STRATEGIC CASE STUDY AUGUST 2018 EXAM ANSWERS

Variant 3

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

Part 1

Suitability, acceptability and feasibility of selling press site one

Suitability

When considering the suitability of the proposal to sell press site one, we must think about whether this action would have a good strategic fit with the current direction of FNG.

Initially it appears it wouldn't have a good strategic fit. FNG are committed to the principle of retaining a first-class in-house printing capability, considering it to be an area of core competence. According to the mission statement, 'we are committed to providing a first-class printing service in-house, both for our own titles and others', and hence selling press site one would significantly reduce the overall printing capability of FNG and completely remove the capability to print their own titles.

That said, there is an argument that selling print site one matches elements of the developing strategy of FNG, given their movement towards being a media group and providing news digitally.

FNGs website refers to 'exploiting technology in response to the changing ways in which our readers want to access our news stories at different times of the day'. To do this to the full, they do indeed need to reduce their dependence on their print activities and spend more time focusing management efforts on their digital offering. Selling Press Site One may well free up the cash and time to take FNG in a new strategic direction.

Acceptability

Acceptability is concerned with whether the strategy (to sell the press site and outsource printing) will be acceptable to stakeholders, both in terms of the likely financial returns and associated risk.

It appears likely that the proposal to sell press site one would be acceptable to shareholders. Not only will it bring B$15m of proceeds into the organisation, generating a profit on sale of B$10.75m, but also will save an estimated B$5m of operating costs annually as shown below:

	B$m
Staff costs	15.0
Site operating costs	1.5
Newsprint purchases	15.6
Depreciation	0.4
Reduction in costs	32.5
Estimated cost to outsource	27.5
Estimated saving if outsource	**5.0**

At a time when margins and dividend distributions are falling drastically, this will be welcome news to shareholders.

It will potentially be less acceptable to other stakeholders. Staff at press site one, for example, may be unhappy, wondering what lies ahead for them under new ownership and whether their jobs will be at risk.

Because FNG is not a listed company, we do not have to worry too much about whether the market deems it to be acceptable.

Feasibility

There are no major obstacles to FNG taking this course of action. Although it hasn't previously sold any major elements of its operation, it can hire the relevant professional expertise to help with this.

It will bring cash into the organisation and, hence, there are no concerns about whether FNG have sufficient financial resources to complete this proposed opportunity, and the availability of alternative printers means that FNG can continue to print its newspapers, it simply won't be an in-house function any more.

Finally, FNG has identified a potential buyer for print site one, and a third party who could provide printing of FNG titles going forward, so it ought to be feasible from this aspect as well.

Part 2

Upside and downside risks of utilising an outsourced provider for the printing of our own newspaper titles

Upside risks

Outsourcing the printing of FNG titles looks likely from initial estimates to deliver cost savings. The production manager at press site one has estimated that B$5m per year will be saved by shifting production to a third party. These estimates will need to be verified before FNG furthers this proposal.

Although FNG has previously considered printing to be a core competence, it does appear that it could be done at a lower cost elsewhere. This may be because the outsource provider has better economies of scale, better technology, or expertise, that facilitates a lower cost process.

These cost reductions will allow FNG to invest more in its digital offering, supporting the current strategic direction of the business.

Furthermore, FNG will benefit if outsourcing print frees up some management time. Although FNG will still have to consider its contract print operation at press site two, this is a smaller site and at least some management time will be released when press site one is sold. This may allow FNG more time to concentrate on digital operations as desired.

Downside risks

There are, however, considerable downside risks associated with this proposal.

Printing is still stated to be a core competence at FNG, and it is mentioned in the mission statement. FNG has publicly declared a commitment to printing its own titles in-house and this move contradicts that, which might make FNG appear strategically confused.

FNG will still be running a contract print facility from press site two and there is the risk that customers will question whether FNG still has the competency to print their products. They may see this as a signal that FNG is also scaling down its contract printing operation and seek supply elsewhere. FNG could lose credibility as a contract print provider.

There is also a risk that anticipated cost savings may not materialise. The outsourced supply could in fact cost FNG more than it currently pays to support an in-house facility; after all, this was supposed to be a core competence for FNG and the in-house team are producing a vast amount of printing. One might have assumed that such an experienced operation was already quite efficient and effective, and question whether another provider could truly produce at a lower cost. If the potential cost savings are over-estimated this step could increase FNG's costs at a time when there is little margin to spare. Negotiation of pricing on the contract will be critical to ensuring appropriate cost savings arise.

A further risk is that FNG will lose control over the process if it is outsourced. It cannot directly control the quality, and this could cause issues if production is sub-standard. If FNG ultimately decides it did it better in-house, it will be too late. The skills and machinery will all have been lost and the cost to rebuild likely prohibitive.

