STRATEGIC CASE STUDY MAY 2018 EXAM ANSWERS

Variant 5

The May 2018 exam can be viewed at

https://connect.cimaglobal.com/resources/may-2018-strategic-case-study-variant-5-questions

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SECTION 1

Requirement 1 – ethical issues

In the first instance, Nolo has offered more than the market price for Couchweb's shares. If the shares were priced correctly by an efficient market then Couchweb's shareholders will benefit financially if they accept this offer. Martine's description of the Board's reaction suggests that the directors are concerned about the impact of this offer on their careers, even though their primary duty is to maximise shareholder wealth. If the bid succeeds, then Couchweb's directors will lose their status and independence as the Board of a quoted company. The founders will also see the entity that they created being turned into a subsidiary of a larger entity. Presumably, that loss of identity will upsetting for them at a personal level.

The principle of objectivity requires that the Board's advice should not be tainted by bias or conflict of interest. Couchweb's directors have a clear duty to consider the offer in terms of what is best for the shareholders. They are paid to act in the shareholders' best interests. In the first instance, this offer will increase shareholder wealth and so it is worth considering on that basis. It would only be acceptable for the Board to recommend a rejection if it thought that Nolo could be persuaded to pay more or if they had a genuine reason to believe that the takeover would be harmful for Couchweb's shareholders in the longer term.

The principle of integrity requires the Board to be straightforward and honest in its advice to shareholders. The press quote attributed to Chet Nolan is potentially quite misleading because he claims that the market price has increased by 15%, suggesting that the 10% premium offered by Nolo implies an underpayment. That argument could be potentially misleading because there are likely to be speculators who will buy shares in the hope that Nolo can be forced to pay even more for them. In the short

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term, the 15% surge in the share price could reverse if the market starts to recognise that there is a limit to what Nolo will actually pay.

The principle of professional behaviour suggests that the Board should comply with all relevant regulations, including the contractual duty to work in the shareholders' best interests. The principle also requires consideration of reputation. If the Board rejects the offer for selfish reasons then it will undermine confidence in governance generally. If Couchweb's three founders act in a blatantly self-interested way then that will be regarded as particularly problematic. They chose to sell 80% of their company's equity and the buyers of those shares are entitled to have them act in their best interests.

Requirement 2 – non-executives

Couchweb has a Chairman and three non-executive directors. They have the same basic responsibility as their executive counterparts, namely to maximise shareholder wealth. The non-executives have a duty to study Nolo's offer and to form an opinion on how best to advise Couchweb's shareholders. This advice will be complicated by the fact that the shareholders are not being offered the cash value of their shares. Instead, they will become shareholders of Nolo, which will have expanded through its acquisition of Couchweb. The non-executives need to consider whether it would be desirable for the shareholders to exchange their shares on that basis.

The most important responsibility from a governance point of view is for the non-executives to keep themselves fully informed of all developments and to participate in all Board meetings. The non-executives should not hold any shares in Couchweb and they should receive fixed salaries for their efforts and so they should be able to offer an independent perspective on how best to manage the bid negotiations. The non-executives should bear in mind that they will be associated with any information released by the Board and they should always consider whether they feel comfortable with any pronouncements. If they are unwilling to associate themselves with the Board's position then they should make their concerns clear. If necessary, they should be prepared to resign.

From a governance point of view, the non-executives will have to be careful about anything that they say in public. They do not have the same interests in Couchweb as the executive directors and so their views may attract more attention because there is less scope for bias. The danger is that they may create the impression that Couchweb's Board is divided and that could encourage Nolo to offer less than it might for the shares. The non-executives should agree that they will not speak on the record to the press unless there is a compelling reason for them to do so.

The non-executives may have to face the loss of their jobs as a result of this acquisition. It would be possible for a subsidiary company to have non-executive directors, but it would be unusual. From a governance perspective, the non-executives should accept that they will have to step down in the event that Nolo's bid succeeds. They can then proceed on the basis that they will do their best for the shareholders without their own self-interest being an issue. The bid may raise the non-executives' profiles and could be an opportunity for them to secure posts with other quoted companies. Acting with integrity throughout the negotiations with Nolo could enhance the non-executive's careers.

SECTION 2

Requirement 1 – Nolo's offer

The latest share price equates 11 x M$91.14 = M$1,002.54 with 5 x M$210.77 = M$1,053.85. That suggests that Couchweb's shareholders will be losing M$51.31 for every five shares that they exchange or approximately M$10 per share. That suggests that Nolo may be undervaluing Couchweb relative to market expectations and that Nolo should offer more. There would be no point in accepting 11 Nolo shares when it would be possible to sell five Couchweb shares for more than those shares are worth.

Comparing the offer on the basis of share prices before the bid gives 11 x M$87.24 = M$959.64 versus 5 x M$178.62 = M$893.10. That suggests that Nolo's initial bid was generous, but market expectations expressed by changing share prices since seem to suggest that Nolo could have offered more. The fact that both companies have increased in value implies that there are synergies to be had. Nolo's increase implies that its shareholders will benefit from acquiring Couchweb and more could be offered in order to share that benefit.

Couchweb's beta coefficient is lower than Nolo's, which means that combining the two entities will increase the risk for Couchweb's former shareholders and reduce the risk for Nolo's. It could be argued that Couchweb's shareholders will have to restructure their portfolios in order to obtain the risk profile that they require and that they should be compensated. In the same vein, Nolo's gearing is higher, which means that Couchweb's former shareholders will be exposed to further risk because of that. The greater volatility makes Nolo's offer less attractive.

