PROFESSIONAL LEVEL EXAMINATION

TUESDAY 8 MARCH 2016

(2½ hours)

# BUSINESS STRATEGY

This paper consists of **THREE** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ballpoint pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which answers are presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

**The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisation included in the paper. No additional credit will be given to candidates displaying such knowledge.**

| | |
|---|---|
| **IMPORTANT**<br><br>Question papers contain confidential information and must NOT be removed from the examination hall.<br><br>**DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK** | You MUST enter your candidate number in this box. |

1. Outil plc (Outil) is a large home improvement retailer, listed on the London Stock Exchange. It operates three divisions:

   - Homestyle Division (UK only)
   - Fixings Division (UK only)
   - Targi Division (Eastern Europe only)

**UK home improvement industry**

The home improvement industry derives its income from homeowners undertaking repairs, maintenance and improvements to houses. Industry revenue has been in decline for several years. Approximately 60% of industry revenue derives from homeowners themselves (domestic customers) and the remainder from tradespeople such as builders, electricians and plumbers (trade customers). The market is influenced by the state of the economy and the volume of transactions in the housing market, with homeowners typically repairing and improving their houses either before a house sale or after a purchase.

Despite recent recovery in the UK housing market, homeowners have been slow to increase spending on home improvements. Industry experts believe this is partly due to younger homeowners lacking the necessary skills to do the work themselves, and preferring to spend their time and money on leisure activities. As a result, there is a move away from a "Do-it-yourself" (DIY) approach to home improvements to a "Do-it-for-me" approach, with homeowners hiring tradespeople. Retailers who service trade customers as well as domestic customers have therefore generally performed better.

Some home improvement retailers have responded by launching services to link their trade and domestic customers, and recommending local tradespeople to homeowners. Some retailers have switched to UK suppliers to reduce the need to hold inventory. Many bigger retailers are also increasing online sales or reducing the size of stores.

**Company history: UK**

Outil was established in 1980 with ten home improvement stores in the UK. It grew organically and the original chain now operates as the Homestyle Division with 252 stores.

Homestyle stores sell to both domestic and trade customers. The stores stock a vast range of home improvement products (30,000 to 50,000 different products). Approximately 30% of the store space is accessible to customers and 70% is used for storage. Stores have extended opening hours and specialist staff are available to provide advice. Homestyle stores vary considerably in size from 5,000 to 15,000 square metres. Newer large stores have demonstration areas for DIY classes plus display kitchens, bathrooms and bedrooms so that customers can plan a major home improvement project with the help of design consultants. However the availability of suitable large sites for new stores is limited by transportation and traffic problems, and by planning restrictions. New stores also require large capital investment.

The Fixings Division was created in 2010 when Outil purchased a UK business that sold screws and fixings. The Fixings Division sells a wide range of small items (tools, nuts, bolts, piping etc) via a catalogue, website and its 395 stores. The division has grown rapidly, opening 50 new stores in 2015. Fixings stores are specifically designed to satisfy the needs of trade customers, although they do sell to domestic customers as well. There is a simple layout with emphasis on convenience, and the majority of store space is visible to customers as it is used to display inventory. Stores carry a limited range (up to 15,000 different products) and are, typically, smaller than the Homestyle stores (up to 5,000 square metres).Their smaller size makes it easier for Outil to find sites to establish new Fixings stores, obtain planning permission and finance the necessary capital investment.

**Company history: Eastern Europe**

In January 2015, Outil acquired a chain of 115 stores branded ‘Targi’ in Eastern Europe, which it operates as the new Targi Division. Targi only sells to trade customers. It provides equipment and materials for professional building companies and tradespeople. Stores carry a limited range of products which are sold in large quantities at low prices. This division currently operates only in Eastern Europe.

**Board meeting**

Outil’s most recent management accounts (**Exhibit**) show a decrease in profit in 2015. This is despite the acquisition of Targi. Outil’s board has been concerned for some time about the performance of the Homestyle Division, which is a mature business.