FNG should probably select two outsourced print providers so that it always has one printer able to produce its titles if the other is unable to print, so it is not completely dependent on just one supplier.

At the very least, managing and monitoring the relationship will be time consuming. FNG will need to set up a service level agreement detailing its expectations, and this will have to be monitored for compliance, and issues dealt with as they arise. Outsourcing printing will mean that there will need to be effective, and common, communication and software systems. The use of, training for, and potential for problems needs to be covered as part of operational risk. All these costs will need to be factored in to the cost / benefit analysis, as will logistics costs as it is not currently clear whether these costs will be included in the B$5m saving.

Finally, there is the risk that outsourcing such a fundamental part of its operations could signal to the market that FNG is struggling. This might un-nerve stakeholders such as suppliers, advertisers and readers leading to a lack of confidence and causing further problems for the group.

SECTION 2

Part 1

How changes in the exchange, inflation and interest rates in Sulandia might impact on financial performance

Exchange rate - transaction risk

By selecting a foreign supplier for this major component of the business, FNG will be exposing itself to transaction risk.

It is likely that all HPM's costs of providing the service to FNG will be incurred in their local currency (including wages) and, therefore, they are likely to want to invoice for providing the service in their local currency as well. This exposes FNG to currency differences.

This could arise if the exchange rate moves on contracted rates, or if the exchange rate between the Borland $ and the currency in Sulandia moves between agreeing a purchase and paying for that purchase. The amount FNG will need to pay will change, creating uncertainty in future cash flows.

The change may be advantageous, but could also be disadvantageous, leading to exchange rate losses.

FNG could hedge against this risk via a selection of hedging techniques, but the only way to remove the risk completely is to persuade HPM to invoice in Borland $. It is unlikely that it would be willing to do this as the risks would transfer to HPM instead of us.

Inflation and interest rates

FNG needs to be confident that HPM's home country is politically and economically stable. This is a crucial supply and anything that could disrupt the cost and ease with which printed goods are provided could seriously harm FNG.

Rising inflation could significantly increase the price HPM seek to charge if, as a result, it faces rising costs in its own supply chain. High inflation rates affecting supply could quickly erode the savings FNG have achieved by outsourcing production if the increase in cost is passed on.

Similarly moves by the Sulandia government to influence interest rates could ultimately impact on FNG. A rise in interest rates, for example, could make borrowing more expensive for HPM, leading to a rise in prices to protect its bottom line. This will increase the cost of supply to FNG if passed on by HPM.

As with the exchange rate, movement in the rate of inflation and interest rates could be favourable as well as unfavourable, but the uncertainty creates risk and as FNG is not in the business of trying to make speculative gains from movements in international economic variables, it will want to ensure that the economy of Sulandia is sufficiently stable and predictable for this not to present a significant risk.

If Sulandia is not that stable FNG should seek alternatives as the potential to reduce financial performance is too great.

Of course, over a longer period of time economic theory would suggest that movements in these variables would balance each other out reducing the net effect on the organisation.

Part 2

Advantages to FNG of an effective mission statement and whether it is worth rewriting

There are certainly benefits to having an effective mission statement. It seems unprofessional and misleading to leave an old mission statement in place when it no longer represents the organisation well. Certainly, stakeholders will notice if a mission statement is significantly out of kilter with reality and this will cause credibility issues and confusion regarding direction.

An effective mission statement communicates to stakeholders what an organisation is all about, what values it has and what direction it is heading in. It can assist with strategic planning if decisions are made that are consistent with the statement and help to set the tone and culture of the organisation.

Alan's new mission statement is a better reflection of the current direction of FNG.

The new statement has removed reference to 'providing a first-class printing service in-house both for our own titles and others' which is partially appropriate as FNG will no longer print any of its own titles in-house.

Whether it was appropriate, however, to remove reference to the contract printing service is questionable. Complete removal from the mission statement may signal that FNG has essentially given up on printing and this could un-nerve contract print customers.

The new statement also removes the reference to serving local communities and refers to 'print and online communities'. This is consistent with movements to digital news provision which is inherently global rather than local.

Although FNG may still seek to serve local communities, the benefits of digitisation is that their audience is no longer *limited to* the local community, so this could be an appropriate wording change.

The only concern is whether removal of the reference to the word 'local' signals that FNG is no longer interested in local communities. This may not accurately reflect the current direction as local communities still appear to be important to FNG even if digital news provision allows the news to go beyond those communities.

Similarly, the new mission statement refers to 'working in partnership with interested communities' rather than 'working in partnership with local communities' as was detailed in the old statement. Whilst I can understand why Alan has made this broader reference, I would be slightly nervous about alienating the still critical local community.

