

CGMA STRATEGIC CASE STUDY AUGUST 2019 EXAM
ANSWERS

Variant 3

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SECTION 1

External social and environmental demands in prioritising our strategic focus on using driverless cars

There are a number of social demands we should consider in prioritising a more focused strategy on using driverless technology. Firstly, its impact on the safety of society in general and road users in particular. An increase in the use of driverless technology is likely to increase safety on our roads, which has huge societal benefits. Reduction in accidents and road deaths will be of huge interest to users. Also, it is likely to result in a reduction in congestion and traffic delays, which currently is of huge inconvenience and costly to road users. If driverless technology does result in the need for less car ownership, then it will inevitably mean savings for users in terms of eliminating the costs of car ownership.

We would also need to take into account negative social influences. So far, there has been limited evidence to prove that road congestion or traffic delays would be as low as predicted, as currently the number of driverless cars on the roads is very low. Convincing users of such benefits will be difficult. There is a general perception that driverless cars are more dangerous than human controlled cars and it may take some time to overcome negative perceptions. There will always be people who want to own their own cars, be they autonomous or not. In addition, we must consider the negative impact on society of the loss of jobs. In the long term we are proposing that Zoom will not need drivers and, looking further into the future, the whole transport industry, including haulage, trains and buses, will also move in the same direction. Therefore, this increasing focus on driverless technology may, indeed, result in a backlash against us from society, who wish to protect livelihoods and jobs.

There are also environmental demands we should consider in putting a greater focus on using driverless car technology. Driverless technology will result in less greenhouse gas emissions on our city streets and this is likely to be a huge positive influence for governments and society. However, this will have to be weighed against the increased need for electricity provision. Local city authorities are likely to welcome the reduction in congestion and reclaiming space in city centres, instead of spending money on building more roads for an ever-increasing number of cars. However, we will need to consider where all of these vehicles will be stored and charged. This, in itself, will be a major expense.

We will need to weigh up the costs and benefits of such a strategic direction. Huge fleets will be needed and also people will likely invest in their own driverless technology for convenience sake, as prices come down in the future. However, to invest heavily at this point in the life cycle of driverless technology means that we may become a leader in the industry.

Business risks of pursuing a strategic direction focused on the use of driverless cars

A strategy focused on the use of driverless cars is likely to be an extremely long-term commitment, requiring significant investment in intellectual knowledge development and development in infrastructure. Its very long-term nature means that future rewards are highly uncertain. At the same time, the potential rewards could be very high. There are clearly going to be some financial risks associated with pursuing a strategic direction focused on driverless car technology. There is likely to be a major cost involved in developing and implementing a driverless car strategy. Although our current fleet of driverless cars has been supplied free of charge by Xota, we will need a much bigger fleet of cars which we will have to purchase, or lease, and the cost of these vehicles is likely to be very expensive, if we are serious in our commitment to this strategy. It is also likely to be costly to purchase the required software packages that we will need to operate the driverless fleet.

Although local and national government will support a commitment to reduced road traffic emissions and improvements in road congestion and road safety, the level of political support is, as yet, quite limited, as governments wait to see how the industry develops. We currently face significant risks in this area, as governments may withdraw support at any time. However, it is likely that, as more driverless cars are allowed onto the roads and more proof can be presented to governments of its long-term societal benefits, then political support for driverless technology will increase and political risk will reduce.

There is also the risk that potential riders will just not buy into the idea of driverless technology to the extent that we predict. This could be caused by many issues, including us not offering the safety and flexibility that riders demand and achieve from owning their own car. The biggest risk is that, in the future, owning their own driverless cars will be the obvious choice for current riders and car owners. Unless we adequately convince people of the benefits of ride hailing driverless vehicles, as opposed to car ownership, then our investment will be wasted.

There is also a risk of reputational damage, particularly if there are safety issues, both in terms of passenger ride safety or cyber-security on our driverless vehicle systems. As this is such an untried and innovative industry in the growth stage of the industry life cycle, there are inevitably going to be challenges such as accidents or data errors. However, these issues will inevitably be highly publicised and, therefore, any accident, injury or potential systems threat will bring harm to our progress, causing delays and more costs. This will bring with it potential risks to our reputation.

However, there is an upside risk to this strategic focus. Should we develop a safe and reliable robust driverless technology system (which of course, will be the ultimate aim of such an investment), then we can be an industry leader and make a significant impact on society and importantly, make significant profits in the long term. The main risk, clearly, is the uncertainty of these potential long-term rewards. Convincing investors and equally importantly, convincing customers, is going to be a major risk to the success of the strategy.

There is also a potential risk that we lose focus on our original core activities – ride sharing. If customers believe that we are overlooking their needs and safety, it may result in loss of business in the short term and loss of faith in our ability to deliver. This then could impact on our core customer base, who we will rely on to drive our driverless technology commitment.

