PROFESSIONAL LEVEL EXAMINATION

DECEMBER 2016

Mock Exam 1

BUSINESS STRATEGY

ANSWERS

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1

Marking guide

Marks

		Knowledge	Skills	Maximum
1.1	Discussion/evaluation of competitive position and performance	1	6	
	Numerical analysis (% share of the market, revenue and advertising)	2	4	
	Additional information		2	
	Max			12
1.2	SWOT analysis: evaluation of threats	1	5	
	Max			5
1.3	Evaluation of two viewpoints	2	6	
	Max			7
1.4	Memorandum format	1		
	Evaluation using three headings (market research, strategic impact and risks)	4	12	
	Preliminary conclusions		2	
	Max			16
		11	37	40

1.1 **Competitive position**

	20X1 %	20X2 %	20X3 %	20X4 (estimated) %
Share of regional newspaper industry market by The GC Voice	9.2	9.6	9.5	9.0
Share of local market (ie, the local market being defined as The GC Voice and The World combined)	82.2	83.3	83.3	81.4

The above table shows that in the local Granchester market The GC Voice continues to dominate local circulation (ie, The GC Voice and The World combined) with over 80% of local sales. These figures need to be treated with care however, as there are other newspapers in Granchester which also may have a small current circulation but are nevertheless competitors with some market share and are likely to have the potential to grow.

Also the local market is influenced by the national papers sold in the Granchester area, which may be regarded as competitors to The GC Voice. For example, there may be regional variations on national papers (eg, for local football teams). To the extent that the local Granchester population may choose to buy a national morning paper, rather than the local evening paper, the nationals are competitors and circulation may therefore be influenced by relative prices.

Despite the significance of the nationals to the sales of The GC Voice, the data provided is not helpful in this respect as it relates to the entire UK. More data is needed on the sales figures of national newspapers in Granchester and surrounding areas.

While the table shows that The GC Voice continues to dominate the local market, it also gives an indication of changes in its competitive position with respect to The World over the period 20X1 to 20X4.

Specifically, The GC Voice gained market share in 20X2 and maintained this position in 20X3. However, in 20X4, there was a significant loss in local market share compared to The World. This was partly because The GC Voice decreased its circulation and partly because The World increased its circulation.

It may be that the increase in circulation of The World was due to the free copies distributed rather than normal competitive conditions. Nevertheless, there is a significant local competitive threat, irrespective of the underlying cause.

The data showing the share in the regional market has The GC Voice with a declining market share ending up at 9% in 20X4. In terms of competitive position however this tells us very little as The GC Voice is not really competing with other regional newspapers. The data is useful however as a benchmark of performance and is referred to again below.

Performance

Circulation

	20X1	**20X2**	**20X3**	**20X4 (estimated)**
The GC Voice	129,000	125,000	115,000	105,000
		(–3.1%)	(–8%)	(–8.7%)
The World	28,000	25,000	23,000	24,000
		(–10.7%)	(–8%)	(+4.3%)
Regional newspaper industry	1,397,000	1,299,000	1,216,000	1,165,000
		(–7%)	(–6.4%)	(–4.2%)
National daily newspaper industry	12,152,000	11,790,000	11,496,000	11,148,000
		(–3%)	(–2.4%)	(–3%)

% figures in brackets show year-on-year change

The table above indicates the performance of The GC Voice relative to its major competitor groups in terms of circulation. This indicates that the circulation of The GC Voice has fallen more substantially than any of these three groups in 20X3 and 20X4. This is however a short-term trend and other explanatory factors would be needed to make a fuller assessment including:

- A longer-term trend – as 20X1 might represent an unusual 'high' for The GC Voice.
- Changes in price. Competitors may have decreased price (perhaps to zero as for some copies of The World) while The GC Voice has maintained the same price.

The World has only reduced its price (selectively) 'in the past few months'. More detailed analysis on the impact on sales of The GC Voice is needed over this sub-period, in order to give a better indication of the longer-term impact, as the full year's figures would not fully reflect this new competition.

Circulation is, however, only one measure of performance. Aspects of financial performance also need to be considered.

Revenues

An examination of revenues generated by The GC Voice indicates that revenue from newspapers have declined in line with sales as there has been no price change. As already noted this decline is substantial and is of concern.

Of even more concern is that advertising revenues have fallen even more sharply than newspaper sales revenue. This is indicated in the following table:

Percentage of revenue generated by newspaper sales and advertising

	20X1	**20X2**	**20X3**	**20X4 (estimated)**
	%	%	%	%
Revenue				
Sales of newspapers	20	20.4	20.8	21.3
Advertising	80	79.6	79.2	78.7
	100	100.0	100.0	100.0

Another way of looking at the relative decline in revenue streams is that over the period 20X1 to 20X4 revenue from newspaper sales fell 15% (1 – 13.6/16) while advertising revenues fell 21.4% (1 – 50.3/64).

The relative decrease in advertising revenues compared to newspaper sales is not substantial but it is a worrying trend. Of more concern is the absolute decrease in advertising revenues of 21.4% over a three-year period.

