change of supplier – perhaps in the form of poorer quality initially or slower fulfilment. Shareholders may also be concerned in the short term, as there are likely to be initial "one-off" costs associated with changing suppliers.

However, there would also be some positives for all three of the above stakeholder groups if we were to switch our allegiance to Dash, such as the potential to improve the value of our business by increasing margins and building long term sustainability (shareholder benefits) as well as pushing down our selling prices and ensuring long-term continuity of supply (customer benefits).

All in all, there are likely to be competing views amongst different shareholders whenever we look to develop our strategies, but this shouldn't stop us from going ahead if we carefully consider the impact on each stakeholder (group).

The downside risk to prioritising short-term shareholder wealth over the long-term welfare of all stakeholders

In many organisations shareholders are the most important stakeholder and hence the focus of the management team is on delivering gains to those shareholders, whether that be via short-term dividend gains or capital gains in the long-term.

Because of the prioritisation of shareholder wealth and a need to keep shareholders happy in the short-term, there has been an issue with myopia in many organisations that is increasingly recognised as damaging to long-term value creation.

If management do prioritise short-term shareholder wealth over the welfare of other stakeholders, as we potentially see in the scenario with HJM and Dash, they may well create immediate gains in profit which may please shareholders. However, this approach may also have significant potential downside risk.

If Vita switch to Dash, it may create immediate improvements to shareholder wealth as the cost of supply looks likely to fall but it may also jeopardise long-term performance. It would be an extremely risky approach and Dash has no track record of being able to provide a quality product.

Vita does not have a long-term collaborative relationship with Dash. So, improvements in the cost of supply may be eroded if inefficiencies arise, for example higher logistics costs, more returns or greater waste because of losing the collaborative relationship it has with HJM.

Vita also has less trust built up with Dash. It trusts HJM and has evidence that HJM supports it through hard times, acting as a true business partner rather than simple supplier. Vita has no evidence this will occur with Dash which may not offer credit if cashflow is challenged or be as receptive to initiatives to work together on improvements.

Furthermore, Vita has no real reassurance that Dash will continue to be a lower cost supplier. It is possible that Dash will eventually increase the amount charged if Vita become dependent on its supply. Hence switching supplier to increase short-term shareholder wealth may benefit immediate performance but damage it in the long-term.

Other examples of where short-term decision making to maximise shareholder wealth could damage performance in the long-term are decisions such as reducing or freezing staff salaries. This may increase profit in the short-term, but in the long-term lead to a falling of productivity and a lowering of morale levels. This affects efficiency and could also affect the quality of the products produced which would have a knock-on effect on sales if customers stop buying our products because of the poor quality.

Customers could also decide to switch to one of our competitors if they feel that process are higher than they would otherwise be if shareholder wealth wasn't being prioritised.

Hence, although it appears to be prioritising shareholder wealth by taking a myopic cost reduction decision, one might question whether this is likely to reduce shareholder wealth in a broader time frame and whether the actual answer to maximising shareholder wealth is to balance organisational behaviours and look after all key stakeholders as far as possible in the short-term to preserve shareholder value in the longer term.

SECTION 2

Appraisal of the figures and a view on the financial health of HJM

The figures and KPIs provided by HJM provide a useful start point to assess the financial health of the organisation. Obviously before we make any final decisions on investment we would need to see considerably more financial data and consider a likely reasonable value for the business.

However, we are not yet that far advanced and for now only considering indications of financial health at a high level which are summarised below:

Revenue

Revenue is improving over time and growth in revenue is highly impressive. As we know we currently comprise about 80% of HJM's business, so the improvements in revenue are a direct consequence of our own improvements in sales.

Operating profit margin

Expectations regarding operating profit margins do vary depending on the industry in which the organisation operates, and we do not know what operating margin may be typical for HJM's industry. However its margin does appear quite low and is falling over time which is another cause for concern. One might have hoped that with vastly increasing revenue efficiencies and economies of scale would be gained leading to improvements in operating profit margin. That the opposite has occurred is worrying and warrants further investigation.