SECTION 2

Valuation of J-AI and difficulties in agreeing a valuation with the owners of J-AI.

For start-ups with little or no revenue or profits and less-than-certain futures, the job of assigning a valuation is difficult. For mature, publicly listed businesses with steady revenues and earnings, normally it's a matter of valuing them as a multiple of their earnings before interest, taxes, depreciation, and amortization (EBITDA) or based on other industry specific multiples such as Earnings Per Share or Dividend Valuation Model. However, these methods are likely to be of little use in this instance.

We could consider calculating how much it would cost to build another company just like it from scratch. The idea is that an investor wouldn't pay more than it would cost to duplicate. We will need to start by assessing the physical assets, to determine their fair market value. The cost-to-duplicate J-AI might be calculated as the total cost of programming time that is gone into designing its software to date, as well the costs to date of research and development, patent protection and prototype development. This could be a useful starting point as it is based on verifiable, historic expense records. The problem with this approach is that it doesn't reflect J-AI's future potential for generating sales, profits and return on investment, nor its intangible assets, like brand value, that it might possess even at its early stage of development. Therefore, it may only be useful as a baseline valuation.

We could also use a market multiple, which would give us a good indication of what the market is willing to pay for a company. This will value J-AI against recent acquisitions of similar companies in the market, to provide a value that comes close to what investors are willing to pay. But finding a business similar to J-AI will be difficult in the start-up market.

For a start-up like J-AI that has yet to start generating earnings, the bulk of its value will rest on its future potential. Therefore, discounted cash flow analysis is an important valuation approach. We will need to forecast how much cash flow J-AI will produce in the future, and then, using an expected rate of investment return, calculate how much that cash flow is worth. We would need to apply a higher discount rate to J-AI, as there is a high risk that it could fail to generate sustainable cash flows. The problem with this is that the quality of the DCF depends on our ability to forecast future market conditions and make good assumptions about long-term growth. In the case of driverless technology AI applications, projecting sales and earnings beyond a few years is a guessing game.

Finally, there is the development stage valuation approach, often used by angel investors and venture capital firms to quickly come up with an estimated business value, based on the venture's stage of commercial development. The further the business has progressed along the development pathway, the lower the company's risk and the higher its value. Again, this approach is only likely to give us a base line for negotiation.

Valuing J-AI is not going to be an easy process and will require a high degree of negotiation between ourselves and the owners. The main difficulty is going to be in

assessing an appropriate and fair price and also convincing the owners that selling to us is the best decision for the business.

Advantages and disadvantages of acquisition of J-AI versus internal development

Advantages

The pace of change and development in driverless technology is rapid and therefore, waiting to develop AI expertise internally is likely to be too slow in this instance. Indeed, we could employ already trained experts in Artificial Intelligence, but to get them up to speed in terms of our own development work with Xota on driverless technology, would be slower than using J-AI, which already work with Xota and have the exact knowledge that we need.

The J-AI developers already have built a knowledge and experience of the technology we will be exploiting and, importantly, have built up a relationship with Xota. It would be very difficult and time consuming if we were to develop this function internally. Investing in a ready-made knowledge base will be far less time consuming and we can use this knowledge base to integrate with our existing expertise in data analytics and autonomous technology. By acquiring J-AI ourselves, it removes it from being a target for one of our competitors. Because of its success so far, if we don't acquire it, then there is a good chance that someone else will.

J-AI has 10 developers already working specifically in this area of driverless technology. Sourcing an equivalent 10 developers with equivalent experience, background and up to speed knowledge would be very difficult to achieve successfully, and likely to be impossible in the time frames we would need to remain competitive.

Disadvantages

We have no prior experience of acquisitions and this will make the process difficult for us and, therefore, we may make costly mistakes in the acquisition process. There are also potential cultural integration problems with any acquisition. We are a service delivery business and J-AI is a technology development company. We have no knowledge of whether the two cultures may integrate successfully and we may find it challenging to manage this team of developers, post-acquisition. They may have a much more open and innovative culture than our own, with high expectations of autonomy and creative freedom, which could cause friction if they are now more constrained by our own cultural expectations. If some of J-AI's key staff did not want to join us on acquisition, this would mean that we would lose some of the benefits that we thought we would be gaining.

This is clearly a successful business with high potential. Therefore, it is likely to be a costly undertaking; significantly more costly than developing internally. The owners will expect a fair price for its future returns and it may indeed be very difficult indeed to persuade them to sell. We would have no such problems with internal development.

It is arguable as to whether we need to have our own expertise in AI to such a level within Zoom. We are responsible for the operation of the cars on the road, not the development of the technology within the cars. It may be worth investing in some expertise to manage the system post implementation of driverless technology on the streets, but the question needs to be asked as to whether we require such heavy investment in the development of the technology itself.