Operating costs

A newspaper is likely to have substantial fixed costs as the editorial content is more or less the same, irrespective of how many newspapers are sold. The fact that some savings have been made might indicate cost reductions have been achieved. If this has meant reduction in quality it may have contributed to the more substantial decline in sales in 20X4. More information is needed in terms of market research to establish the link between journalistic quality and sales volumes (but this is considered in part 1.3 below).

The printing costs are likely to have fixed cost (eg, labour, depreciation) and variable cost (eg, newsprint) elements. Perhaps as a consequence, printing costs have decreased by only 11.8% compared to the decline in sales volumes of 18.6% over the period 20X1 to 20X4.

Marketing and other costs appear to be entirely fixed as they have not changed over the period.

As a consequence of high fixed costs, there is high operating gearing, thus operating profit has fallen 58% (1 – 8.4/20) over the period 20X1 to 20X4 while sales revenues have decreased by 20% (1 – 63.9/80) over the same period.

Summary

It is clear that the decline is due, in part, to difficult industry conditions as other newspapers have also suffered declining circulations. Nevertheless, the fall in sales of The GC Voice is greater than any of the benchmarks which indicate that the decline is not entirely explained by industry-wide factors. Comparisons with The World are inevitably crude but, to the extent to which they can be relied upon, it would also appear that local market conditions in Granchester do not explain the decline of The GC Voice.

The disproportionate decline in advertising revenues is further evidence that financial performance is even weaker than editorial/circulation performance.

More external information is needed to improve benchmark comparisons (market research, breakdown of industry data to local level) and more internal information is needed to highlight areas of underperformance (journalism quality, marketing, operations, day-by-day sales analysis).

1.2 **Competition from new entrants**: Especially free newspapers. Free newspapers would enable rapid market penetration into the Granchester area and may quickly capture part of the market of The GC Voice. This would be more damaging still if the newspapers were evening editions. A national chain or another regional paper may be able to give financial support to such a venture and may have existing print and distribution facilities. The fact that Granchester is a large city without a free newspaper may indicate that such a market entry has a high probability of realisation.

The World increasing the number of free copies: While more evidence is needed, there is some indication that, due to the policy of providing some free copies, The World has increased its circulation in 20X4, while The GC Voice has reduced its circulation in the same period. If the free copies were to be increased in volume then the impact on sales of The GC Voice may be more substantial.

National newspapers: There is a competitive threat from national newspapers which have much greater circulations and economies of scale than local papers. The GC Voice is distinguished from national papers in two respects: first, it is published in the evening and hence has a different 'news window' in terms of timing; and second, it has a local focus to the news. However, to the extent that national papers have regional editions for each area of the country, then they present a threat to The GC Voice which may be increased by better quality journalism.

Internet: The growth of online news media is a growing threat to all of the newspaper industry. The threat is two-fold, in that people may buy fewer newspapers if they can access news online, and that advertisers may prefer online media where a wider variety of images and features can be brought to the attention of consumers.

Small local newspapers: There may be growth in competition from the smaller newspapers in Granchester which may develop and take market share, particularly if they are free or low priced.

Population changes: The population around the Granchester area is substantial but it may continue to decline over time, thus reducing the customer base.

1.3 The responsiveness of circulation to price needs to be considered by market research. One of the difficulties with such a regular purchase is that people's initial response to a price change may not be the same as their response over time. For instance, a price increase may be followed by an initial decline in sales as people resist the increase, but over time they may restore their demand patterns.

The issue here however is twofold. A change in price may alter circulation and this will directly affect the revenue generated from the sales of newspapers. However, there is a secondary, and more important, effect in this industry, which is the increased advertising revenues that can be generated as circulation is increased.

The case for lower prices (the marketing director's view)

- Higher circulation means more advertising revenues.
- Compete more with free copies of The World on a like-for-like basis.
- Need to restore readership following reductions in circulation.

The case against lower prices

- May give perception of poor quality journalist content. This may (1) discourage advertisers who do not want to be associated with poor quality papers (2) discourage readers and therefore push down demand rather than increase it.
- If demand is inelastic then revenues from newspaper sales will fall.

The case for higher prices with improved journalism: (the editor's view)

- If demand is inelastic then revenues from newspaper sales will increase.
- Higher quality journalism may attract new readers.
- Higher quality may attract advertisers.
- Distinguish The GC Voice from The World.
- Compete more with the sales of Nationals in the Granchester area.

Disadvantages of higher prices with improved journalism

1 Needs more market research as presenting a package of two new features:
   - Higher price
   - Better journalism

2 People may not be willing to pay more particularly when some free copy is available.

3 People may not want 'better' journalism if it means a change in the style or language of the paper.

4 Costs will increase to attract more or better journalists.

5 A higher quality higher price newspaper may bring The GC Voice into more direct competition with national newspapers in the Granchester area.

1.4 **Memorandum**

To: Directors of Newsville plc
From: External consultant
Subject: Evaluation of strategic proposals
Date: XX/XX/XX

Strategy 1: Free local newspaper

(a) **Market research**

A free local newspaper is a new venture and thus market research may be difficult to obtain. Nevertheless, both desk and field research may give a reasonable idea.

