CGMA STRATEGIC CASE STUDY FEBRUARY 2019 EXAM ANSWERS

Variant 3

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SECTION 1

Evaluation of the potential major investment projects

Development of a smartwatch

It is quite surprising, given the flood of smartwatch models into the marketplace over the last few years, and given how innovative Vita is, that Vita has not developed a smartwatch product to date.

As the distinction between what constitutes a smartwatch and what constitutes a fitness tracker has become blurred, so the market has been increasingly dominated by smartwatches that offer all the functionality of a fitness tracker, and more, for a similar price.

It seems likely that if Vita does not develop a smartwatch soon, it may be left behind in the market and considered old-fashioned, labouring to develop a product that has been largely replaced by something better.

On the other hand, research and development costs to jump from fitness tracker functionality to smartwatch functionality could be significant. Smartwatches after all do tend to offer more than a fitness tracker and Vita may already have missed its opportunity in this market. Following the smartwatch trend does little to position Vita 'ahead of the market'. Perhaps an alternative strategy would be to simply focus on offering the best fitness tracker possible, reducing costs and securing those people with little interest in the additional capabilities of a smartwatch. However, if you look at purchasing patterns and product developments to date, on balance you might conclude that ultimately Vita will have to offer a smartwatch to compete.

New product partnership with the University of Northfield

Another possible consideration for Vita is to invest in something completely innovative and ground breaking, taking a first mover position in something new rather than being late to join the smartwatch trend.

The product partnership with the University of Northfield is an exciting opportunity to develop a medical heart rate tracking product that has not been offered to the market before. This could allow Vita to set the tone for the market and take advantage of the high prices that can sometimes be charged when a unique product has no real competitors and early adopters are keen to be the latest to try a new product. To launch something so unique could be very profitable indeed and could consolidate their image as innovative, dynamic and forward thinking.

However, Vita has no experience in developing or launching medical devices and could incur considerable costs and time delay trying to bring something of this nature to market.

New medical devices are generally subject to intense government scrutiny in the countries in which they are sold and need to be extensively tested with evidence showing that they do what they claim to do medically. The requirements will be far more onerous than for a fitness tracking device and as well as leading to high costs could take a lot of time distracting management from the running of their core business and change the risk profile significantly.

The rewards for such a venture could be very high, but so are the risks, and if Vita fails in this venture it may face public humiliation damaging sales of its core products.

The different options for financing a major venture of this nature

The organisation has limited cash resources after the levels of research and development expenditure in 2017 and 2018. Although Vita generates a lot of revenue each year, vast amounts are invested into research and development in the ordinary course of business.

Committing to more substantial development spend will therefore require additional funding from grants, debt or equity.

Grants

These are often available from government sources keen to encourage innovation. They tend to carry no cost, if certain conditions are met, and therefore should be explored first. It appears more likely that Vita would obtain a grant for the ground-breaking work with the University of Northfield, rather than the smartwatch work which may not now be considered to be particularly innovative.

Debt

The business has very low gearing and has a number of unencumbered assets, such as debtors. These could be used as security against debt, which should mean that borrowing costs could be low. Interest will also be tax deductible which reduces the relative cost of debt. Obviously, the debt will need to be repaid over several years which will affect future cashflows.

If all the H$250m was raised as debt, gearing would increase to 48% (4% in 2017 and 4.2% in 2018) so this is a significant jump, increasing financial risk. Although this level of gearing would not be extremely alarming in itself, the movement in one year might unnerve shareholders.

Equity

Vita only listed in 2017 and raised considerable cash from issuing new shares. Whilst there is no policy or expectation to pay dividends, and therefore annual costs for equity are low, nevertheless, the market may not agree with this strategy and finding new shareholders might not be straight forward.

This could be discussed with the company's advisors, first to assess whether this option is feasible, particularly as the use of funds could be described as "risky". Should it be possible, then equity might be the best strategy given low ongoing costs and cashflows for the company.

Joint venture

A further option for the Northfield collaboration would be a joint venture where the joint venture itself raises the money from venture capital. Whilst this would solve the funding issue for Vita, it would also mean giving away equity in the joint venture which would limit the upside to Vita from this collaboration and limit the potential control over product development.

SECTION 2

Joint venture or simpler strategic alliance

A joint venture would entail Vita and the University forming a new entity (Vitanorth), whilst each party retains its own current entities. The new entity would work on joint investments but not on any legacy operations.

The joint venture suggested by the University does not currently appear to be particularly fair.

Vita is being asked to provide most of the investment, so needs to ensure the rewards are commensurate with the risk taken. With the current terms, Vita would have to assess whether a 50/50 split of Vitanorth is acceptable, even though this arrangement does allow both parties to bring what they are good at to the table.

It may also be unreasonable to require a route to market in 9 months unless the product development and regulatory processes already undertaken by the University are quite advanced.

Furthermore, the condition about access to suppliers needs further discussion and assessment for reasonableness.