SECTION 3

Benefits of a knowledge management strategy

A knowledge management strategy may well be beneficial to Zoom as it would provide us with a focus on how we acquire, store and utilise the knowledge we have to enable the most effective problem solving, decision making, dynamic learning and strategic planning.

Information and transforming this into knowledge is likely to be a key competitive approach for a dynamic and innovative business like ours that not only exploits data in its day to day operations but also relies on that data to shape its strategic direction. A key aspect of knowledge management is to encourage the sharing and dissemination of organisational knowledge and experience throughout the organisation, allowing everyone use and build on what is already known and thus extend it further to create new opportunities. Therefore, it encourages a culture of sharing and learning.

A knowledge management strategy would allow Zoom to formalise its acquisition, storage and use of the data and information it holds at a strategic level and therefore set the tone from the top in terms of sharing organisational knowledge. A knowledge management strategy would therefore create a knowledge sharing culture and hopefully motivate staff to see the benefit of knowledge sharing and the key strategic importance of the data and information held and used by Zoom. A knowledge sharing culture should also encourage creativity and learning in Zoom which should increase our competitive advantage.

Ways Zoom could exploit the big data analytics as a strategic resource

By collecting information relating to customers, the journeys they take and the traffic and road conditions these journeys are taking place within, we will get a detailed understanding of every aspect of each journey taken, not just start and end place. We could use this information to identify trends and correlations in the data we collect, in order to identify and focus on routes that are safest/ quickest/ most beneficial to users in real time. For example, we may identify a correlation between time of day and road conditions (i.e. recurring rush hour bottlenecks). This could help us to re-route drivers to safer, quicker routes, thus improving our customer service and our customer relationship management. Through the huge amounts of data we hold relating to our customers, such as age category, usage patterns, transaction amounts and journey profile, we will be able to target customers more effectively with the right ride at the right time, thus saving resources in time and effort and pinpointing and predicting their needs with a greater degree of accuracy.

Big Data analytics could allow us to segment our customer base to identify high-value customers, which is essential for fine-tuning our pricing model and our sales and marketing efforts. Data from our apps, and from our AI data, could be used to identify patterns of behaviour, journey preferences, and user frequency. More effective targeting of our services will inevitably lead to cost savings and hopefully increased usage of our service. Contextual information, such as start and end point locations of our customers, time of day of journeys taken, length and frequency of journeys, age ranges and demographic information, could provide valuable correlations. Big Data analytics can be employed to test longer-term tactics and strategies. For example, advertising expenditure.

Ethical considerations of allowing partner organisations to use our customer data

It would not be illegal to allow partner organisations to have access to our customers' data and is common practice in business. However, we must be honest with customers as to our intentions for use of their data. It is also important that we ensure that our partner organisations use our customers' data in an appropriate and ethical way.

A concern of many customers will be that we are making a profit from selling their data to external parties and it may be questionable as to how objective we can be in this transaction. We must prove to our customers that we demonstrate due care in how we manage our relationship with partners and how we expect them to use customer information. We cannot merely deny any responsibility for how partner organisations use information once we have allowed access to it. We have a duty of responsibility to our customers to protect their information. There is certain information that we must have utmost integrity over. The financial information we hold about our customers must be protected. We have to have systems in place to ensure that we do not pass on any sensitive customer data such as addresses which may put our customers at harm or risk. Security of customers, and how their information is used, must be a top priority.

Ultimately, we must be completely open and honest with customers as to how their data will be used. When users sign up to us we must make explicit reference to partner organisations and that their data may be used by third parties. Users must be presented with the opportunity to opt in or out of any use of their personal data.

The value of our financial statements to investors in appraising performance

We are still very much in the growth stage of our business life cycle. Therefore, as a business that requires significant investment in development of systems, intangible knowledge and expertise, the financial statements do not give a full picture of our current position. The financial statements obviously only show the financial perspective of our operations from a historical context. The development work and the hidden benefits of our business operations cannot be seen and in reality have yet to be fully realised. As a business, we are investing heavily for future returns, which could take decades to realise.

Our current financial statement of position shows a business with huge losses. But it is a developing industry where profit should not be expected nor sought immediately. However, the issue for us is that investors in businesses like ours will know this. Therefore, it will not, at present, be a cause for concern for them. They are investing for the long-term future returns we expect to deliver, as do other businesses in our industry, such as Optim.

To address this, we could consider using an Integrated Reporting approach which takes a wider and more integrated information perspective on business reporting. It not only focuses on the financial aspects of the business, but also other aspects such as social, environmental and developmental activities of the business. Perhaps more importantly for Zoom, Integrated Reporting encourages a more long-term, future-oriented approach to reporting, this giving not only our investors, but all of our stakeholders, a longer-term outlook of Zoom's prospects.