STRATEGIC CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 3

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SECTION 1

Requirement 1 – strategic stakeholders

Harland's Ministry of Health is a key stakeholder. It has demonstrated a high interest through initiating the proposal. It has high power because it can also threaten to deprive us of a key market. The most obvious response to this stakeholder's interest would be to agree to the demand, although that would involve significant cost to Novak. Alternatively, we might attempt to diminish the Ministry's power. One way to do that would be to enlist the support of the press in Harland. If we could persuade them that Novak's products include the most effective treatments for some serious illnesses, then it may become difficult for the Ministry of Health to carry out the threat of banning further purchases from us.

Cronland's government will have a great deal of power because Novak will continue to be based there, even if we relocate one of our factories from there. The government will also have high interest because of the implications for any government of a significant loss of jobs and prestige associated with the relocation of a multinational company. Novak might manage that relationship by agreeing to close the Rontan factory if it becomes necessary to locate in Harland. It would, however, be preferable to lobby Cronland's government to intervene with Harland's government in support of permitting Novak's factories to remain where they are and without penalty in terms of purchases.

The employees at the factories that are faced with closure will have a significant interest because their jobs are threatened. They will have relatively little power over Novak, other than threatening to resign in pursuit of alternative jobs while Novak still needs them. One strategy for dealing with these stakeholders would be to work with them to make it attractive to retain their services while the factory in Harland is under construction, perhaps by enhancing redundancy payments. Alternatively, Novak might seek employees' support in lobbying the governments of both Cronland and Rontan to permit Novak's factories to remain where they are, thereby augmenting and channelling their power and exploiting their interest.

Novak's shareholders will have a significant interest in this event because the ultimatum from Harland's Ministry of Health is likely to reduce their wealth because the

company must now choose between an expensive relocation and the loss of a major customer. The share price will probably fall as soon as the news becomes available to the market. Once the share price has fallen then the shareholders will have relatively little power, other than to threaten to replace Novak's directors for having permitted this situation to arise. Novak's board should aim to minimise the fluctuations in the share price by ensuring that the markets are kept well informed. The directors should also make it clear that they are working towards the outcome that best supports future net cash inflows.

Requirement 2 – ethical arguments

Novak's employees will clearly be significantly disadvantaged if they lose their jobs. The question is whether it is acceptable for Novak's board to impose that on them in order to protect the revenues from sales to the Harland Health Service. Essentially, that requires the board to consider the interests of the shareholders in relation to those of the employees, because it could be argued that pursuing the workers' interests could conflict with those of the shareholders. There could also be a conflict between the interests of Novak's present employees and the potential employees who live in Harland, who are presumably in need of jobs. The CIMA Ethical Guide is often a sensible starting place for resolving ethical dilemmas.

The first question is whether making these employees redundant would imply a lack of integrity, which requires straightforward and honest behaviour. The relationship between Novak and its current workforce is defined by the contracts of employment and by employment law in Cronland and Rontan. It is inconceivable that Novak's contracts of employment guarantee its employees jobs for life. It is almost certainly understood that staff have jobs for as long as it is commercially viable to keep them. Both the contracts and the employment legislation will specify the compensation that is due in the event that Novak terminates these jobs and there is no lack of integrity in making staff redundant provided they receive everything that they are entitled to.

Directors' contracts almost certainly impose a specific responsibility to act in the shareholders' best interests, which ought to be taken into account in any management decisions. The principle of objectivity states that there should not be any bias when making a business judgement, such as a bias in favour of safeguarding the employees' jobs when they are not entitled to jobs for life. The fact that there is a direct conflict between the interests of the shareholders and the employees means that the board should respect the specific duty to pursue the shareholders' needs. The employees' interests are the subject of other specific responsibilities, but the board can address those by ensuring that the employees receive a realistic redundancy package that complies with the law.

