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A2 GCE APPLIED BUSINESS

F248/01/CS Strategic Decision-Making

PRE-RELEASE CASE STUDY

JANUARY 2013

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INSTRUCTIONS TO TEACHERS

- This Case Study **must** be opened and given to candidates on receipt.

INFORMATION FOR CANDIDATES

- You **must** make yourself familiar with the Case Study before you sit the examination.
- You **must not** take notes into the examination.
- A clean copy of the Case Study will be given to you with the Question Paper.
- This document consists of **8** pages. Any blank pages are indicated.

Creacon Developments plc (CD plc)

The business

Creacon Developments plc (CD plc) is a property development company. It builds a wide range of domestic properties from 1-bedroomed flats to 5-bedroomed houses. *CD plc* sells its homes directly to the public with prices starting at £75 000. It does not operate in the rental market. The company has developments underway in various parts of the UK. Its head office is in Derby.

CD plc's activities begin with the identification and purchase of suitable land and end with the marketing and sale of the properties. In between is a complex and lengthy process of obtaining planning consent, designing the site and construction. Unlike many of its competitors, *CD plc* has its own building division responsible for the onsite construction of the properties.

Sold under the Creacon brand name, its properties have a reputation for being well built and good value for money. The company is noted for building homes with creative designs and environmentally friendly features. In addition, *CD plc* has an excellent reputation for customer service. Despite building well over 2000 homes a year, and having an annual turnover in excess of £300 million, the company's market share is less than 2% of the national market of over 115 000 new builds each year. *CD plc*'s leading competitors are more than ten times its size. Since its inception in 1985 the company's motto has been "large enough to deliver, small enough to care".

Troubling times

In 2009, *CD plc* surpassed its profit objective for the year, achieving a net profit margin of 8%, a figure just above the average for the construction sector. However, poor performance in 2010 saw the company's net profit margin plummet to 0.8%, falling woefully short of its profit objective, as levels of sales started to fall. Earnings per share fell to 0.6p, affecting share prices and investor confidence.

In 2011, at the mercy of economic conditions and despite the best efforts of the marketing division, *CD plc* experienced a further significant fall in sales volume. The company expects to record a trading loss for 2012. With competing demands for shareholders' funds, the company must fight for its survival. *CD plc* is not alone. The adverse economic conditions have affected the entire construction sector – domestic and industrial. The lack of availability of mortgage funds has hit companies which build domestic properties especially hard. Consequently, competition within the industry has intensified.

CD plc's directors are concerned that the company's brand name and reputation for excellent customer service may not be enough to keep it afloat. Like many other businesses in the sector, *CD plc* is facing the very real possibility of failure.

Added difficulties

Even when market conditions are more favourable, operating in the property development market is never easy. Identifying sites suitable for development in marketable locations is, perhaps, the biggest challenge. Once purchased at a suitable price, planning consent needs to be obtained. Current UK planning regulations make obtaining planning consent a complex and lengthy process. Even for a business which deals with planning applications on a regular basis, the outcomes of planning decisions can be unpredictable. Since construction cannot begin until planning consent is obtained, any delays in this process are expensive and have a negative effect on *CD plc*'s cash-flow. Not uncommon, especially after a change of government, changes in planning legislation further complicate matters for *CD plc*'s planning division which frequently has to come to terms with new regulations.

When construction work finally gets the go-ahead the building division may encounter technical difficulties caused by unexpected ground conditions or adverse weather, leading to further delays. Even when a sale is agreed the problems are not over for *CD plc.* Whether by necessity or choice, buyers frequently pull out of an intended purchase before the sale has been completed. The company is then forced to find an alternative buyer, causing an inevitable delay in the receipt of revenue. With a cancellation rate of approximately 18%, in line with the industry average, this has a significant impact on the company's cash-flow position.

More problems

The price of land is very expensive. Operating in the property development market requires frequent purchases of large quantities of land. There is no possibility of revenues being earned from a site until at least one property has been completed and sold. *CD plc* finances land purchases through secured loans. Being highly geared, the company pays finance costs in excess of £10 million per annum.