Vita should also consider whether the value that the University is offering to bring to the joint venture is reasonable. Access to the required technology for only 5 years may not be long enough if this is a successful product and the offer of access to researchers according to their availability may add little value to Vita.

It will be beneficial to be able to advertise the product as 'developed in conjunction with the University of Northfield' if the University has a good reputation for research.

So, we may conclude that the joint venture option, as offered, is not attractive to Vita at present but this does not mean that a joint venture would necessarily be a bad idea if these terms were improved.

A joint venture can combine the best elements of two different companies without disrupting the structure or operations of the parent companies and can help organisations to share risk. A new entity is set up usually with its own team of people, with a specific purpose, and owned by the founding organisations. In this scenario the new entity would be responsible for bringing the Beat Saver product to market utilising the skills and expertise of the University, and the assets and cash of Vita. There may be arguments over who fundamentally controls how the new organisation works, and imbalances in what each organisation brings to the venture but there will at least be a dedicated organisation set up to bring the product to fruition.

The alternative suggestion of a strategic alliance offers more of a contractual relationship, with no new entity being set up. Strategic alliances like this are simpler, more flexible and less committed in many ways as no new organisation needs to be set up. However, they can be harder to keep going as commitment may be lower, there is no organisation set up with the specific purpose of the venture in hand and both sides of the alliance may be more reluctant to share confidential information. It can also be difficult to work out ‘who keeps what’ if the alliance dissolves.

If the joint venture terms can’t be improved, a strategic alliance may be preferable for the venture under consideration. Vita knows very little of the University of Northfield and initial indications show it to be quite greedy in terms of what it wants compared to what it is prepared to give to a joint relationship. Vita may protect itself better through a carefully constructed strategic alliance designed to allow both parties to share their unique expertise but free to leave the arrangement if it does not appear to be working out.

The activities and processes to assess the new risks arising from this venture

Risk register

Vita maintains a risk register and updates it and the associated risk mitigation plans, as necessary. Vita should assess the new risks arising from this venture by looking at the different issues that may occur and assigning the probability of occurrence as well as the impact they would have on Vita. Vita can utilise the assistance of the audit and risk committee in ensuring risk is fully understood and can be mitigated where necessary. If the venture presents an unacceptable level to risk to Vita it should not be pursued.

Check the history of the University of Northfield

Vita should spend a considerable amount of time researching the history of the University of Northfield. This may involve finding out more about previous projects of this nature, spending time talking to staff at the university, checking the press for stories about the university and obtaining third party references about the department and key people working within the department. Obtaining this information will allow Vita to better assess the risks that may arise from working with this new partner.

Good communication

As with any partnerships good communication is vitally important and can prevent confusion, ambiguity and bad feeling amongst the parties involved. By setting up robust channels of communication with the university, Vita can obtain all the information it needs to assess the risks that might arise from working together. Being honest and transparent with each other is an important part of a good partnership and the better the communication between the two parties, the lower the risk that a major issue will go unidentified.

Research the marketplace

To reduce the risks arising from launching a completely new type of product into the marketplace, Vita must research the market and understand fully if a product like this is desired. Furthermore, Vita needs to investigate the rules and regulations governing launching a new product of this nature. As it is a medical product, they could be onerous, and it may be more time consuming and expensive than any product launches Vita has experienced before. Vita must ensure the returns will be good and the costs sufficiently low for this product to make a profit.

Obtain additional advice/expertise where needed

Finally, this is a new area for Vita and if Vita doesn't already have the expertise in house to answer all the questions it has about operating in this new space, then it needs to take steps to buy in that expertise in order to go into this venture fully informed and fully equipped.

SECTION 3

Introducing the University to the 'cost of quality'

We know that Vita 'rushed this product to market to keep the University happy' and that Vita 'did not impose [its] usual quality control systems'. It appears the University put undue pressure on Vita to launch the Beat Saver as early as possible without giving due consideration to ensuring the quality was right before the product reached the market.

This rush has caused all the problems experienced now and could have been avoided if the venture had undertaken Vita's usual approach to high quality and careful testing.

Individual organisations approach quality differently. Some choose to ignore it as an issue. Others impose internal controls such as quality assurance (QA) measures, e.g. product inspections. Others adopt a fuller, comprehensive organisational philosophy of quality often involving a Total Quality Management (TQM) approach. Vita takes quality seriously. With its scientific research background, it is likely that the University takes quality seriously too, but it seems that this may be focused mainly on the quality of its research and ensuring that the science is sound. It does not extend to the importance of quality with regards to the finished product and ensuring that we 'get it right first time'.

Therefore, it would appear to be beneficial to educate University staff in the commercial importance of 'the cost of quality'. It refers to the costs incurred to bring a high-quality product to the marketplace and, as a concept, encourages organisations to allocate resources to activities that prevent low quality from arising and save costs in the long run, via better quality control processes. Whilst they don't need to know all the details behind the concept, what is important is that they understand the costs associated with not getting quality right, as well as the costs involved in trying to prevent this from happening. This should help to get them on board for future product launches.