Desk research

Obtain data on:

- The success of free newspapers in other cities that are similar to Granchester in terms of population and incumbent paid-for newspapers (eg, from the press association).
- Whether the success of free newspapers in other cities impacted on the circulation of paid for newspapers in that area.
- What features and style the free newspapers have that have proved successful.
- To what extent free newspapers are read (eg, just the sports pages; a brief glance; or reading in detail).
- The impact on The World's circulation arising from giving away free newspapers would indicate the success of this type of operation.
- The success of small-circulation, free newspapers in the Granchester area.
- Whether there is any noticeable impact on advertisements appearing in The World following the free distribution policy.
- Whether there is any noticeable impact on advertisement fees for appearing in The World following the free distribution policy.

Field research

Questionnaire surveys amongst existing readers may ascertain whether they would:

- Be likely to obtain and read a free newspapers.
- Intend to stop buying other newspapers and if so whether this would include The GC Voice.
- Intend to place personal advertisements in a free newspaper and would this be in preference to adverts in The GC Voice.
- What style and contents they would like to see in a new free newspaper.

Questionnaire surveys of non-readers might also be appropriate, particularly if the answers are compared on a statistical basis to answers from readers of

The GC Voice. This may indicate the extent to which Newsville would be widening its readership and thus its advertising base.

Another form of field research would be a trial testing of a free newspaper for a few weeks or in only part of the region. A problem with this strategy is it would detract from the initial impact of a new launch and may be half hearted unless sufficient resources can be committed.

(b) **Strategic impact**

This would depend on the measures used to determine success.

Two possible (and interdependent) aspects of success would be:

1 Circulation achieved (specifically the 'readership' volume as any amount of newspapers could be given away).

2 Advertising revenues generated.

Of these, the circulation/readership might be regarded as an early hurdle for viability as advertising revenues might take a little longer to become established as advertisers need to be assured of the value of the new paper. Also, advertisers may be locked into existing contracts and may not be able to move easily in the short term.

There are however some difficulties in these measures:

- The incremental advertising revenues generated need to be measured against the incremental costs of publication including editorial, printing, marketing and distribution costs.
- A break-even level would be one measure of viability although this could be measured after an initial period of losses to penetrate the new market.
- The net revenue impact needs to be assessed in terms of lost sales and lost advertising in respect of The GC Voice in order to give a wider picture of viability to Newsville.
- There may be opportunity costs, eg, if contracted-in printing is used in future there may be lost revenues if the printing of the new free paper consumes significant printing capacity.

Strategy deters competition – if Newsville does not launch a free newspaper then another rival company may do so and damage sales of The GC Voice anyway. In this respect the free newspaper may prevent a competitor from occupying this product-space in the market. Strategic impact therefore needs to be seen in the context of competitors adopting the same strategy.

(c) **Risks**

- The World may retaliate by launching its own free paper.
- The World may expand the number of free copies particularly around the time that Newsville launches its paper. The idea would be to prevent it getting a 'toehold' in the market.
- Front end costs may be sunk if the project fails.

- Exit costs may be high if the project fails.
- There may be reputational loss to The GC Voice if the project fails.
- There may be an unexpected impact on the circulation of The GC Voice despite market research.
- A high initial circulation may not be followed by advertising but there may be a delay in realising this with significant costs being caused in the meantime.
- Market saturation may occur with an additional newspaper and perhaps competitor reaction. This may damage all participants in the Granchester area newspaper market.
- Liquidity risks from investment in new project in advance of new advertising revenue streams.

Strategy 2: Launch of *Eighteen+*

(a) **Market research**

This is a new venture where the target market is well defined but it leaves open the issue of readership (will anyone read the paper?) and advertising capacity. The market research objective would initially need to attempt to quantify these two issues.

Desk research

Obtain data on:

- The newspaper and magazines currently being read by the target group and the extent to which such publications address the issues that *Eighteen+* intends to aim at.
- Any 'official' literature, or other literature available in the education sector, which covers the issues of exams and universities in a similar manner to that intended by *Eighteen+.*
- Where advertisers such as universities and employers currently place advertisements.
- Size of market of students/pupils in full time education (national statistical office).
- Spending ability and patterns of target market if available from existing research groups.

Field research

Schools and students:

- Approach schools colleges to assess their willingness to distribute Eighteen+ to students/pupils (write to a sample of head teachers or college heads).
- Questionnaire survey to students/pupils to assess whether they would read a free magazine with indicative contents.

- Questionnaire survey to students/pupils to assess what contents would encourage them to read Eighteen+.
- Questionnaire survey to provide new evidence of spending ability and patterns of target market.
- Consider whether there is an additional market in second/third readers of Eighteen+, eg, parents, siblings.
- Questionnaires to be divided by sub categories (eg, gender, age (16,17,18), geographical region, establishment, ie, school or college etc,) to see if there is a different level or type of response which may influence the nature of the advertising.
- Issue a copy on a limited trial basis and survey the reaction (eg, in a particular region or in selected schools/colleges).

