CGMA STRATEGIC CASE STUDY AUGUST 2019 EXAM ANSWERS

Variant 4

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SECTION 1

Key risks of entering Noland

When an organisation decides to enter a new country, it will always face new risks, as the environment is unfamiliar and it takes time to gain an understanding of all the factors that will impact on operations.

The magnitude of the new risk faced depends on how different the new country is from the one the organisation is currently operating in. If there are few differences in culture, regulations, conditions, economic factors and the currency is the same, then there may not be too many new risks to deal with other than those associated with extending finance if that is required to support the move.

Risks exposure could be quite short-term in a scenario where the new country is similar, whilst the organisation simply familiarises with the new country and tweaks its mode of operation to best suit the ways of working it finds at the new location.

If conditions are very different in the new country, however, then there will be many new risks to consider. There are indications that Noland is much less politically and economically stable than Jayland, which will lead to new risks.

Firstly, it appears likely that the governing party will change over the next month, as it is widely anticipated that the Modern Purple Party will win next months' election. A considerable amount of risk arises from the fact that what this party will do, if they gain power, is largely unknown. They have only been formed for 2 years and so are unpredictable as there is no precedent regarding their behaviour or long-term values. There also remains the risk, of course, that they won't be elected.

The things that they have pledged in their manifesto may cause Zoom some concern. They have stated they will increase regulation in many areas relevant to Zoom including emissions, human resource management and employment law, which could lead to some difficulties operating in Noland and potentially some additional costs.

The pledge to 'save the planet' could be a downside or upside risk for Zoom. Again, it is unpredictable how this will impact Zoom at this point and exactly what actions will be taken by the government to support this pledge if they come to power. The Modern Purple Party has talked about striving for an increased use of public transport, which could be a positive sign for Zoom if taxis are considered to be 'public transport' by the

Party. If, however, support for public transport refers to support for buses and trains, and does not include taxis, this could negatively impact Zoom.

Another potential upside risk for Zoom relates to the plans to reward organisations that ‘save the environment’. Zoom should be well placed to take advantage of rewards of this nature

They key problem for Zoom is the sheer quantity of what is currently unknown in this scenario. Large scale changes to areas relevant to Zoom could make entry into Noland financially unviable. If Zoom enters Noland without understanding how things will change, it risks embarking on a project that turns out to be considerably less lucrative than projected.

Using scenario planning as a tool to help with this strategic decision

Zoom may wish to use scenario planning to help decide whether entering Noland is a good idea. This will help Zoom conceptualise different visions of how the future may evolve and respond accordingly.

Several scenarios can be pictured and then played out in a virtual environment, with numbers generated to reflect the financial outcome in each different scenario.

These numbers will be based on forecasts and assumptions about different things that will happen in the future. Generating just one set of numbers can limit thinking and mislead decision making. Scenario planning runs several sets of numbers based on what would happen if different circumstances transpired – for example, if the ‘Modern Purple’ party fails to win the election.

Zoom could use scenario planning to identify high-impact, high-uncertainty factors in Noland, ranking those in terms of importance. The next step would be to bring clusters of factors together to identify several different potential future states or ‘scenarios’.

For each scenario, Zoom would then construct a detailed analysis showing the likely financial outcomes and strategic implications, matching those up with the different courses of action that would be taken to optimise performance in these conditions.

Zoom will have to forecast how many cars it will launch in Noland, how many journeys those cars will make, the distances it anticipates being travelled and what fares it will charge, and calculate all the costs associated with this activity. It may start with a scenario that is based on variables that are like those experienced in Jayland, but then start to look at the financial impact if key variables turn out to be different.

Some variables can be forecast with relative accuracy – for example, the number of cars Zoom intends to launch. Other variables may be less certain – for example, it may find predictions for the levels of fares it can charge difficult to ascertain and costs such as licensing and staffing the administrative office may be higher or lower than anticipated.

By developing several ‘pictures’ of how things may turn out, Zoom can improve foresight and, therefore, make a more informed decision about whether or not to invest in the expansion. If uncertainty about one or more important variables makes the difference between a profit making or a loss-making venture, then Zoom should spend time understanding what is most likely to occur with that variable before it enters Noland and work out what things it can do to reduce uncertainty and take control of the situation.

Zoom may discover that expansion into Noland is only going to be financially viable if certain conditions unfold. If a different scenario unfolds it could be a problematic drain on resources. Zoom would then want to look at the probability of those conditions occurring and, if they seem unlikely, and all other more realistic less-positive scenarios seem more likely, it may make the decision not to invest.

