STRATEGIC CASE STUDY FEBRUARY 2018 EXAM ANSWERS

Variant 4

The February 2018 exam can be viewed at

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SECTION 1

The impact that Pennies Gyms entering the budget gym market will have on our ability to meet our strategic aims as listed in our annual report

Royals results are very sensitive to a large competitive threat of this nature. Losing a high number of members makes it very difficult to achieve our four strategic aims:

1. Membership numbers will be significantly affected both in terms of acquisition and retention if people choose Pennies as a cheaper alternative to Royals. The lower price offered by Pennies will be enticing to customers, particularly in our sector of the market - budget gyms.

2. The launch of Pennies will make it harder to open more gyms in Hylandia as we will be less confident that we can attract sufficient customers to achieve target ROCE by site. Even if Pennies is not currently operating in an area, we cannot be sure they won't open there in the future. However, it may make it more attractive to open gyms further afield where Pennies does not operate and is unlikely to operate in the immediate future - for example, overseas.

3. Whenever a new competitor joins the industry, market share is going to be under threat and hence Pennies entry to the market will clearly reduce our market share of the budget gym sector in Hylandia. Although some new joiners to Pennies will come from other competitors and some will be new to gym attendance attracted by the very low membership price, there will also be a movement of people from Royals to Pennies and this will be concerning.

4. If customers choose Pennies instead of Royals this will have an immediate effect on our operating profit. If membership numbers fall, revenue will fall and unless costs decrease by the same level this will mean less profit. As a business with high fixed costs it would be hard to reduce costs so quickly meaning profit margins could be rapidly affected. If we select the marketing

programme option to address the threat this will reduce operating profit in the short term. It looks likely that whatever action we take our operating profit performance is going to be detrimentally affected.

Should we reduce our prices?

The first proposal to reduce prices is clearly not a long-term solution. To match Pennies price of H$5 per month, we would have to reduce our price by 67%.

In a model with a high volume of customers even a small reduction in the membership price will have a big impact on profit. For example, applying a H$1 price reduction to the 2017 average of 3,514 members per gym multiplied by 125 gyms demonstrates that revenue would reduce by H$5million over a year. This would eliminate most of Royals profit. Also, if we assume Pennies is a short-term threat, a reasonable assumption given the unsustainably low prices they will charge, we may struggle to increase prices again if/when Pennies fails. This would be unpopular with customers and cause a considerable amount of bad feeling.

You might consider reducing price at only those Royals gyms near to a Pennies opening to reduce the impact on revenue but this gives us a differential pricing model and is likely to upset those Royals members affected, and lead to customer complaints of unfairness. This will damage Royals reputation and could lead to significant loss of members.

It is worth remembering that Royals already charge H$5 less per month than the average budget gym membership fee in Hylandia and even with several dollars reduction in fees it will still not match Pennies price and hence customers may still leave for the H$5 proposition. Matching Pennies price would create a completely unsustainable loss position.

Therefore, I would suggest that reducing membership price to any degree is not a viable proposal.

Should we undertake an expensive marketing programme?

The proposal to spend H$6million on marketing has more merit.

If we can persuade members to stay with Royals by offering incentives such as rewards for referring a friend or several attendances at the gym in a week we gain many benefits. The refer a friend programme could attract new customers and help retain existing customers as members who have a friend at the gym would be less likely to cancel. Rewarding attendance is also effective because as well as persuading the customer to stay at Royals it also increases their gym use so customers feel they are getting value for money.

The investment in branding and national TV campaigns has a less direct, obvious benefit but any work to increase brand strength is likely to be effective in developing customer loyalty.

A further benefit of this sort of proposal over the reduction in price is that it can be adapted over time when it becomes apparent what works well. If Pennies does not sustain its position in the market as suspected, there is no commitment to carry on spending this sort of amount on marketing. In contrast to changing prices unpredictably, customers are less likely to feel badly towards Royal when marketing spend ceases and may not even notice it at all.

The disadvantage to this approach is the high cost which would significantly reduce current year profit. We would have to hope it was sufficiently effective in terms of retaining customers to make Pennies an impossible proposition in the long-term and we could then look forward to returning to previous levels of profit.

Overall, the second proposal seems to be more appropriate, giving us the chance to reduce the short-term damage caused by Pennies low cost entry to the market, but also providing a long-term strategy that will help us achieve our strategic aims for the next three years.