Advertisers

- Approach universities and employers to ascertain whether they would be interested in advertising in Eighteen+ (eg, questionnaires; face-to-face interviews).
- Approach universities and employers to ascertain their advertising budgets and amounts that they might be willing to spend.
- Approaching other potential advertisers to assess the level of interest (eg, advertisers in other older teenage magazines).
- Offer free advertising on the trial issue in return for monitoring the response.

(b) **Strategic impact**

As with Strategy 1, impact needs to be seen in terms of both (1) readership/circulation and (2) potential advertising revenues.

Also incremental costs need to be compared to incremental revenues. Again, initially any comparison may be unfair as *Eighteen+* needs to break into the market. In a steady state however, viability may best be judged by the ability of advertising revenues of *Eighteen+* to cover incremental costs and thus break even.

In this instance there would appear to be few interdependencies of circulation or advertising revenues with The GC Voice. However, there are likely to be economies of scale with respect to printing costs and administration. There may be limited editorial synergies.

Distribution costs are however likely to be very different as *Eighteen+* is national distribution and The GC Voice is local. Also, as distribution is outsourced, this is likely to be a significant new cost with few scale economies or economies of scope linked to the existing distribution system.

A key issue to control incremental distribution costs is whether *Eighteen+* is distributed through schools/colleges or to individuals. The lower cost option is clearly to schools/colleges as this enables far fewer deliveries of larger numbers. This, however, gives dependence on schools/colleges being willing to implement effective internal distribution systems so the paper reaches its target audience.

Seasonality is an issue because universities would probably only be interested in advertising at key times in their recruitment cycle, thus any assessment of viability needs ideally to have a full cycle.

Publishing frequency – monthly may be viable but fortnightly may not be depending on initial response. Monthly may be initially a way of breaking into the market.

There may be opportunity costs, eg, if contracted-in printing is used in future there may be lost revenues if printing *Eighteen+* consumes significant printing capacity.

(c) **Risks**

If the project fails, then many of the financial risks are similar to those noted above for Strategy 1 (eg, sunk costs, exit costs, front end cash outflows with delayed revenues).

The reputational risks of failure may however be less as *Eighteen+* is a segregated market from The GC Voice with limited local association and less likelihood of retaliation by competitors.

The uncertainty over readership and advertising revenues is however much greater than with Strategy 1 as this is an unfamiliar readership both in nature and in geographical coverage.

The distribution of the paper also gives more uncertainty of costs.

If the venture is successful there would appear to be few barriers to entry that would prevent competitors entering the same market and competing away any profits. Even if first mover advantage enabled *Eighteen+* to maintain its position as leader in this market, this may not be enough to sustain long-term viability if there are new entrants.

Conclusion

Both strategic proposals present significant opportunities for Newsville to enhance its current performance. Regardless of which proposal is accepted (if either) it is evident that greater market research will be needed in order for a fuller assessment of both proposals to be made. The benefits offered by both proposals are countered by the fact they involve significant levels of risk. In some ways Strategy 2 appears to represent the riskier of the two due to the inherent dangers of entering an unknown market. The Board's attitude to risk is likely to be an essential consideration in determining which proposal is the most appropriate.

2

Marking guide

			Knowledge	Skills	Maximum
2.1	(a)	Financial and non-financial impact of losing Henton contract	2	6	
		Max			7
	(b)	Consideration of factors in deciding whether to accept the price reduction		8	
		Max			7
2.2	(a)	Ethical issues and MS's employees	2	5	
		Max			7
	(b)	Change management and mitigation	3	6	
		Max			7
	(c)	Evaluation of Jane Wise's suggestion	2	5	
		Max			6
			9	30	34

Marks

2.1 (a) **Financial impact of losing Henton contract**

MS's total revenue is:

£200 × 200 employees × 250 days = £10m

Of which the Henton revenue is

£200 × 75 employees × 250 days = £3.75m

Thus, the downsizing in terms of volume of activity is 37.5% which is substantial. This assumes that employees are equally productive on both types of contract in terms of days employed to days charged. However, if this is the case, then of the 200 employees, 75 would need to be made redundant if the Henton contract were to be lost in full on 1 January 20X8, assuming there is no compensating growth elsewhere in the company.

In terms of the impact on profit, if the Henton contract were to be lost in full on 1 January 20X8, and there is no compensating growth or price changes elsewhere in the company, then the situation would be as follows:

	20X7 total	*Loss of Henton*	*20X8*
	£'000	£'000	£'000
Revenue	10,000	3,750	6,250
Labour costs	4,000	1,500	2,500
Raw material costs	2,500	937	1,563
Fixed costs	2,000	–	2,000
Profit	1,500	1,313	187

This assumes:

- Labour and raw material costs occur evenly over the Henton contract and other customers.
- Compensation for travel costs paid by Henton are ignored.
- Fixed costs will not reduce with the Henton contract being lost.

Therefore, while the company will still generate a profit without the Henton contract, the margins will be much smaller than was previously the case. Also, this is only the case if the redundancies can be made in full to compensate for the loss of trade from Henton. The calculations also ignore any one-off redundancy costs to be incurred in 20X8.

Non-financial impact of losing the Heaton contract

Other than the immediate financial impact from operating activities, there are the other consequences of downsizing to consider. These include the liquidity problems of finding enough funds to pay redundancy costs.