We might also argue that Couchweb will contribute a host of synergies that might not have been properly valued by this deal. For example, Nolo might reduce its operating costs by promoting Couchweb's streaming service in place of selling physical disks. Couchweb's systems might also lend themselves to other forms of electronic delivery, such as downloads of ebooks in place of paper volumes. Nolo might be able to adapt some of Couchweb's systems to generate sales, for example, the algorithms that Couchweb uses to recommend future viewing could be used to make suggestions for future purchases based on shopping history. The two companies could also combine their IT systems in the interests of operational efficiencies and cost savings.

Requirement 2 – currency risk

At first sight, both companies are based in the same country and so both are exposed to movements in the same currency, which might imply a greater exposure to the M$. However, the acquisition will make it more cost-effective for Nolo to expand its treasury function to meet this threat. A better-resourced treasury will be able to identify opportunities for hedging that might either have been too complicated before or would involve excessive cost. Couchweb's cash flows differ in that it has foreign currency inflows, but no outflows and so the company may have had to develop more efficient ways of managing foreign cash balances.

Nolo will incur significant operating costs overseas, with a distribution centre in each country. It will also incur significant cost of sales denominated in the countries from which goods for resale are imported. Thus, Nolo has significant outflows for operating expenses that may be disproportionate to revenues in the same countries. Couchweb has revenues in most currencies, but no significant operating costs because everything is streamed from Mayland. That creates scope for netting off costs and revenues in a larger number of currencies than would have been possible for Nolo before the acquisition.

Couchweb generates a greater proportion of its revenues in M$ than Nolo, so the Nolo group will have a larger inflow of M$ after the acquisition. That will provide Nolo with a steadier supply of M$ with which to pay dividends and to service any debt in M$. The shareholders will enjoy greater consistency in dividend payments, with less scope for volatility in payments. It will also provide a ready source of M$ to meet the running costs for the head office and IT centre in Mayland.

At present, Nolo has distribution centres spread around the world. They will almost certainly be owned by overseas subsidiaries that will have to be consolidated. The Nolo Group's consolidated financial statements will create a potential exposure to translation risk, with movements between local currencies and the M$. Acquiring Couchweb, which is entirely in Mayland with no assets overseas, will not actually hedge against translation risk, but it will add M$ assets and liabilities to the group totals without increasing currency adjustments. The overall impact on net assets will be less significant relative to the size of the Nolo Group.

SECTION 3

Requirement 1 – Resistance to change

Nolo's has experience of acquiring other companies and delivering savings and efficiencies and so the senior management team is probably used to attempts to resist change. There has been considerable change to Couchweb's Board and the new chief executive and other directors will be determined to demonstrate success in managing the company's transition. It would be a sign of weak management if Couchweb's staff were permitted to block changes in a significant way. Having said that, two of the founders will remain on the Board and they may have greater influence than, say, a manager who is concerned about redundancy.

The fact that Couchweb has a different business model could make it easier for staff to resist change in the short term. Any changes suggested by the new Board members might be criticised by managers who claim that their experience suggests that the ideas will not work. It will be discouraging for incoming managers from Nolo if they have to fight to implement every change that they wish to make. Couchweb has a relatively few assets and a small staff, so there will be little scope for meaningful savings in any case, which will further support any resistance.

Requirement 2 – responding to resistance

The first priority is to establish the trust and the support of the founders. This may have been accomplished in part already by promoting Chet Nolan to Nolo's Board. If the founders are open to and supportive of change then it will be more difficult for managers at other levels to resist. At the very least, the founders should be consulted on any changes that are proposed, with an opportunity for them to voice their opinions. Any managers who object to a proposal can then be told that the founders are aware of it and believe that it is a positive step.

Couchweb's staff should be kept informed of Nolo's plans so that they know what challenges they will face in protecting their interests. If staff cuts are a possibility then the scale of any losses should be estimated and the basis for selecting staff for redundancy should be clarified. The possible loss of key staff should be addressed by identifying those whose jobs are safe and by ensuring that they are aware of that. The focus of all communications concerning changes should be on the staff as individuals. They will not be reassured that all changes are intended to make the company more prosperous for the benefit of Nolo's shareholders.

Requirement 3 – financial objectives

In the short to medium term, the most important financial objective for Couchweb is to maximise its operating profit. The Nolo Group has invested heavily in Couchweb and so improving operating profit will enhance the parent's return on investment. Care will have to be taken to reduce the risk of dysfunctional behaviour in the process. For example, Couchweb should write off the cost of any licences for new content as an operating expense, given that content will be purchased on an ongoing basis. The profits will yield net cash inflows and that will contribute to Nolo's ability to pay dividends to its shareholders.

The fact that there is very little in the way of marginal cost for adding additional subscribers suggests that monthly revenue will be a key non-financial objective for Couchweb. Maximising subscriptions will essentially maximise operating profit and so shareholder wealth.

Operating costs should also be scrutinised for potential savings. Although Couchweb should take care to avoid making dysfunctional savings, such as reducing the outlay on new content to the point where subscribers are lost.

Requirement 4 –non-financial objectives

The non-financial objectives should be selected on the basis that they will support the financial objectives. That will avoid conflict and reduce the scope for dysfunctional behaviour. For example, subscriber numbers should be tracked closely, with a view to establishing what proportion of the potential market is being served. Almost every home that has an internet connection can receive Couchweb and subscriptions are affordable, so marketing is crucial. If a particular market has a low level of penetration then it may be a sign that more effort should be put into attracting more subscribers. These figures should be compared with the numbers of subscribers boasted by other streaming companies, if any.

On a related note, measures of customer satisfaction for existing subscribers should be tracked closely. Losing subscribers will involve the cost of finding new customers to replace them. Statistics such as the average number of programmes watched in each market will indicate the extent to which subscribers are using Couchweb. The average rating given to programmes will also help us understand whether subscribers enjoy the content that we have provided.