Gearing

Although gearing was reasonable in 2014 at 26% it has grown significantly over the years and initial assessments may suggest that HJM has had to borrow large amounts to expand production enough to continue to supply Vita's ever-increasing demand. The current gearing level of 62% is high and presents a risk to the organisation. It is important for Vita to understand the debt situation at HJM far better before considering investment.

Capacity utilisation rate

Capacity utilisation rate is currently very high, which Vita is already aware of. The percentage of 97% is to be expected particularly given this is a request to raise funds to invest to increase capacity. In one sense it is good that machinery is well utilised and not sitting idle. However, clearly this has gone slightly too far at HJM which needs to invest to increase production upwards in line with future demand.

Reportable health and safety events

It appears that HJM was once very good at following the relevant health and safety regulations in a way that prevented any adverse reportable events as no events were reported in 2014 and 2015. However, it seems events are on the rise with 4, 8 and 9 events reported in 2016, 2017 and 2018 which is less encouraging and may reflect additional pressures caused by working near to capacity.

Staff turnover

Again, we can see a worrying trend as staff turnover was once very low and is now significantly increasing. The current rate of 22% is cause for concern as high staff turnover could jeopardise efficient production and increase costs in the future.

Payables and receivables days

Further pressure on funds can be seen in payables days. Payables days appear to be increasing over time which means HJM is taking longer to pay suppliers. This could ultimately cause issues with purchasing and again is not indicative of improving organisational health.

Receivables days appear stable, although HJM has offered Vita good credit terms in the past to help with cashflow issues this no longer appears to be occurring.

Conclusion

Overall these summary indicators show a poor and deteriorating picture of the financial health of HJM in some key areas such as operating profit margin, gearing and staff turnover. This should make Vita very cautious about investing in HJM. Much as there is a pressing need to find a way to improve capacity, this may not be the solution.

Should we try to change the culture at HJM if we invest, should it be more like Vita?

A further issue with investing a significant amount in HJM, in addition to the worrying financial picture discussed above, is that it clearly has a very different culture to Vita. This is not a problem per se and has evidently not caused any trading issues to date but, inevitably, Vita may want to consider influencing the culture at HJM if it thinks it can do so positively and hold enough of the share capital to give it the ability and desire to do so. At present 30% of the share capital is being discussed and, although this is not enough to gain control, it is certainly enough to render Vita significantly influential. In fact, one may argue that Vita already is significantly influential given the level of sales made.

As there are issues with operations at present, the low and decreasing operating profit margin, an increase in reportable health and safety events and increasing staff turnover, Vita may feel that it can help HJM by changing the culture to improve performance.

We know that HJM is diligent, studious, lean and efficient but also quite restrictive with some possible oppression of staff views.

Vita may feel that alleviating some working restrictions and allowing staff to give their views more freely, as they would if they worked at Vita, may offer some improvements in elements of performance that are currently struggling, and this may be true to some extent, although it is hard to ascertain from the limited information we have at present.

However, it may also be true that interference in HJM's culture could affect performance detrimentally. New rules and different ways of working could further worsen staff turnover, particularly if HJM are not receptive to the changes and feel Vita is interfering in the way it works. This risk is even more pertinent, given this could affect the quality collaborative relationship enjoyed for so long. Vita would need to be careful here.

Although Vita would hold potentially 30% of HJM this would not give Vita control and so any attempts to change things could cause bad feeling and simultaneously be ignored.

Furthermore, it may be that the culture at HJM works very well given its history and the norms of its country and industry, and that it is not culture that is causing current operational problems.

We don't need HJM to work in the same way as Vita to prosper. It may be that other things, such as the debt structure and tendency to operate so close to full capacity, are the elements of the business that really need focus and change for improvement.

Certainly, at the current stage of just making initial considerations of this proposal, Vita would probably be best placed by just striving to understand the whole business of HJM far better before making any decisions as to whether to invest or change the culture if they do so.

SECTION 3

Steps we should have taken to manage the risks of switching to the new supplier, Studio

It is surprising that Vita has encountered such significant problems in utilising a new third supplier, Studio. We might have anticipated that for such an important element of the business that it would have undertaken a significant amount of work to ensure that the supplier selected would be robust and quickly able to fall into the beneficial ways of working Vita has enjoyed so long with HJM and Force.

