PROFESSIONAL LEVEL AND STAGE EXAMINATION

WEDNESDAY 11 JUNE 2014

(2½ hours)

BUSINESS STRATEGY

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

1. Ensure your candidate details are on the front of your answer booklet.
2. Answer each question in black ball point pen only.
3. Answers to each written test 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.

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

Question papers contain confidential information and must NOT be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box.

BLANK PAGE

1. Albatross Golf Equipment plc (AGE) is an unlisted company which manufactures golf clubs.

Market background

Golf clubs are used to play the sport of golf and are sold individually or in sets of clubs. They make up about 70% of the wider golf equipment market which also comprises golf clothing, bags, balls and other items related to playing golf.

Golf equipment is the largest single sector of the sports equipment market in the UK, mainly due to its high price compared to equipment for other sports. The UK golf equipment market amounted to £350 million in 2013, using manufacturers' selling prices. This represented a decrease of 16% since 2008.

Distribution channels for manufacturers comprise general sports retailers and specialist golfing shops.

Company history

In 1970, Ben Fogan opened AGE's factory in the UK to manufacture a range of high quality golf clubs. All raw materials have always been sourced locally in the UK. AGE has never made any other types of golf equipment.

When he started the business, Ben was a successful amateur golfer and a professional engineer. He made innovative adjustments to the standard design of golf clubs available at that time and patented his idea, under the LazySwing brand name. As a result, many golfers purchased the LazySwing branded clubs and reported improved scores when they played golf with them. In 1974 a major boost to AGE's sales occurred when the winner of the Open Golf Championship, a globally recognised golf competition, used LazySwing golf clubs and this had a favourable reputational impact for the LazySwing brand.

AGE has, to date, sold only to specialist golfing shops, both in the UK and the rest of Europe. These shops are owned by a variety of companies and individuals, and Ben visited them personally on a regular basis to make sure that AGE products were being displayed and promoted, alongside rival brands, in an appropriate manner.

Ben continued to innovate with golf club design, but over time he could not match the rapid changes in technology achieved by larger competitors with significant research and development budgets. As a result, the LazySwing brand declined in reputation, with a decreasing customer base. Ben died in 2004, by which time sales had fallen significantly from their peak in the 1970s. In October 2013, AGE was acquired by a private equity company, Fuller Finance plc (FF).

Lee Trebino was appointed by FF as the new chief executive of AGE. He immediately undertook a strategic review of AGE in order to explore opportunities for developing the company and returning it to growth. He asked Putt and Pitch LLP (PP), the firm of business advisers for which you work, to attend a meeting to plan the next steps following his review.

Possible strategies

Lee opened the meeting: "When I took over as chief executive of AGE it was clear we needed to make changes to turn the company around. It was in decline and lacked a clear strategic direction. AGE has performed poorly in recent years (**Exhibit**).

I would like PP to analyse why this is the case and to compare the performance of AGE with that of Galdo plc, the UK market leader in manufacturing golf clubs.

“The LazySwing brand still has a reasonably good reputation. However, it has now become a mid-range brand trying to compete in the high-end sector of the market. I believe it can no longer expect the required price premium or generate the required volume of sales in the high-end sector. I therefore propose a repositioning strategy for the existing LazySwing golf clubs, which is to move the LazySwing brand downmarket into the mid-range sector. We would continue to sell the existing clubs through specialist golfing shops, but at a reduced average selling price of £55 per golf club, to reflect the new mid-range market positioning.

“In addition to repositioning the existing clubs, I believe we can achieve real growth by importing some basic quality golf clubs from JiangGolf, a manufacturer in China. We expect these imported golf clubs to appeal to a wider market than our current range of clubs. We would need to guarantee to purchase a minimum of 100,000 clubs per year under a two-year agreement with JiangGolf. In return, JiangGolf has agreed it would supply AGE at an average price of £15 per golf club which, for the level of quality, is a lower price than any European supplier. I have two alternative strategies for the imported clubs:

Strategy 1: Sell the imported golf clubs under the LazySwing brand through the same specialist golfing shops as our existing LazySwing clubs, but price the imported clubs, on average, at £30 per club. They would therefore typically be the cheapest clubs available in these shops.

Strategy 2: Sell the imported golf clubs under a newly created brand name, ‘Eagle’, and distribute them through general sports retailers priced, on average, at £25 per club.”

Ethical issue

For the last few years, AGE has used a professional golfer, Gary Paler, to promote the LazySwing brand name. Gary signed a new four-year contract with AGE in 2012 to promote the LazySwing brand. He was chosen due to his success in golf competitions, but also because of his public image as a player with integrity. At a celebrity party in March 2014, Lee was told in confidence, by a professional golfer, that Gary regularly took performance-enhancing drugs. The possession and use of such drugs are banned in many countries.

Lee is aware that, if this information became public, it would significantly damage the LazySwing brand and severely harm Gary’s career. Lee said nothing for a few months, but is now very concerned about the ethical implications of the following two options open to him: breach the confidence and disclose the information, which would damage all concerned, or stay quiet until the end of Gary’s contract.