SECTION 2

How we can manage our relationship with the bank better in the future

The relationship to date has been very informal which has been beneficial in some respects, not least a relatively cavalier approach from the previous bank manager to providing us with more debt if we needed it. The new manager at the bank appears to want more formality and structure, which means that any variation from the rules set out in our agreed facilities (such as missing a reporting deadline or breaking a covenant) might give us significant issues. These could range from closer monitoring of the business, to an independent accountant being asked to report on the business (at our cost), to increased borrowing costs or more constricting covenants, or to the reduction or complete withdrawal of the facility.

To avoid any issues with the bank, we should:

1. Review the bank facility documents and note all reporting requirements, set appropriate timetables at least 6 months ahead to ensure that these timetables are met, ensure that all staff involved in the production of those reports are made aware of the importance of providing the information on time, and assign responsibility for this overall task to the Chief Finance Officer. It would also be sensible to include this item on monthly board meeting agendas, so that the Board can monitor adherence.

2. Communicate to all staff that all correspondence and communication with the bank in future should be left to the Chief Finance Officer. One point of contact will ensure that messages are consistent and at a high level.

3. Consider widening the relationship with the bank to other more senior officials so that the relationship goes beyond a single point of contact.

What we can do to ensure we continue to meet our covenants

Financial covenants are often set around profitability and cashflows, as well as other covenants for specific businesses. For Royals, there are EBITDA and cashflow covenants set by the bank, and covenants with GEM around the level of debt allowed in the business.

Covenants should be set out based on the rules set by the bank/GEM. These should then be regularly monitored by the business – not just based on historical trading but also looking forward at least 6 months. The forward-looking covenant review will clearly be based on forecast profitability and cashflows, and could therefore be subject to over or under performance. The forecast process must therefore be robust so that the impact of expected performance can be properly assessed.

When the forward look suggests that a covenant could be breached, or are very close to being breached, we should take corrective action to ensure that a breach does not occur, such as delaying capital expenditure or other costs. If this is not possible, we should communicate with the funder early to warn them of a potential breach – this will give them confidence in our ability to manage the business.

Finally, the historic and future covenants should be reported regularly to the Board so that it is aware of any potential breach at the earliest opportunity.

With regard to the existing bank facility and GEM covenant, the company should consider increasing its facility and requesting permission from GEM to do so. It should seek permission well in advance of any requirement.

How we could use IT to provide a cheaper method of communication to staff

Spending H$500,000 on the marketing campaign on staff communication and training does sound excessive at first, but we need to consider the benefits of doing so in the way that has been suggested. Having face to face communication sessions would give us the opportunity to explain to staff why we need the marketing campaign and what we expect it to achieve. It would also help get buy-in from the staff. The training seminars would help to ensure staff are prepared and working consistently. However, using IT as an enabler would help to get the message across more quickly and with less cost.

When communicating straight forward information, as this marketing programme appears to, it might be over the top to spend H$500,000 if a cheaper, equally effective alternative method of communication could be used. Conferences and seminars involve considerable time and expense that could be avoided by the effective use of technology.

Royals could, for example, use an intranet to convey the basic principles of the programme providing a FAQs page and interactive question and answer forums as appropriate. Other information or updates could be posted here or distributed via mechanisms such as Skype, Facetime, conference call or email. The Board could hold a series of live presentations via video link with an opportunity for staff to ask questions.

Training seminars could be via a series of interactive sessions and we could even include some form of 'test your understanding' questions that staff can submit their answers to. This would help them to ensure that they understand what is happening and would give us a check to know who has, or hasn't, undertaken the training.

These ideas represent quick, cheap and easy ways to transmit a large volume of straight forward non-confidential information.

Advantages/disadvantages of using a bonus scheme to incentivise marketing staff

The key advantage of using a new bonus scheme to incentivise marketing staff is that it is likely to increase staff's motivation to achieve the ambitious targets set out by management. It ensures goal congruence between the desires of management and staff. As the membership targets are challenging there is a risk that staff could become demotivated by the magnitude of the requirement. A bonus scheme could be an effective way to counteract any reduction in morale and make it more likely staff will work hard towards the targets.

As a general point, such a scheme could make staff feel more valued and important even before any targets have been achieved.