There may, however, be some positive financial effects if surplus assets can be sold off or spare capacity can be utilised in some other way.

Non financial effects may include:

- Loss of reputation – if it is widely known that MS has lost the Henton contract there may be a perception that MS has been at fault or its work has been found inadequate.
- The scale of the company is smaller so it has less market presence to attract customers.
- Economies of scale may be lost, thus the reduction in costs may be less than *pro rata*. This might include: quantity discounts on raw materials; loss of access to larger suppliers; flexibility in work scheduling where many jobs are being carried out simultaneously.

(b) **Price reduction**

	20X8 *without Henton*	*Henton (full year at current activity level)**	*Henton (50% of activity)*
	£'000	£'000	£'000
Revenue	6,250	2,812	1,406
Labour costs	2,500	1,500	750
Raw material costs	1,563	937	469
Fixed costs	2,000	–	–
Profit	187	375	187

The first column assumes that the non-Henton part of the business continues at its current level of activity and prices as in part (a) above.

The second column calculates the effect of continuing the Henton contract at reduced prices but at the current level of activity.

The third column calculates the effect of continuing the Henton contract at reduced prices but with the level of activity falling from its current level to zero over the year (and therefore averaging half of its current level over 20X8).

It can be seen that the continuing of the Henton contract will double profit in 20X8. There may also be additional favourable effects:

- It would provide an adjustment period where the scaling down of activities would take place gradually over a year rather than almost immediately.
- The implementation of the new procurement strategy may be delayed by Henton, thus providing work for MS beyond 20X8.
- There may, despite the indication of Henton's procurement director be a real option for more work in the future, if the business contact is maintained (eg, if Henton's new strategy is not working out).
- There is a liquidity advantage from deferring redundancy costs.
- Some staff may leave due to the uncertainty thereby reducing eventual redundancy costs.

MS should also consider the following:

- Henton's motives for the change in procurement strategy – Debbie Cheng could be using this as a bluff to put pressure on prices.
- As a new employee Debbie's actions may be unpopular internally and the strategy may prove to be shortlived.
- Due to the peaks and troughs of business, it would be unusual for a large building company such as Henton, to only operate with employees. At peak periods Henton is still likely to require some contract work and this will give it more flexibility to cut costs in recessionary times.
- Given its size, some fixed costs may be saved as a result of the loss of the Henton contract.

2.2 (a) **Ethical issues**

The proposals to downsize the number of workers MS employs and/or introduce a pay freeze raises a number of ethical considerations.

Downsizing

Fair and transparent redundancy process

The process of selecting appropriate employees for redundancy is considered in greater detail in part (b) of this answer when change management is discussed. From an ethical perspective it is important that the directors ensure that any redundancy selection process is fair and transparent. There is an inherent danger that employees are unfairly selected for redundancy due to management not adhering to a pre-determined redundancy criteria.

In practical terms this means that those employees not selected for redundancy should only be chosen on the basis of the businesses needs and not on the grounds of personal friendships with the founders or length of service with the company.

Redundancy payments

Jack Fegan has raised concerns over the MS's ability to meet redundancy payments at the current time. Clearly, any failure to make redundancy payments when due raises legal considerations for the company. From an ethical perspective it could be argued that MS has an obligation to reward employees affected by redundancy at the time of the termination of their employment. Employees will have worked in good faith in the expectation of being treated fairly by the company in all future dealings. An inability to pay employees redundancy payments when due is a breach of this implicit agreement.

Pay freezing

Employees leave

Jane Wise's suggestion to freeze the pay of those employees remaining with the company increases the likelihood that skilled workers may decide to leave MS. Instigating a pay freeze may be regarded by some workers as being an unethical move especially if in the longer term this decision is not reversed. Potentially it could be seen as an attempt at constructive dismissal, possibly in the hope that employees may decide in the long run working for MS is financially unviable and seek employment with rivals, without MS having to fund redundancy payments. Furthermore, affected employees may feel a degree of betrayal if the founders of MS do not reduce or freeze their own pay, or if the pay freeze is not carried out uniformly.

Quality of work

A pay freeze may serve to demotivate MS's employees as the incentive to complete work to the required standard is reduced. Although this may appear to represent an operational issue it is likely that this point can be regarded as an ethical consideration. As MS operates in the building sector it is highly likely that any fall in the quality of workmanship increases the risk of injury or even death to customers if work fails to meet the necessary quality standards. Therefore, the need to balance suitable levels of pay against the need for workers to produce safe output is of paramount importance to the directors of MS.

Punitive effect

In the event that MS introduce a pay freeze for all staff across the company, there is a danger that those employees who have had limited involvement with Henton may feel that they are being punished for the failings of those workers which have traditionally been involved in the contract. Although not intended as a punitive measure, a pay freeze could be regarded as being an unethical move by those workers which predominantly worked for Jack Fegan on the small to medium sized building jobs.

(b) **Change management issues**

The style of change management needs to be appropriate to the nature of the change.

This is not planned change, but a sudden change in the environment. The change is therefore reactive rather than proactive by the company.