The current decrease in effective demand for new build homes has left more flats and houses than normal unsold and on the company's books. *CD plc* is, therefore, carrying higher than normal finished stock levels in the form of completed, but as yet unsold, properties. Whilst its current asset ratio is a healthy 3.5:1, the illiquid nature of the completed properties has led to the company trading with an acid test ratio of 0.7:1.

The number of flats and houses which the company builds will inevitably have to be reduced in line with demand. This raises further issues for the staff employed in the building division. The division currently employs 180 fully qualified construction workers. Each worker specialises in a particular trade such as bricklaying, roofing, decorating and so on. Nearly all of the construction workers are members of a trade union. The Finance Manager of *CD plc* has warned that within weeks, if nothing changes, there will no longer be enough demand to justify employing all of the workers in the building division and decisions will have to be made. Some workers in the building division are already left with no option but to stand idle through parts of their shifts; time *CD plc* can ill afford to pay for. The lack of demand will affect other workers in due course.

In addition, the directors of *CD plc* have been concerned for some time about increased costs and declining performance in the building division. The directors acknowledge that poor human resource planning on the part of the onsite supervisory teams is partially to blame for the problem. Annoyed by inconvenient scheduling and constant changes to their shift patterns, workers, who once displayed pride and commitment in their work, now exhibit little respect for the onsite supervisory teams and a lack of loyalty to the company as a whole. For the past three years, on virtually all sites, productivity has been falling and wastage levels rising. Absenteeism and labour turnover have reached unacceptably high levels. Morale in the building division is at an all time low. The fear that some construction workers may lose their jobs as a result of reduced demand for the company's properties is adding to the problems.

The dilemma

Doing nothing is not an option. Something has got to be done, and done quickly, or *CD plc* will not survive. Acting on advice from the Finance Manager, the directors are considering two options.

Option 1 – Amalgamate

CD plc would amalgamate with a similar sized property development company called Industicon plc. Industicon plc is a developer of small industrial properties. Its head office is in Leicester. Currently all of the industrial units which Industicon plc develops are custom-made to order. Industicon plc does not directly employ its own construction workers. The company is able to finance most of its operations through equity funding and is consequently low geared. Whilst its profit margins have fallen in recent years, its cash-flow management is good.

The two companies would deliver their full product portfolios (domestic properties from 1-bedroomed flats to 5-bedroomed houses and customised industrial units) but operate with pooled resources. Sharing financial and human resources in particular should lead to an improvement in performance over and above what could have been achieved by the two companies individually.

In addition, a new venture would be embarked upon – the building of an industrial estate on the outskirts of Nottingham. The development would consist of 40 standardised industrial units which would be made available to let or to buy. This major undertaking would utilise the expertise of both parent companies. It would require the newly-formed amalgamated company to purchase suitable land, obtain planning consent, design the estate, build the units and successfully market the properties.

The total cost of this option is estimated to be in the region of £4 million.

Option 2 – Downsize

CD plc's directors would downsize the company by closing the problematic building division. The company would use external contractors to construct its Creacon brand of properties in much the same way as most other property development firms. The vast majority of the 180 workers employed in *CD plc's* building division would be made redundant, although a handful would be retained to act as site inspectors. The site inspectors would be required to keep a check on the work being done by the external contractors and deal with any problems which arise.

The strategic decision to close the building division will have redundancy and other costs totalling £1.2 million. After the closure of its building division, *CD plc* would continue to develop homes but it would concentrate exclusively on building starter homes with no more than two bedrooms using external contractors. These small flats and houses would be targeted at people living alone and couples without children. In order to keep prices low, designs would be simplified, hopefully attracting first time buyers.

Appendix 1

Ten common reasons why businesses fail

1) No strategic focus, no mission or vision: No drive for business excellence, only upon survival.

2) Poor financial control: No profit planning. Disregard for effects on the business' balance sheet of spending decisions. Poor credit control. No bad debt protection.

3) No cash-flow management: Poor management means high finance charges, eg overdrafts or factoring costs. It often means business failure when coupled with high payments, eg VAT or sudden bad debts. No cash-flow forecasting.