SECTION 2

The merits of entering Noland via option one (buying existing company, 'Tyres')

The benefits of expanding into Noland using the existing company 'Tyres' is that it is already up and running successfully in Noland, with a known brand and established customer base. Zoom will have the choice of whether to retain the Tyres brand or rebrand as Zoom at an appropriate time and will immediately be able to generate revenue in this new country by simply letting Tyres carry on as it was for the very short term, post-acquisition.

Another benefit is that the Tyres workforce will be familiar with the rules and regulations of operating in Noland as well as how things work culturally. This could be very beneficial given that Zoom has not operated taxis in this country before, and time spent talking to staff at Zoom and gaining an insight into their knowledge about operating in Noland will be well spent and a good way to understand the taxi industry in Noland better.

Acquiring Tyres also allows Zoom to enter Noland very quickly and, although profit is low, Tyres is not loss making and the valuation of N$25.6m could be deemed a potential bargain as it is pitched at net assets value, which is generally considered to be the method that will generate the lowest valuation.

The merits of entering Noland via option two (setting up from nothing)

The merits of setting up from scratch are that, compared to option one, it is more familiar territory. Tyres operates a different form of taxi company, utilising employed workers rather than a sophisticated software-based network of self-employed individuals as is used at Zoom. Zoom is not set up to deal with employees in this way, and it may be difficult incorporating these employees into the existing processes and procedures at Zoom. They would stand alone as a unique part of the organisation. Zoom would have to answer questions such as "do we train them"?

By setting up from nothing, Zoom can continue to use its well-established approach, using a network of software systems to organise drivers around the country. Furthermore, there will not be the need to integrate two very different organisational cultures which will save a lot of time and effort.

For such a small part of Zooms overall business, time dedicated to managing Tyres could be better spent on things that are core to the successful operation of Zoom. By 'testing the water' with a few cars, and then expanding as and when things work out well, Zoom can take up far less management time, simply seeing this as a slightly different extension of its normal business rather than a distinct unit which needs a different style of management.

Although N$20m initial investment and N$7.4m losses over the first two years means that option two requires slightly more investment than option one in the short-term, it does have a much better projected profit after year two. The anticipated profit from year 3 onwards is N$4.6m per annum, which is far higher than the N$4,000 annual profit at Tyres. By choosing option one, unless Zoom makes some major changes it would be an extremely long time before the cash generated from $4,000 profit per year paid back the initial investment of N$25.6m.

Finally, if Zoom decides that operating in Noland is something it no longer wishes to do, it would be easier to exit the country if option two has been followed. It will still present issues in terms of reputation, and the closure of the administrative office and termination of freelance drivers will have to be managed, but there will be fewer 'employees' affected than there would be in option one.

Financing the expansion

Zoom must raise N$25.6m to buy Tyres or it will need finance of N$27.2m (N$20m set up plus two years of cash absorbed totalling N$7.2m) to set up its operation. Whichever option it chooses to expand into Noland, the amount required early on is roughly the same.

Zoom has three options to finance the expansion:

1) *Using cash resources*. You have intimated that Zoom needs to raise further funds, but at the last statement of financial position date Zoom had N$264.1m of cash resources. Given the cost and time associated with raising further funds via debt or equity, we should first consider if this expansion can be financed out of existing cash, or whether this cash has been allocated to other purposes in the business such as another project or to continue to support the existing loss-making main activities at Zoom.

2) *Debt finance*. Whilst Zoom is loss making, there are still possibilities to raise debt, either in Jayland or Noland. If Zoom acquires Tyres, that organisation owns a fleet of cars that could be used as collateral for debt – indeed, net assets overall are N$25.6m, suggesting that the level of assets (grossed up for liabilities) could be enough security to cover all of the loan. If Zoom starts up its own operation, then there would be no collateral and a parent company guarantee might be required to support a loan. This should be explored.

3) *Equity*. A third option would be to raise further funds from our existing investors explaining our plans for growth. They may be reluctant to make further investment at the moment, given Zoom has failed to generate a profit to date. However, if they can be convinced that this expansion is part of a programme of activities to turn results around, then they may be willing to invest again. Zoom could also attempt to raise funds from new investors, but would again face the issue of convincing them that the investment would generate a good return in the future, an argument that may be difficult to make given current performance.

In conclusion, if the use of existing cash is not possible, I would suggest exploring debt opportunities first, as these will be relatively cheap compared to further dilution for our shareholders.