In this case the change is fundamental in scale, although it does not fundamentally alter the nature of the business or the way it is carried out. Nevertheless, the change is of a 'transformational' nature.

The transformational and reactive nature of the change therefore classifies it as 'Forced Change', according to the Johnson, Scholes and Whittington model. Moreover, given the circumstances it needs to be implemented quickly.

In terms of managing the impact of change then there are very different effects for employees staying with the company and those being made redundant. While there is a major effect on those being made redundant, in the longer term they will not be employees so, while the leaving process needs to be managed carefully, there may be limited long-term effect on motivation of these workers. In the short term however all employees may be affected by uncertainty whilst the changes are implemented.

There is also a danger of focusing only on change with respect to employees. The changes may have an adverse effect on MS's reputation. Other stakeholders should also be considered including:

(1) Continuing customers – who need to be reassured that they will continue to be delivered a quality service

(2) Suppliers – that while quantities ordered may be reduced in future, there will be a continuing relationship.

However, change does not only involve people, but also:

(1) Changes in management structure due to the smaller scale of the business. The Henton contract may have required different types of administration (eg, settlement terms, recording of operations, quality control reviews). These functions may no longer be needed.

(2) Change in culture. Although the merger took place in 20X1 there may still be elements of the two separate cultures in existence. A particular issue in this case is that the two separate cultures of Sean and Jack may persist and the customer base that is lost relates very largely to Sean's business. There may therefore by a group conflict between:

- The two sets of previous employees
- Jack and Sean

To the extent that the two groups have integrated and that there are new employees recruited since 20X1 then this cultural conflict may be reduced.

Mitigating the change management problems

A change plan is necessary to design and implement the change process in the most effective manner. Communicating the plan for change to all stakeholders is critical and should be a continuous process.

The need for change arises from the loss on the Henton contract. The communication of the cause for change and that it is external to the business (the 'external enemy') may improve the acceptance of change amongst employees.

A key issue is the scale and timing of the loss of business from Henton over 20X8 (assuming that the price change is accepted). The reduction in the workforce needs to match the fall in sales over this period.

The manner of implementing redundancies is also important, eg, voluntary or compulsory. This will affect timing but also the mix, eg, voluntary redundancies first and then compulsory, but also consider natural wastage. Minimising the need for compulsory redundancies may reduce the level of resistance.

Selection of which employees for any compulsory redundancies is likely to be important as the best employees are currently working on the Henton contract which is disappearing. Legal rules regarding selection of employees for redundancies must be complied with, which may make it difficult to make the less able employees currently working on household jobs redundant. Trade unions or employee representatives should be involved at an early stage so they feel like they are being consulted.

There needs to be rapid implementation, but this needs to be consistent with satisfying remaining jobs for Henton over the year. The change requires continuous evaluation. For instance, Henton's strategy may change in nature or scale during the year. It may be that the effects could be moderated if Henton is taking on new staff, they may employ some MS employees – thereby reducing the need for redundancies and cutting redundancy costs.

Barriers to change in these circumstances are likely to arise from uncertainty. A quick and clear decision will enable those who are not being made redundant to avoid the need to feel threatened and thus they may not resist change.

Those who are to leave may be demotivated but their term of employment is limited and they will at least have more time to plan their departure and alternative employment. Meanwhile their work may need to be closely monitored.

(c) **Jane Wise's suggestion**

Jane Wise's strategy is to cut selling prices and cut costs per unit but, as a consequence, reduce quality.

The reduction in selling price is intended to increase the volume of activities (in terms of days charged out). This assumes that demand for building services is price elastic and that the lower price will have a disproportionate effect on demand.

Market research is required in order to substantiate this notion. This might include:

(1) Assessing customer resistance to previous price changes

(2) Assessing the number of failed quotes for work and whether price was mentioned as a factor

(3) Reviewing the prices charged by rivals (eg, where customers disclose other firms' quotes on a proposal)

If demand is elastic, and therefore responsive to price, then the advantage of this scheme is that activity levels will be raised and redundancies reduced and therefore, as far as possible, maintaining the workforce as employees.

There are, however, a number of problems with the proposal:

(1) The business model to date has been to offer a good quality service with good quality raw materials. This proposal will therefore breach the way the company has historically sold itself to customers.

(2) The price may be a signal of quality (perceived quality pricing) if the price falls, then the perception of quality may fall and demand may actually fall rather than rise.

(3) The margin is likely to fall per labour hour with the price cut. The cost-cutting would therefore need to be consistent with the price cutting in order to restore the margin. To the extent that the new margin is lower, then increased sales volume would be required.

(4) The price cutting may be unnecessary, as if customers are loyal to MS, they may be willing to pay the higher prices. New customers or those customers lower in the socio-economic groupings may however respond positively to a price cut. Some form of flexible pricing such as price discrimination may allow MS to offer a high price, high quality service to some customers and a lower price, lower quality service to others.

(5) The competitive position of MS would be affected.

    The new proposed strategy takes the view of lowering price and but reducing quality. Quality is a question of perception where it is not always readily observable by the customer. It may be that demand will be based largely on the fact that the service and materials used in the past have been good quality.