The concept of professional behaviour suggests that all regulations should be complied with and that the board should not act in a manner that discredits Novak's reputation. The closure of a factory, particularly in a developing country, is likely to have a negative effect on the company's reputation. That is particularly true when the reason for doing so is to protect the company's profitability. That might justify exceeding the legal and contractual minimum when compensating staff for the loss of their jobs. While the shareholders are the principal stakeholders, it is generally accepted that companies have a duty to other stakeholders and so it could be in the shareholders' commercial interest to make a more generous settlement.

SECTION 2

Requirement 1 – issues arising from applying APV

The first challenge is to evaluate the Harland factory project as if it is all equity financed. There are various models that we might apply to our observations of the share price in order to yield WACC or the beta coefficient of the equity, taking account of gearing. Once we have that result, we can then strip out the effect of debt or gearing in order to get to an observable cost of equity. If we assume that the Harland factory is essentially just a continuation of business as usual then we can use Novak's current cost of equity to discount the future marginal cash flows. We will, presumably, have to assume that the Harland factory will continue into the indefinite future once the cash flows have settled down after the relocation.

The closure costs for the Cronland factory will have to be estimated and taken into account in determining the total cash flow. We will also have to estimate any impact on costs and revenues during the transitional period, bearing in mind the effects of any inefficiencies from operating the Cronland factory while creating the replacement in Harland. The estimates will be highly subjective and will have to take account of possibilities such as the threat to sales in markets outside of Harland as well as the additional revenues that being the HHS preferred supplier will generate. We may face problems with our remaining factories in Cronland and the cash flow implications of those will have to be considered.

The financing package will have to be studied closely. We should treat the 6% wage subsidy as an element of the funding offered by Harland's government because it is a grant rather than an operational cost saving. The present value of the lease payments, allowing for our expectations of future payments after the 20 year initial period has elapsed, should be determined. The tax relief created by these expenses will also have to be estimated and be an issue. The present value of the net cash flows should be determined by discounting them at Novak's pre-tax cost of debt**.**

The project APV is basically just the net value of the cash flows described above. A positive (or zero) APV suggests that the relocation to Harland is desirable while a negative figure suggests that it is not. Care should be taken in evaluating risks because the cash savings from the tax relief are being evaluated at the relatively low cost of debt and those benefits may be overstated. The evaluation should take account of potential problems, such as the post-tax cash inflows from the disposal of the Cronland factory being insufficient to cover the setup costs in Harland.

Requirement 2 – beta

The beta coefficient reflects the systematic risks faced by an entity. These are the risks that affect all market participants and cannot be diversified away. In principle, it could be argued that Novak will continue to make and sell the same products after the relocation of the factory and so the company's systematic risk may be left largely unchanged.

The relocation could change Novak's overall gearing, which would have an effect on beta. Increasing debt, through the lease on the new factory, will increase gearing and so could increase the company's geared beta.

The relocation may have an impact on the currency risks faced by Novak. Novak has 12 factories in total, with three presently in its home country. Relocating one of those three could make Novak more susceptible to fluctuations in its home currency which

could increase its beta because exposure to movements in key currencies may be one of the factors that have an impact on systematic risk.

The fact that the Harland Health Service will treat Novak as a preferred supplier, when it is presently the source of 9% of Novak's revenue, could have the effect of reducing the sensitivity of Novak's profits to changes in the business environment. If Novak's revenues are protected then its beta coefficient may decline.

The most immediate impact of any change in beta is that the cost of equity will change, with an increase in beta increasing the cost of equity. An increase in the cost of equity will reduce the share price. This will have no direct impact on the company itself, but it will reflect a decrease in shareholder wealth. In an efficient market, there will be nothing that Novak can do to alter its share price or restore it to previous levels, not unless the company can somehow release positive news that had not been anticipated by the markets.

The decreased share price will lead to an increase in Novak's cost of equity and so the hurdle rate for new projects may increase. This may make it more difficult for Novak to expand or to maintain its competitive position by investing in new research projects. The directors may also feel pressured to restore the share price and convince the markets that the required rate or return is too high. This could lead to problems with governance if the board misleads the shareholders about the risks or the likely returns to be had from investments.