There won't, however, be the benefit of a 'tax shield' as Zoom is loss making at present and debt, of course, requires repayment, so a key consideration will be how the business is able to repay this debt and its associated interest in the future.

If the acquisition of Tyres is the preferred option, debt repayment may be partially possible out of Tyres' operating profit, although it only makes N$4,000 per annum at present so the contribution that could make to repaying a debt of N$25.6m is negligible.

SECTION 3

Keeping quiet on the matter of incorrect employment status

Although it is tempting to 'stay quiet' on the matter of the classification of our Noland workers, I do not believe this would be the best course of action for Zoom.

Saying nothing in the short-term keeps costs down but we should not be thinking about acting unethically. As you suggest, the government may not notice our misclassification and the consequences, if we do get found out, are just a gentle telling off and a small fine. Irrespective of this situation we could be very poorly considered when we do ultimately get found out creating far more costs from damage to reputation than we have saved by carrying on as we are.

Also, we are new to Noland. Are we sure that the only consequences will be a small fine and gentle telling off? We need further advice on this matter. We have a brief letter from Simmons Solicitors where they outline the penalty for breaching the rule. There are still unanswered questions such as will we have to back date our treatment of employees applying the classification retrospectively and making good any financial differences that have occurred through treating them as freelance when they weren't in this country?

In conclusion, it is not ethical to continue to classify these workers as freelance, when we know they should be classified as employees, just because we think we can 'get away with it' without being noticed.

To do so would reduce trust between Zoom and the Noland government and people, which would be a bad way to start in this country and could do irreparable damage to our reputation.

Pulling out and the impact on reputation

Pulling out of Noland only 3 months after entering the market could damage reputation a little. Any Noland customers who liked the service Zoom offered would be disgruntled, the government may be disappointed, and competitors and critics of Zoom may use this to back up any arguments they may have that Zoom is not a global player and not competent outside of Jayland.

However, Zoom has only recruited 130 drivers in Noland so far and, hence, is a very small operation in the context of the Noland taxi industry.

It may go largely unnoticed if it decides to pull out now and would be easier to do it now than later, when it has built up more of a presence.

Therefore, if Zoom does pull out, it needs to do it in a quietly respectful way that will attract the least attention and reassure investors and the public that there are no major issues at play and that Noland simply didn't work out as planned – it is making a rapid exit to safeguard the performance and valuation of the business and will be looking at other options for expansion soon.

When customers, competitors or the media pick up on Zoom pulling out of Noland and take steps to create a fuss and bring much attention to this, then we will need to have a response ready. Again, the key is to keep things calm, outline that this was just a venture seeking growth that has not completely worked out, but that Zoom has plenty of great plans and that everyone should feel very positive about the future. There should be total openness in all responses and Zoom could look to compensate any locals who spent money to enable themselves to be eligible to work for Zoom and possibly lost the chance of employment elsewhere.

Communicating with investors

External investors expect to receive regular information on the business. This will often include trading updates, financial information, and strategic matters. The right to receive information is often set out in a contract.

The issue described is a serious one that could lead to bad publicity, and/or Zoom pulling out of the country, and potentially a loss of N$20m or more which would fall due under the bank guarantee.

We should therefore be transparent with our investors, and invite them to a presentation where we should set out:

- The issue (employed vs self-employed status)
- The advice received
- The potential options and financial impact of the recommended course of action

In this scenario it would not be appropriate to ignore the issue. The company should communicate with the Noland government and the 130 drivers to see if there is any way the status quo could be continued. The company should set out to both parties the benefits that will accrue if this business continues, but also make it clear that the business will close if no satisfactory solution can be found.

The position with bank debt

The debt we have used to finance this expansion has come requiring security over Zoom assets and with covenants relating to our gearing and cash levels. This places restrictions on Zoom that could disrupt the business and cause issues moving forward. We have already identified that we may breach the cash covenant given our future investment plans and that could lead to the loan being recalled at short notice, causing problems with cashflow and putting at risk the assets the floating charge is over. We may wish to switch to the alternative debt offered. Even though the interest rate is higher, it is less likely to fundamentally disrupt the business as there are no charges or covenants attached to that debt. We do not, however, have information here about whether there are early redemption charges if we were wanting to refinance the debt.

Zoom has not used debt finance before and has raised billions of J dollars of equity finance. Given that Zoom usually reports losses it might be wise to explore equity routes again or even look at whether the current cash balance can support this activity rather than refinancing with more debt, although the latter option may be unlikely given the indications that the cash covenants were about to be broken.