    - The relative price difference between companies is more observable than quality.
    - Short-term and long-term price-quality effects may be different as reputation may ultimately be affected.

3

Marking guide

			Marks		
			Knowledge	Skills	Maximum
3.1		Internal factors limiting the development of JudoJuice	3	7	
		Max			9
3.2	(a)	Memorandum format	1		
		Explanation of advantages and disadvantages of Cappen's structure	2	4	
		Max			6
	(b)	Benefits and problems of Cappen working with Adam	1	5	
		Max			5
	(c)	Evaluation of the desirability of a joint venture with Adam	3	4	
		Max			6
			10	20	26

3.1 **Internal factors**

Two issues arise in this context:

(i) Whether Adam would be able to successfully develop, produce and sell JudoJuice in the context of packaged volume sales to intermediary customers (eg, supermarkets)

(ii) Whether Adam could achieve the above independently, but would be more successful working in co-operation with a larger partner (eg, due to scale problems)

Adam appears to have successfully developed JudoJuice as a successful product with consumer appeal. However he still faces a number of problems:

(1) Development of the container
(2) Establishing large scale production operations
(3) Marketing and distribution

(1) **Development of the container**

- **Financial resources**: It seems doubtful whether Adam has the financial resources to complete the development of an appropriate container as he indicates 'the development is getting costly for me to obtain a final operational version'.
- **Other resources**: In addition to finance there is a need for physical resources to adequately develop and test the container.
- **Core competences**: Adam and his employees are essentially juice retailers and thus are unlikely to have the core competences to develop containers with technical attributes.

(2) **Establishing large scale production operations**

- Adam has demonstrated that his company can produce JudoJuice successfully on a small scale with short time scales between production and consumption. Larger scale production of the juice with a delay before consumption of JudoJuice is likely to meet more problems of storage, hygiene and quality control.
- Once the juice is produced, Adam has no expertise in the technology to insert the juice into containers and secure the contents. This would require:
  - Large scale initial investment
  - Expertise in training and operating the equipment efficiently
- Large scale production would require support processes. With a chain of 20 shops Adam may have some of these but their scale and nature are likely to be different for large scale commercial production. These may include: HRM, IT, procurement and other business processes.
- Adam could outsource aspects of production/distribution – but would need to consider what other potential partners are available.

(3) **Marketing and distribution**

While there has been some interest from supermarkets any new product requires significant marketing to establish sales and promote customer and consumer interest.

Issues include:

- **Financial investment**: In promotion and other marketing activities. Adam may have limited access to funding.
- **Marketing expertise**: Adam may have engaged in marketing activity but is unlikely to have established marketing relationships as a partner such as Cappen will have done.
- **Distribution**: CafeO has a distribution chain based on a retailer model where customers come to the company. With the new product, the goods need to be sent to the customer. An efficient distribution chain is very important as the product is perishable and the longer it takes the shorter the residual shelf life for the supermarkets. A partner such as Cappen will have established distribution chains not just for OJD but for much of its food and drink product range. Economies of scope are therefore available from Cappen but lacking in Adam's business.
- **Large scale marketing and sales** will lead to economies of scale thus even if Adam could perform all the above functions on a small scale he may still be more successful with a larger partner such as Cappen (depending on the terms of the agreement).
- Adam will lack the experience of dealing with the large supermarkets and will have relatively little **bargaining power**.

- **Branding**: depending on how the product is branded, as a market leader, Cappen may be a stronger brand than CaféO and therefore attract more customers for the new product.

3.2 **To**: The Board of Cappen plc
From: Senior manager
Date: XX/XX/XX
Subject: Potential co-operative venture with Adam Highton

(a) **Current organisational structure**

The current organisational structure of Cappen is product-based divisionalisation. While there is day-to-day operational autonomy there is close financial control of divisions and key strategic initiatives are centralised and top-down. Divisional managers therefore have little long-term autonomy over the activities of their division.

The benefits of the product-based divisonalised structure with central control include the following:

- Individual managers can be held accountable for the profitability of individual food and drink products. To the extent that individual revenues and costs can be identified for groups of products then their performance and viability can be assessed. Pricing decisions linked to cost can also be better measured.
- Specialisation can be developed. For example, employees will be trained in aspects of production related to a particular product (eg, specific food hygiene issues). Managers may become more aware of rival companies' strategies for the same product type. Service engineers who specialise in a single product should also provide a better service.
- The different functional activities and efforts requiring specialisation are concentrated together at group level permitting expertise in finance, HRM and IT for example, as well as avoiding duplication of activities.
- The decentralisation of key strategic decisions is important where rapid responses are required in a changing and dynamic environment. However, food and drinks manufacture is a reasonably stable environment which is more suitable to slower, more considered decision making.
- Cappen is a large company and, as size increases, decentralisation tends to increase to enable at least lower level operating decisions to take place without central approval. The speeds up decision making.
- The more diverse the organisation, the greater the need for lower level decision making. In the case of Cappen however, there is a concentration in food and drink so centralised control of decisions may be more appropriate as the specific knowledge of divisional managers is not dissimilar from that of central management.