The managing director commented at a recent board meeting:

“Given the excellent performance of our other divisions, we should refocus as a business that sells to trade customers only, so we should close the Homestyle Division. Smaller Homestyle stores could be re-branded and operated as Fixings stores, or used to establish Targi as a brand in the UK. Larger Homestyle stores are too big so would need to be closed outright. Employees, where possible, would be transferred to remaining divisions. There would be a cost in terms of lease penalties and redundancies but overall I believe that results would improve.”

The director of the Homestyle Division advocated continuing the current strategy:

“2015 was a very tough year and one of the Division’s major competitors closed, but we still managed to keep sales revenue constant. Margins were affected by customers choosing lower margin products, increased delivery costs and more pricing promotions but I am confident that the market will improve eventually in line with activity in the housing market.”

A different approach was proposed by the Fixings Division director:

“An alternative is to sell the Homestyle Division outright. This would generate funds for Outil to expand the Targi and Fixings brands. Our website has recently attracted lots of attention from international customers. I would like to test the market for our international expansion by initially opening four Fixings stores in Germany, on a trial basis, with a dedicated German website.”

**Requirements**

Prepare a report for the board on the future strategic direction of Outil.
Your report should:

1.1 Use the data in the Exhibit and the other information provided to:
- evaluate the company's overall performance between 2014 and 2015, and
- compare the performance of the three divisions in 2015. **(17 marks)**

1.2 Discuss the proposals for the future of the Homestyle Division. Refer to your calculations in 1.1 and the directors' comments where appropriate. Ignore the proposed German expansion for the purpose of this requirement. **(10 marks)**

1.3 Identify **two** stakeholder groups that are likely to be affected by a decision to close the Homestyle Division, and advise on the strategies that Outil could adopt to reduce any barriers to change. Refer to relevant models where appropriate. **(8 marks)**

1.4 In relation to the Fixings division, discuss:
- the merits of undertaking test marketing before a full international expansion, and
- the strategy of opening four stores in Germany, on a trial basis. **(8 marks)**

**Total: 43 marks**

**Exhibit: Extracts from Outil plc management accounts**

**Financial information: Year ended 31 December (£ million)**

| | 2015 | | | | | 2014 |
|---|---|---|---|---|---|---|
| | **Home style** | **Fixings** | **UK Total** | **Targi** | **Outil Total** | **Outil Total** |
| Revenue | 2,635 | 1,955 | 4,590 | 835 | 5,425 | 4,343 |
| Gross profit | 771 | 821 | 1,592 | 251 | 1,843 | 1,560 |
| Traceable divisional costs | (620) | (672) | (1,292) | (178) | (1,470) | (1,167) |
| Divisional contribution | 151 | 149 | 300 | 73 | 373 | 393 |
| Apportioned central costs | (20) | (14) | (34) | (6) | (40) | (35) |
| Operating profit | 131 | 135 | 266 | 67 | 333 | 358 |
| Net assets (at carrying amount) | 728 | 495 | 1,223 | 266 | 1,489 | 1,160 |

**Operating information: Year ended 31 December 2015**

| | **Homestyle** | **Fixings** | **Targi** |
|---|---|---|---|
| Number of employees | 14,595 | 7,200 | 3,430 |
| Number of stores | 252 | 395 | 115 |
| Average store size (square metres) | 10,000 | 3,500 | 5,600 |
| Average number of product lines per store | 43,500 | 13,750 | 10,750 |

2. Dreamy Potato Products Ltd (DPP) is a food processing company based in the west of England.

**Company operations**

DPP purchases potatoes from local farmers then peels, washes and processes them into two uncooked forms: whole or cut. It sells these products to food manufacturers which choose to buy from companies, like DPP, that benefit from economies of scale in procurement and processing.

DPP has grown steadily. Approximately 80% of its revenue comes from four food manufacturing clients that produce ready-meals for UK supermarkets. DPP's contracts are, typically, renegotiated every three years, although terms change frequently. This is often as a result of specific demands by supermarkets in relation, for instance, to quality or type of potato.