We could draft a high-level estimate of the costs that we will have incurred by rushing this product out before it was ready. Some of the costs will be easy to quantify and explain, for instance compensation offered to effected customers. Other costs will be less obvious but still quantifiable, for example the cost to receive back and replace 100 units. Other costs will be more difficult to quantify and explain, such as reputational damage and the effect on future sales.

We also need to give them an idea of the costs that we would have incurred to help make sure that the product was launched at the appropriate time when it was fully ready and the fact that these costs would have been less than the costs of getting it wrong.

Proposed compensation of H$15,000

It may be argued that payment of H$15,000 to a limited number of customers, (12 in this instance) is a small price to pay to compensate those people for upset caused and potentially protect Vita's reputation if it 'buys their silence'. It may engender goodwill and help retain them as a customer once the improved product is launched. At H$180,000 to compensate all 12 individuals it is a tiny cost in the context of Vita's performance overall. It is in keeping with our commitment to customers that we state in the stakeholder engagement section of our integrated report. It is likely that at least some of these customers would see this as a positive move and an acceptable compensation for the worry caused to them.

However, it appears the customers have not asked for compensation at present and one may wonder where the amount of H$15,000 has come from. Is it wanted by customers, and why that value? It could be a simple waste of money from people who weren't expecting the payment and it is not completely clear if the amount is commensurate to the level of upset caused.

It is also questionable whether 'buying silence' is ethical, if that is the aim of the payment or if that is how the payment would be perceived if news emerged of it happening.

Finally, it could damage Vita's reputation if they payment is viewed as an admission of guilt and lead to further claims for compensation regarding this product and perhaps even other products in Vita's portfolio. If some of the affected customers decided to launch a lawsuit against Vita this could seriously damage our performance and brand.

Instead of opening this 'can of worms' resultant from offering monetary compensation, an alternative approach may be to offer all 100 customers of the trial product a new and improved product free of charge when it is available as well as, perhaps, some other products from our current range. We could also invite them to the University lab to take part in the testing of our improved product to show how much effort we put into testing and to reassure them that the improved product will be free of defects.

Communicating the failed trial to the public

Vita is a listed company and it is very important that matters of this nature are communicated transparently and in good time. It has a good track record of building strong relationships and communicating with stakeholders well, so should be well placed to provide a suitable message to the media.

Vita cannot afford to hide important matters relating to its operations, particularly when they relate to ground breaking new work such as this. Hiding information would significantly unsettle shareholders leading to uncertainty, speculation and potentially damaging share price significantly.

We need to communicate the facts to shareholders and the public, conveying in a professional manner what has happened, why and how Vita intends to fix things moving forward. We also need to emphasise that whilst people became very worried about some of the inaccurate readings, and whilst Vita takes that very seriously, no physical damage was caused to any users. We can explain that we are taking the feedback seriously, that we are in contact with each of the affected customers directly and that we are working closely with them in ensuring their concerns are considered when carrying out improvements to the product.

We can explain that nothing like this has even happened before and set out the precautions we are going to take to prevent a recurrence.

It would be appropriate for shareholders to be contacted directly and for the public to be informed via the press and website, and important that we do this sooner rather than later to demonstrate that we take our corporate responsibilities seriously.

Share price movements

The extent to which Vita's share price will move will depend upon several factors.

Share price may reduce in the short-term as a response to the newspaper article. As Vita has said nothing so far about the issues experienced this fall may be significantly larger than if Vita had spoken to shareholders and the public first about the issue and put out its view of the situation immediately. We need to remember that, although it is customers that have been affected and social media allows people to communicate bad news quickly and sometimes erroneously, it is not the public who ultimately influence the value of a share, but how well the news is received by the market and the attitude of our shareholders.

If we do not communicate with shareholders and this newspaper article is the only information they have, they may decide to sell their shares leading to a reduction in share price.

However, if Vita now quickly addresses the rumours and lays out what it plans to do about the issues share price could rise again as shareholders will be reassured and there won't be any long-term damage to the reputation of Vita and its brand. If, by contrast, the market believes that high profile and expensive law suits are likely to follow, then this could have a serious downward effect on the share price, which would be much more difficult to recover from.

In the long-term Vita must therefore keep shareholders informed and quickly works to resolve the issues so that share price is not affected too significantly. Shareholders need to remember that Vita invests high amounts every year in innovation and new product ideas and innovations will not always work out well.

If Vita communicates well, fixes the current problem and moves on confidently to new innovations and ideas shareholders will be confident that Vita remains a socially responsible organisation with a commitment to putting any mistakes right and developing new and courageous ideas for the marketplace. Share price in that scenario should be relatively stable and could even increase if the market sees that Vita can weather a storm with confidence and bounce back easily.