It is encouraging to see reference in the new mission statement to FNG's commitment to investing in its digital offering to 'ensure we are at the heart of digital information going forward'. This is certainly the emerging strategy at FNG and it is good to see strong commentary about it in the mission statement.

SECTION 3

Part 1

The ethical issues FNG faces because of the actions of HPM

Although FNG is clearly not perpetrating the bad behaviour we have read about at HPM, it does have some responsibility to ensure its business partners operate in an ethical, fair and safe manner. If FNG ignores this responsibility it could be considered to be "guilty by association" and accused of being unprofessional in its selection of HPM on the basis of price - putting profits before ethics.

It is inappropriate for FNG to continue trading with HPM and accepting its low prices, when it knows the way in which those low prices come about - at the expense of the health and safety of HPM staff. To continue to associate with HPM, without attempting to fix the evident issues, would lack integrity and make FNG almost as guilty as HPM.

FNG could be tainted by association with HPM and perceived to condone its bad behaviour if it does not visibly object to what is happening to staff at the HPM site. This could damage its reputation and harm FNG commercially.

With such widespread global use of the internet and social media, it would not take long for the whole world to know about the issues at HPM and scrutinise and ask questions of those dealing with HPM. FNG needs to be able to show that it has acted ethically and taken remedial action with this supplier as appropriate.

Part 2

What action we can take to improve the situation at HPM

As mentioned previously, one of the main issues with outsourcing a key component of the supply chain is the loss of control, and hence in this situation FNG cannot directly control the production process and make the instant improvements it might like to see at HPM right now.

However, FNG can state what is acceptable from a trading partner and what is not.

It may already have detailed in its service level agreement (SLA) expectations over basic work conditions and operating standards. If it hasn't detailed such requirements in its SLA, now is the time to include expectations in writing.

FNG would be wise to urgently investigate other suppliers for this crucial service and if HPM are reluctant to change the awful operating conditions at their site, FNG should move their business elsewhere as soon as practically possible. Loss of business is the key leverage FNG has over HPM and we should use it.

It is disappointing that FNG entered into this arrangement with HPM without detecting these issues up front. A site tour would surely have revealed the awful operating conditions and deterred FNG from entering into a trading arrangement with HPM.

Unfortunately the bad practices were not detected and FNG is now in a position where it is somewhat reliant on HPM, at least in the short term. The very least FNG should now do is make sure that it monitors conditions at HPM from now on, and ensure it is very clear about what are acceptable standards moving forward.

Part 3

How FNG can protect against foreign exchange risks

There are several ways in which FNG can protect itself against foreign exchange differences arising on foreign purchases with HPM.

FNG may insist on trade being done completely in Borland $. This passes the exchange rate risk on to HPM and removes the problem completely. HPM may not, of course, be willing to accept this arrangement which may be just another reason for FNG to seek an alternative supplier. Ceasing to buy from overseas, of course, also removes this risk completely.

However, if FNG wishes to continue with HPM, a forward exchange contract could be utilised to counteract the value due to HPM. The forward contract value moves in the opposite direction to the purchase leaving no net effect and mitigating the risk. FNG could buy the home currency of HPM forward, so that the liability for future payments is covered and the exchange risk removed. The contract provider will charge for this service, but it is an effective technique.

Leading and lagging would be another technique by which FNG could attempt to negate the effects of exchange rate movements. If it anticipates the exchange rate is about to move adversely it could pay HPM invoices early, if it anticipates the exchange rate is about to move favourably it could attempt to delay payment. This is not always a successful technique as exchange rate movements are unpredictable. Also, this would be commercially difficult for FNG and wreak havoc with its working capital cycles at a time when this is already presenting challenges.

Part 4

Whether the sale of press site one could have affected lenders perceptions of our creditworthiness and why

Lenders will rigorously assess how likely they are to recover their debt. Part of that assessment is to look at how liquid an organisation is, the level of gearing, and what security is available in case things unexpectedly go wrong.

FNG trading performance is declining and so lenders are naturally going to be more nervous about providing debt finance to the organisation. The more nervous they are about the recoverability of their debt, the keener they will be to secure it on an asset of the business.

FNG has now sold a key asset of the business and one which may have been used as security. The proceeds of the sale may not benefit the gearing and liquidity ratios of the business if they are invested in non-capital projects such as increasing the digital offering, leading to further adverse movements in liquidity and gearing ratios and signaling to the bank that FNG is less creditworthy than it was before.

Additionally, there may have already been security over Press Site One, and when it was sold the bank may have required some of the proceeds to go towards payment of the attached debt.

Finally, the bank will also consider whether the sale of such a key part of the business is a desperate measure by an organisation struggling to survive. If that is the perception of the lenders, then they will consider FNG to be more of a risk and less worthy of their credit.