The food processing industry is highly regulated for health and safety. DPP's clients, prompted by the major supermarkets, also have their own strict quality control requirements. DPP's workforce consists mainly of weekly-paid workers, on the UK minimum wage. DPP is subject to restrictions on working hours, enforced by European Union regulations.

DPP's raw material costs and selling prices are driven by the market price of potatoes, which fluctuates considerably, depending on the availability and quality of the annual crop. DPP acquires its potatoes from local farms, with which it has exclusive purchase agreements. The company owns a fleet of trucks for distributing products to its clients.

**Competition**

The market-leader, Estima plc (Estima), has a 30% share of the UK market for processed uncooked potatoes. It is a vertically-integrated, national business which grows its own potatoes and supplies both uncooked and cooked potato products to the catering industry and food manufacturers.

A further 35% of the UK market consists of DPP and two other competitors - one in the south and one in the east of England. The rest of the market is fragmented. Many farms supply unprocessed potatoes direct to the catering industry. Some potato farmers operate their own processing plants, but these are regional businesses, often specialising in particular market niches eg supplying processed uncooked potatoes to local schools or hospitals.

**Proposals**

In the year ended 31 December 2015, DPP generated an operating profit of £352,000 on sales of £10.8 million. It is considering two opportunities for future growth:

<u>Proposal 1: fast-food contract</u>
DPP has been approached by a national fast-food chain that wants to buy uncooked cut potatoes. The initial contract would be for three years, at a fixed price of £210 per tonne. To implement this strategy, DPP would need to acquire a new machine to grade and cut the potatoes and rent a further 9,000 square metres of premises. Working assumptions for this contract are provided in the **Exhibit**.

Proposal 2: use of waste
Starch residue from washing the potatoes could be sold to local farmers as cattle food. DPP is also considering investing in a digester machine, which can convert potato waste into gas to power DPP's processing plant. As well as potentially improving profits, better use of waste would be positive for sustainability and help differentiate DPP from Estima.

**Client request**

Potters Pies (Potters), a major client, buys processed uncooked potatoes from DPP to produce pies for two supermarkets: Giant (a low-cost retailer) and Quality (a high-quality retailer). Potters' contract with Giant is due for renewal shortly and Giant has told Potters to reduce its prices if it wants to retain the business. Andrew Baxter, a director at Potters, wants DPP to drop the price that it charges Potters for potatoes for the Giant contract by 5%.

Andrew explained to DPP's sales director: "If you drop the price on the Giant contract, I am prepared to increase the price per tonne we pay DPP for potatoes for the Quality contract by the same percentage.

"I am confident that I can go to Quality and persuade them to pay more for our pies. I will convince them by pretending that we have had to pay our supplier more because they have started to supply higher quality potatoes.

"This will help ensure that we don't lose the Giant contract, which would be bad news for both Potters and DPP. If you agree, I will make sure that DPP is our preferred supplier when we renegotiate contracts later this year. If not, then I may have to move our business to Estima."

**Requirements**

2.1 In relation to the potato processing industry, prepare an analysis of the following elements of the Porter's Five Forces model:
- Barriers to entry
- Power of suppliers
- Power of customers

You should explain the relevance of each force for DPP. **(9 marks)**

2.2 Evaluate the fast-food contract in Proposal 1 and discuss whether it should be undertaken. Show supporting calculations. **(10 marks)**

2.3 Assess Proposal 2 for the use of waste and suggest further actions that DPP could take to enhance its sustainability. **(7 marks)**

2.4 Discuss the ethical issues for DPP and Potters that arise from Andrew Baxter's request. **(7 marks)**

**Total: 33 marks**

**Exhibit: Working assumptions for Proposal 1: fast-food contract**

1. Expected sales volume: 9,000 tonnes pa at £210 per tonne, for three years.

2. Direct labour and variable costs of processing are expected to be £65 per tonne pa.

3. In 2015 DPP's fixed overhead absorption rate was 12% of revenue pa. Fixed operating expenses will increase by £25,000 pa as a result of this contract.