Disadvantages of Cappen's organisational structure include the following:

- It increases the overhead costs and managerial complexity of the organisation as service centres need to recharge their service using artificial transfer pricing mechanisms.
- Highly centralised structures tend to stifle innovative strategic solutions and result in less flexibility to react to changing marketplaces.
- Divisionalised structures restrict collaboration and 'joined up' strategies. With few managerial links between divisions there is lack of shared expertise and experience.
- Bureaucratic structures focus on maintaining the *status quo*. This is indicated by the lack of incentives to innovate and develop new products from divisional initiatives.
- Profit centre and not investment centres are used so divisional managers have limited control over expansion, development and new investment.
- The result of some of the above factors is that managers are likely to be demotivated.

(b) **Benefits and problems of JudoJuice project**

The arrangement with Adam, if it is to be acceptable, must do something for Cappen that it cannot do for itself. Careful and sceptical scrutiny is therefore needed of the unique benefits that Adam is claiming to be offering and the costs and risks that might be incurred by Cappen as a consequence of entering into any arrangement with him.

Benefits

Adam appears to be offering a blend of fruit juices that is popular and he has unique access to the recipe. In support of this, subject to evidence being obtained he offers:

- Market testing in his cafes where it appears popular
- Some additional independent market research
- Favourable contacts with supermarkets but without any contractual or other commitments from them

The benefits to Cappen are potentially:

- Access to a new product which appears to have significant potential
- The new product is in the core area of OJD and thus would complement existing products, perhaps with some synergies
- Cappen's distribution channels and production facilities would put it in a strong negotiating position compared to Adam to capture most of the profits generated by the JudoJuice
- Potential access to innovative skills of Adam in future, if these are not available within Cappen to bring new products to market

Problems and risks

- Setting up an agreed structure and mechanism for sharing the benefits (see (c) below)
- Even with an agreed arrangement there is potential for major conflicts of interest over profit shares, amounts invested, the marketing strategy and the management of the joint venture or other arrangement
- Problems in protecting intellectual property, such as the recipe, as this will become common knowledge once the agreement is entered into
- Adam will not be disclosing the recipe without firm contractual guarantees and a viable solution to the container problem. This means significant costs and undertakings will be entered into before access to detailed knowledge is provided
- Danger that partner may seek to leave joint venture if its priorities change (eg, shortage of funds) and thus the agreement may need to be disengaged
- Lack of sustained Cappen management interest. The JV will be seen as outside of the main structures of the parent firms
- Exit routes may be unclear if the venture fails, including sharing of the assets generated in the venture
- Most of the financial investment appears to be with Cappen in developing the container and setting up new operations. If the venture fails then most of the costs may be sunk and will have fallen on Cappen. The financial downside risk of the venture is therefore very one sided

Despite marketing evidence of current demand being high this may not be realised as it may be a short-term fashion or taste fad, but be unsustainable. Alternatively, it may popular in the context of juice bars but not as a take away sports drink or kids' snack.

If JudoJuice is seen to be inappropriately targeted at children, there is a risk that any venture may damage Cappen's main business.

(c) **A joint venture**

The arrangement would need to be a departure from the current organisational structure of Cappen.

Any acquisition of CafeO, or merger or buy-in seems to be excluded by Adam's first criterion, but there may be alternatives to a full JV arrangement such as a looser strategic alliance or a licensing arrangement. Nevertheless, the present focus is on a joint venture.

Joint venture

There are two broad types of joint venture that can be set up between Cappen and Adam.

Joint venture entity: Two or more organisations set up a third organisation or co-operate in some other structured manner to share control.

A joint venture arrangement: It is a 'contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control'.

In a joint venture entity with Cappen, it would appear that Cappen is incurring most of the costs and risks and it is delivering most of the added value. Any joint venture entity would therefore need to deliver the majority of the benefits to Cappen. Shared ownership is not therefore likely to be in equal proportions between Cappen and Adam.

Nevertheless, Adam's criteria require that he maintains some control. This could be achieved by contractual agreement with specific rights over the recipe.

Given that the recipe is to be released late in the development process (eg, after the container design is finalised) then any JV would need contractual arrangements that commit Adam at an early stage before major costs are incurred by Cappen.

Another of Adam's criteria is: 'I also need to be assured that the financial performance of this product can be separated from other Cappen products, so we can determine the shares of the benefits fairly.'

This is a difficult objective to achieve as production processes are likely to have some commonality with OJD's existing production – indeed, synergy is one of the advantages to Cappen of entering into any arrangement. This is likely to be true whether or not a JV entity is set up, but is particularly the case if it is only a JV arrangement.

The issues of overhead allocations, joint costs, recharging container development costs, recharging central service costs, common distribution costs are all likely to cloud the issue of the costs that can be directly attributable to the JV arrangement and thus the sharing of benefits.

A final concern on desirability is that a JV arrangement is outside the normal divisionalised structure of Cappen. This may be regarded as a problem in accommodating something different for the sake of a small project and as a result may be unlikely to receive head office support. Alternatively, it may be seen as an opportunity and as a pilot for cross divisional co-operation and a model to develop more new designs and products.

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