However, it does not appear that this has been the case and clearly Vita is now experiencing major issues with the quality offered by Studio and delivery situations.

To have reduced the risks of this happening Vita should have taken the following steps:

- Significant investigation into the capabilities of Studio, including obtaining references from other customers, a factory visit, checks made to its financial accounts and an appraisal of key performance indicators that could impact on its ability to supply reliably.
- Clear communication regarding the expectations of Vita as a customer, detailing quality standards, delivery expectations and any penalties that may be levied in the event of being significantly let down. A robust supply / purchase contract should have been clearly laid out to deal with what would happen if there were any instances of non-compliance.
- Engagement of the new supplier in a manner which does not allow a large element of supply to be jeopardised. For a stock-out situation to be likely in Westia is extremely bad planning which could have been avoided with more sensible logistics planning across all three suppliers. Vita may have benefitted from testing Studio out with small and unimportant order quantities until its reliability was proven.

Should we help Studio introduce the lean systems of existing suppliers as requested

Certainly, we should help Studio understand our ways of working and how we like to operate with suppliers. We should take reasonable steps to help it work in an efficient and effective manner as would benefit our long-term relationship.

However, it is extremely dubious to have one supplier request that we supply exact details of our suppliers (and their competitors) activities and if we do so we could cause considerable trouble within our supply chain.

Gerry Doyle has asked us to supply details of fundamental approaches, the hardware and software used and provide pictures within the premises of our existing suppliers.

Not only do we probably not know all this information, it would be highly unethical for us to find it out and supply it to Studio. Much of the information will be confidential and part of how HJM and Force protect their competitive advantage.

If we give this information away, as is not our right to do, we could put HJM and Force in a worse competitive position and damage our excellent collaborative working relationship forever.

How to communicate with customers about the stock-out and product fault problems

If we cannot resolve the stock-out situation by moving surplus inventory from another country to Westia then we should ensure customers are informed of the problems experienced and reassured that supply will soon be back to normal. If customers think that inventory is not likely to be replenished soon, they may select a competitor's product, so Vita needs to take steps to prevent that from happening. If Vita thinks it can resolve the situation quickly it may be enough to clearly inform customers of when inventory is due. If Vita thinks it may take longer to replenish the inventory and that there is a risk that customers will go elsewhere, then it needs to provide customers with an incentive to wait. It could offer Westia customers a small discount for orders placed in the first week that inventory is replenished, for example.

Regarding the product faults, again, Vita should clearly communicate with customers about the failure issues offering replacements or refunds as required and making it easy for customers to resolve their issues with the products satisfactorily. Hopefully this problem is limited in terms of global sales as Studio is a new supplier and has made few products so far. Vita should be able to contain the problem quite easily and ensureits social media accounts are well managed to deal with any scathing comments as they arise.

Raising more cash

Vita currently has a good gearing ratio, it was 4.0% in 2017 and 4.2% in 2018. There also appear to be several assets against which the bank could take security. This means that if it does want to raise debt it is unlikely to be problematic. Vita has a strong trading history and lenders are likely to consider Vita a strong and stable organisation with a relatively low risk of default.

If Vita does utilise debt it will benefit from the fact that interest expense is tax deductible which reduces the relative cost of debt verses equity.

However, unlike equity, debt does have to be repaid which makes equity a more permanent source of finance. Dividends are unlikely to be expected from the shareholders at present as they have never been paid in the past and the company has indicated that this policy will not change. This may make equity finance an attractive option to Vita at present. Realistically it is unlikely that such a high performing company will have problems raising either debt or equity at present although the market may question why it is raising more equity so soon after listing. The key reason for falling operating profit year on year appears to be investment which shareholders may well view as a positive sign – particularly as they would have expected high levels of investment understanding Vita's current strategy. If Vita can show that it will continue to perform well in the market, innovate and improve sales it should have no problems raising either debt or equity moving forward.

On balance it may be preferable to raise debt at this point. Gearing is very low, interest is deductible and administrative costs are lower than those associated with equity.