4. For the first year of the contract DPP has agreed, with its existing suppliers, a purchase price of £125 per tonne of potatoes. Industry price forecasts assume that year 3 potato prices are conditional on market prices in year 2. The predicted average purchase prices are as follows:

| | Year 2 | | | Year 3 | |
|---|---|---|---|---|---|
| | **Probability** | **Price/tonne (£)** | | **Probability** | **Price/tonne (£)** |
| Low price | 0.40 | 125 | Low price | 0.45 | 115 |
| | | | High price | 0.55 | 135 |
| High price | 0.60 | 160 | Low price | 0.65 | 150 |
| | | | High price | 0.35 | 170 |

3. The Zed Museum (Zed) opened in Venice, Italy, in 2000. It hosts one of the finest collections of sculptures and modern art in the world and is a popular destination for locals and tourists.

The museum is a not-for-profit organisation, managed by trustees and largely staffed by volunteers. It charges nominal admission fees and relies on private donations. For the last three years, Zed's income has just covered the costs of operating the museum, insuring the exhibits and running educational programmes. After the recent death of Zed's wealthy founder, Emilio Zissi, the museum is experiencing a financial crisis and some of the staff and donors feel that it lacks direction. Without a significant injection of cash, the museum may have to close and, if it is found to be insolvent, the trustees may be liable for any losses.

Zed has a sizeable collection, only a small proportion of which is on display at any given time. Most of the items in the collection are not owned by Zed but were given in trust to Zed to hold, conserve and use in exhibitions or programmes for future generations. Despite their value, the items are not liquid assets and Zed is prohibited from selling them to pay for operating expenses.

The trustees have appointed a new chief executive to address Zed's financial situation and to attract a wider audience and additional revenue streams. She is keen to operate the museum on a more commercial basis and exploit its collection, as she explained at a recent meeting of the museum's trustees:

"Zed's ability to remain open rests purely on how fast we can raise sufficient additional funds – a task that I believe may be accomplished, in part, by licensing our brand and collection. I have been approached by a well-known billionaire, Kazuo Tada, who owns a Japanese island. Mr Tada is developing the island into an exclusive cultural destination. A 20-year licence to operate a Zed-branded museum on the island will attract wealthy international tourists and other world-class visitor attractions. In addition to paying the annual licensing fee for the Zed brand, Mr Tada has promised us a substantial one-off donation. The Japanese museum will be stocked by us with exhibits from our collection, in return for the annual licensing fee. Other international museums have successfully licensed their brand and collection, and I believe that we should do the same."

Some of the trustees disagree with the chief executive's proposal. They do not believe that the licence deal is appropriate for a world-class museum, which is seen as an educationally-driven entity and a steward of Italian culture. They also argue that the proposal may be contrary to the founding principles established by Emilio Zissi:

**Founding principles of the Zed Museum**

- Hold the collection in trust for society and safeguard the long-term public interest in the collection
- Recognise the interests of the people who made, owned, collected or donated items in the collection
- Encourage visitors to explore the collection for inspiration, learning and enjoyment
- Consult and involve the local community, users and supporters
- Review performance to innovate and improve

The chief executive is aware that some stakeholders have expressed concerns about the museum's future. She also believes that some of Zed's problems have arisen because of a failure to monitor performance adequately, and is evaluating how best to measure the museum's success. Historically, Emilio Zissi simply counted the number of visitors each year.

**Requirements**

3.1 Analyse the interests and influence that the following stakeholders are likely to have in their relationship with the museum:

- Trustees
- Donors
- Staff **(9 marks)**

3.2 Explain the advantages and disadvantages for Zed of pursuing a licensing strategy with a third party and any specific considerations relating to the proposed Japanese museum. **(8 marks)**

3.3 Recommend an approach to performance measurement that is suitable for Zed and some specific performance measures to assist the chief executive in measuring Zed's performance. **(7 marks)**

**Total: 24 marks**