SECTION 3

Requirement 1 – Kurt's costings

Kurt's costings represent a significant increase of roughly 50% in manufacturing costs. We cannot simply accept such an increase without attempting to mitigate it. Roughly half of the increase is due to increased formulation and factory costs that may be largely attributable to wages. There may be little that we can do to avoid that increase because Harland's government may be unwilling to accept, say, the use of automation to reduce staffing levels. There may be ways to offset the increase in materials costs, perhaps through more efficient management of currency risks. The fact that significant sales are to be made in Harland may mean that there is a natural hedging between costs and revenues when the net cash flows are remitted back to Novak's head office.

It will undoubtedly demotivate production if we hold them responsible for the increased costs. The increases were motivated by a strategic decision made by the Board in order to protect revenues from the Harland market. The Production department has no immediate control over these increased production costs and it will take time to determine whether it is possible to introduce efficiencies in the operation of the new factory. We should, however, check Kurt's costings carefully in case he has added some slack in order to make it easier to meet those cost targets while the new factory is coming on stream. We may find that some of the assumptions that he has made are unduly pessimistic and so we cannot take them as our starting point without further discussion and investigation.

We cannot afford to relax quality standards during the transitional phase. If we sell batches of poor quality antibiotics, then we could harm patients by giving them defective medicines. Inferior quality medicines may not have the desired effect and so patients' conditions are effectively being permitted to worsen. There could even be a more direct threat if there has been contamination that causes further illness or injury. From an ethical perspective, Novak must ensure that it does not risk patient health for the sake of cutting corners on its relocation.

The sale of poor quality products could have a severe impact on Novak's reputation. Prescribing habits may change if doctors, or even patients, start to worry that Novak's medicines may be harmful. Once those habits change, it may take a very long time for doctors to revert to Novak's products because our competitors are likely to offer alternatives to most of our products. The fact that we have concerns about the quality from the new factory suggests that we are aware of the risk and ought to take care to manage it. In the event of a significant problem arising then we will be even more open to criticism if it ever emerges that Novak did nothing in response to the heightened risk.

Requirement 2 – dealing with regulators

The biggest challenge that Novak is likely to face is that new treatments are likely to be more expensive than older drugs. Research-active companies such as Novak must recover their development costs, including the costs of unsuccessful research activities. They may, however, find themselves competing with companies that manufacture off-patent medicines that are relatively inexpensive to make and that have already been proven to work. The challenge in launching a new drug, that will almost certainly cost more than generic competitors (some of which may have been developed and sold by Novak) is that the regulator has to be satisfied that the new product offers sufficient additional benefit to justify the additional cost.

The PRA and similar organisations also have to consider patient welfare. New or modified products may create a risk of unknown and unexpected side-effects that could harm patients. Existing products will have built up a history and their risks and benefits are well known. Regulators may be reluctant to risk authorising the use of new products, thereby accepting responsibility for any problems that they create. Not only would that risk the regulator's credibility, it would also impose a burden on the health service in treating the patients who had been harmed.

The first challenge could be dealt with by focusing on developing products that offer significant advantages over existing treatments. As part of the process of deciding which development projects to pursue, Novak should consider whether they have the potential to be significantly better than available treatments. Novak should also make use of the press to publicise any new products that are coming up for approval. Regulators may be reluctant to reject an expensive treatment if it offers a significant advantage in the treatment of a serious disease, especially if potential patients are already aware of the possible benefits that it would offer them.

Novak cannot guarantee that every new product is entirely risk free, but it can take care to reassure the regulators. Ideally, Novak should exceed the minimum standards when conducting trials, although that could create problems if it put more test subjects and patients at risk in the testing stages. Certainly, anything that Novak can present to the regulators to demonstrate that its products have been tested thoroughly would help, particularly if it exceeded the testing conducted by competitors. The company should also take care to collate reports of any problems, perhaps by creating a website or call centre to which doctors could report any problems. If Novak made any such reports available to the regulators, in the interests of transparency, then it would be a further confirmation of confidence.