Requirements

(a) Using the data in the Exhibit and the other information provided, analyse the performance of AGE:
   (i) over the period 2011-2013; and
   (ii) in comparison with the performance of Galdo, the UK market leader.

   Indicate briefly any further information that would be required to make a more complete analysis.

(18 marks)

(b) As a business adviser working for PP, write a memorandum to the AGE board which evaluates the chief executive's strategies to: (i) reposition the existing clubs; and (ii) import clubs. Use the following headings:
   - Supply chain management
   - Market positioning and branding.

(14 marks)

(c) Explain the ethical issues arising for Lee, and for AGE, in relation to Gary Paler. Set out and justify the actions that Lee should now take. **(8 marks)**

(40 marks)

Exhibit – Financial, operating and market data

Financial data

	AGE			Galdo		
	2011	**2012**	**2013**	**2011**	**2012**	**2013**
	£'000	£'000	£'000	£'000	£'000	£'000
Revenue						
UK sales	17,600	16,400	15,455	40,000	38,400	36,800
Export sales	4,400	3,600	2,945	60,000	57,600	55,200
Total	22,000	20,000	18,400	100,000	96,000	92,000
Manufacturing cost	17,600	16,400	15,456	70,000	67,200	64,400
Gross profit	4,400	3,600	2,944	30,000	28,800	27,600
Fixed operating cost	2,900	2,900	2,900	10,000	10,000	10,000
Operating profit	1,500	700	44	20,000	18,800	17,600

Operating data

	AGE			Galdo		
	2011	**2012**	**2013**	**2011**	**2012**	**2013**
Number of golf clubs sold (000s)	250	240	234	556	519	484

UK market data – golf equipment

	2011	**2012**	**2013**
	£'000	£'000	£'000
UK market sales (at manufacturers' selling prices)	380,000	365,000	350,000

2. Best Fresh Bakeries Ltd (BFB) is a family-run company with five shops, each of which bakes and sells high quality, fresh produce including breads, pies, cakes and pastries.

Company background

BFB was founded by Henry Hardcastle in 1986 when he opened one shop in a small town.

Over the following 15 years, Henry opened four further shops in the local area. All the food has always been freshly baked on the premises of each shop and BFB is well-known locally, with a loyal customer base. One of Henry's slogans is "Baked and sold on the premises, on the same day."

BFB is a key customer for some of its smaller local suppliers.

There has been no expansion in the number of shops since 2001. However, in 2004 Henry's two sons, Ralph and Nigel, joined the business. Henry gave each of them 10% of the ordinary share capital and retained the remaining 80%, with Henry taking the position of chief executive. Ralph and Nigel are the other two directors. Each director has one vote at board meetings. Brief biographies of the three directors are provided (**Exhibit**).

The net assets of BFB recognised in its financial statements are £3 million. Last year the board rejected an offer of £5 million from a large confectionery company for the entire ordinary share capital of BFB.

Henry intends to retire in 2019 and it is the intention that his two sons will then buy all his shares at their market value. Henry does not want to expand the business before then, but his sons are keen to grow the business as soon as possible. This caused conflict at a recent board meeting.

Board meeting – expansion strategy

Ralph opened the meeting: "I think we should expand by centralising baking production at a single new centralised baking facility. We could then distribute the products each morning to our shops. This would give us greater capacity and enable us both to sell internally to our own shops and to make new sales to third parties. The new bakery would be set up as a separate division so we could monitor its performance after implementation. The five shops would together form the other division. I estimate my strategy would require initial capital of £2 million."

Nigel joined the conversation: "I agree with Ralph. We can expand the business this way, as larger scale production will deliver greater economies of scale, for instance by bulk buying raw materials and having larger production runs."

Henry was not pleased with his sons: "I will retire in five years at which time you can buy me out and do what you want with the business but, until then, I really do not want to invest more capital and incur the risk and effort involved in a major expansion. You both want to expand the business, but you have no money of your own to invest."

Nigel rejoined the conversation: "We believe the company can borrow £2 million to finance the new development, so we are not asking for any more personal investment from you. Ralph and I are serious about this; if necessary, we will vote together for the expansion plan at the next board meeting, where we will have a two to one voting majority."

A governance issue

The day after the meeting Henry was still angry and discussed what had happened with a couple of good friends, Jon and Gemma, who are unconnected to BFB. Henry said: “Ralph’s suggestion might be the best strategy to expand the business, but I just do not want the extra strain from a personal point of view. It’s my business and I don’t want my sons to take control away from me at board meetings before I retire.”

Jon supported Henry: “You’re the chief executive and major shareholder, so why don’t you appoint Gemma and me as non-executive directors? We will vote with you to make sure that you have a majority at board meetings.”