However, the scheme will be costly at a time when profit is already a concern. Furthermore, staff in other departments may feel demotivated as a result of not being part of a bonus scheme. We may then have to extend bonuses company wide, which will be unfeasibly expensive or alternatively experience lower morale in other areas of the business when we most desperately need everyone to be working together.

A final point to note would be that it might be difficult to remove a bonus scheme for marketing staff once one is in place so if Royals introduce this now they may be under pressure to sustain it long-term.

SECTION 3

What risks would we be exposed to if we continue to outsource machine maintenance and security services and what controls we can use to prevent a similar accident

The risk of outsourcing machine maintenance and security services is that these services do not meet our requirements.

We have seen this in the case of Pennies that an adverse event has occurred as a direct result of the work of the external companies. Not only did the accident fail to attract the attention of the 24-hour security monitoring, but it appears likely that the accident occurred in the first place because of poor machine maintenance - again from an external service provider.

It is harder to control services when they are outsourced, as standards have to be set through discussion and Service Level Agreements (SLAs), monitoring is hard, and if circumstances or requirements change the process to communicate this to the external party takes time. This operational distance from the company increases risk and hence considerable controls are required to ensure the costs do not outweigh the benefits.

The first thing we need to do is check what controls are already in place. For instance, do we have an SLA with the security and maintenance companies that stipulate our expectations? This is absolutely necessary and if we don't have one a detailed SLA should be implemented immediately, clearly laying out our requirements.

In terms of machine maintenance, we must ensure standards for response time and quality of repair work are included in our terms and conditions so that any breaches of those conditions are noted and addressed with the outsource provider. We may want to apply penalties for not meeting our required standards or conversely reward excellent service from our supplier.

In terms of security services again we will need to lay out our expectations. It should be completely clear what sort of response times are acceptable and we may even request a test system whereby we are permitted to run occasional ‘mystery customer’ tests of response time. Again, we could increase likelihood of compliance with our requirements by either penalising non-compliance or rewarding compliance as described above.

It is likely that a clear agreement on service levels is required by our insurers and, if we are exposed like this, we may not be covered by our insurance. As with the family in the highlighted case here, it is likely that we would face a claim for compensation should a similar incident occur.

Finally, just having an SLA in place won't guarantee adherence to the standards put in place. Regular meetings need to be held with the outsourcer to manage the relationship.

Advantages and disadvantages of bringing all outsourced functions in-house

Although an issue has occurred at Pennies, outsourcing has worked well to date at Royals and it may be rash to suggest all these services are now brought in-house in response to one incident. However, the pros and cons are outlined below.

Positively, if we do bring these services in-house we will gain complete control over them. Therefore, these services become our responsibility and we will be able to prioritise them and ensure they meet the standards we require. The staff would be employed by us directly and we would have more influence over them and the way they go about carrying out their tasks. We would be training them in line with the expectations of Royals and this would help engender the culture that we are looking for. Bringing the service in-house does not necessarily mean that security staff would need to be on site 24/7, we could still operate a remote surveillance process like our current providers do. However, the responders would be under our control.

I do however see some considerable potential problems with this approach. These services will just be another area for us to manage and we are already a very busy, growing business. This is not our core area of expertise, and hence it seems likely we may not provide these services as well as our current specialist providers do. The outsource providers do nothing but provide these services and therefore benefit from economies of scale in their provision. It is unlikely therefore that we could cover these roles as cost effectively as they do. Furthermore, in addition to recruiting and funding the required staff, we would also need to carry out an on-going training programme to ensure that our staff in these areas are fully up to date with health and safety and other requirements, as well as the technical skills required to operate the services.

On balance, I would suggest we continue to outsource these functions, control them more tightly and swap provider if we need to.

Three KPIs to drive the performance of the in-house maintenance service

There are many KPIs that would be useful in driving good performance from the in-house maintenance service.

Three examples are:

Number of accidents reported per month arising from machine faults

The target for this KPI should be zero. A penalty should be incurred if any accidents do arise from machine maintenance issues, and steps taken to prevent it happening again in the future.

Number of maintenance call outs per month

This could be useful in assessing how often machines are not working. Any instances where maintenance is called out more than once for the same issue should be investigated to establish if the work provided is of sufficiently high quality.

Customer feedback scores on machine operation

Royals could seek customer feedback on many elements of their operation including machine maintenance and operation. Examining the scores provided in this area will offer information about how happy customers are with the quality of machine maintenance.