Requirements

(a) Explain the risks that should be considered in evaluating the expansion strategy from the perspective of: (i) BFB; and (ii) each of the three existing shareholder-directors. **(12 marks)**

(b) Assuming the expansion strategy is implemented, briefly explain the factors that should be considered in determining transfer prices from the new centralised baking production facility to the five individual BFB shops, and recommend how the transfer prices should be set. **(9 marks)**

(c) In light of Nigel’s and Ralph’s voting intentions, and Jon’s suggestions, explain the governance issues for BFB. **(7 marks)**

(28 marks)

Exhibit – Biographies of the directors

Henry – aged 60: Henry owns his own house and has savings of about £200,000, but the proceeds from the sale of his shareholding in BFB will be his main source of retirement funding. Henry intends that his sons should buy all his shares at market value when he retires in about five years’ time, even if they have to borrow from their banks to do so. Henry is risk averse.

Ralph – aged 35: Ralph is single, has no savings and rents, rather than owns, his house. He has an extravagant lifestyle, spending nearly all his income, but he has no debts. He believes in taking reasonably high risks.

Nigel – aged 30: Nigel is married with a family. He owns his house, but has a large mortgage. He has some limited savings. He is risk neutral, but ambitious.

3. ElectroInfo Ltd (EIL) operates in the electrical and IT services industry. The EIL board is currently reconsidering the company's pricing policy to customers.

Operations

EIL offers electrical and IT services to customers for their homes. These two types of service are offered independently and are provided by different EIL employees. The electrical services provided by EIL include traditional home electrical services, such as wiring and fuse box installation, and also broadband installation and maintenance. The IT services offer solutions to basic software problems experienced by customers on their home PCs, laptops and tablets.

EIL operates from 30 depots located on business parks in towns throughout the UK. The depots are located about 50 kilometres away from each other in places where there is less competition than in large cities and where local reputation can be established more easily. EIL employs qualified electricians and IT specialists. Typically there are three electricians and three IT specialists operating from each depot. Customers all live within 25 kilometres of a depot. The company aims to offer good quality customer service.

EIL has a centralised structure so prices and wages, plus most other aspects of operations, are determined centrally. Each depot head reports directly to EIL's board of directors.

Competition

EIL aims to have a market position between large service companies and small sole proprietor businesses which operate from proprietors' homes. The large service companies tend to carry out both commercial and consumer work, but charge higher prices at £38 per labour hour upwards. Sole proprietor businesses offer lower prices, charging £28 per labour hour or less, but they often lack the most up-to-date training.

Pricing

EIL charges all its services, to all its customers, at a single rate of £32 per chargeable hour. The average variable cost to the company for both IT and electrical services is £20 per chargeable hour.

To increase profits, some directors suggested raising EIL's price to all customers for both types of service, but the *finance director*, Denise Jones, was concerned about this. "Some customers are willing to pay more, but many are on low incomes. They are resistant to price increases and many would move to lower priced competitors if we raised our price. Instead, I believe we should consider charging a different price for each of our two different services, IT and electrical, to all customers, even though it costs us the same to provide these services in terms of both wages and other costs."

The *marketing director*, Amy Ashad, disagreed: "We should be charging different prices to different customers, but pricing each of the two types of service the same."

Market research

The board agreed to obtain more information about customers' attitudes to price through market research based on questionnaires and examination of actual behaviour in response to previous price changes. This research revealed the following information about the sensitivity of demand (chargeable hours per year) to selling price (£ per chargeable hour):

Selling price per chargeable hour	**£30**	**£32**	**£34**	**£36**
Demand (*chargeable hours per year*)	250,000	230,000	200,000	160,000

Further market analysis was completed, using two different approaches to segmenting the customer market for electrical and IT services, firstly by customer income, and secondly by service type.

Segmented by customer income

Selling price per chargeable hour	**£30**	**£32**	**£34**	**£36**
Demand (*chargeable hours per year*)				
Low income customers (*Note 1*)	85,000	70,000	45,000	20,000
Other customers	165,000	160,000	155,000	140,000

Note 1: Classified using the estimated value of the customer's house as a rough measure to indicate the level of the customer's income.

Segmented by service type

Selling price per chargeable hour	**£30**	**£32**	**£34**	**£36**
Demand (*chargeable hours per year*)				
IT services	125,000	120,000	110,000	100,000
Electrical services	125,000	110,000	90,000	60,000

The *chief executive* has now made a further suggestion: prices should be set locally by each depot head, rather than centrally for all the depots by the directors.

Requirements

(a) Assume that the same price is charged for both electrical and IT services and that prices are set centrally:

(i) From the four choices of price identified in the tables above, calculate the price per chargeable hour that EIL should charge in order to maximise total contribution under each of the following alternative assumptions:

- A single uniform price is charged to all customers (as per the current policy)
- One uniform price is charged to low income customers and a different uniform price is charged to all other customers.

(ii) Discuss the feasibility and benefits of Amy Ashad's suggestion of charging different prices to different customers based on income. Refer to your calculations in (i) above.

(12 marks)

(b) Evaluate Denise Jones' suggestion that a different price should be charged for the two different service types, IT and electrical. Provide supporting calculations. Assume the same single uniform price continues to be charged to both low income and all other customers, and that prices are set centrally. **(9 marks)**

(c) Evaluate the chief executive's suggestion of depot heads setting prices locally and explain the issues which are likely to arise in implementing this policy. **(11 marks)**

(32 marks)