4) Inadequate cost control: The selling price is always known, but what is the cost price? The contribution from operations must exceed the overheads by a long way. Remember, capital repayments and Corporation Tax, etc, are in addition to overheads.

5) Negative working capital: To make and to deliver goods there must be ready cash available to purchase raw materials and pay wages. Her Majesty's Revenue and Customs (HMRC) must be paid up to date, and not paying such a very powerful creditor can be fatal. Banks are not in business to bale other businesses out of these problems.

6) Poor customer relationship management: Poor quality management always leads to customer dissatisfaction. They go elsewhere! The cost of winning a new customer is very high – the cost of retaining one is very low.

7) Poor employee relations: Lack of respect, lack of training, no teamwork. All lead to a disenchanted workforce which will be inefficient and uncaring.

8) Fraud and wastage: An uncaring workforce will allow waste to occur unnecessarily. With no ownership values in place, stock or property theft will soon overtake profits.

9) Inadequate insurance: Material disasters, business interruption, management health, bad debts, can be fully insured to help prevent business failure.

10) Shareholder disputes in an owner-managed firm: Major disputes seriously deflect focus from the business. Legal intervention can easily lead to liquidation of assets and the breakup of the business.

Appendix 2

Is the golden age of home ownership over?

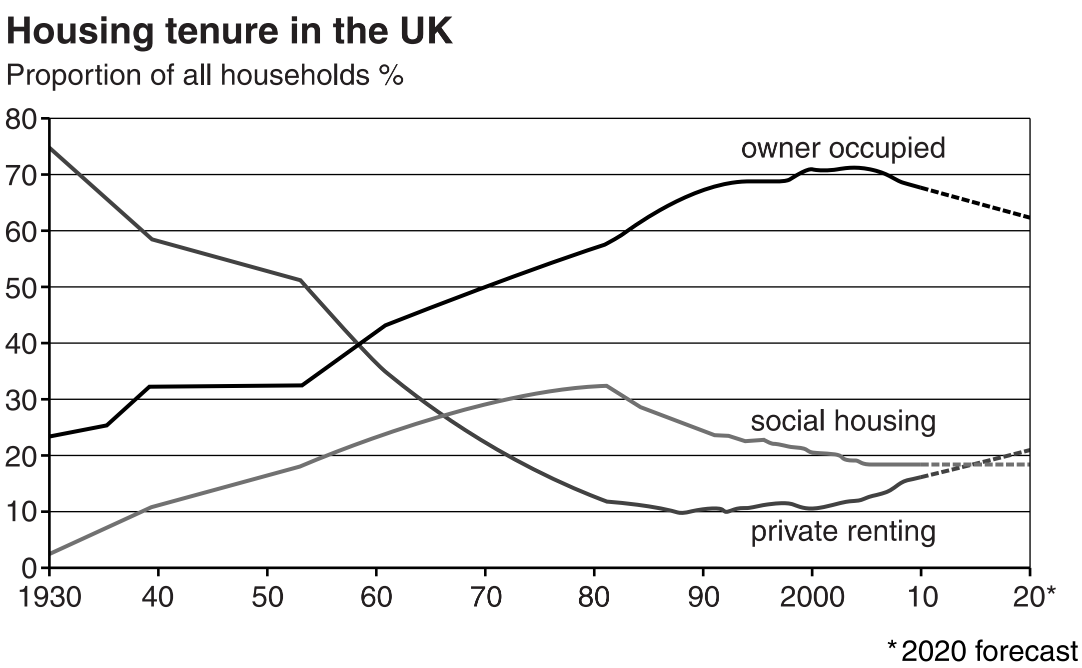
For millions, the ideal of buying, owning and making a hefty profit from one's own home has gone from a dream to an expectation, which has fuelled an insatiable demand for TV property programmes. It is as much a national obsession as football, pets and complaining about the weather.

But in the post-credit crunch world, reality is slipping behind the fantasy of ever-rising prices and a mortgage for all.

According to a report by the Chartered Institute of Housing, the era of the owner-occupier could be in decline, with millions facing a lifetime as tenants rather than freeholders.

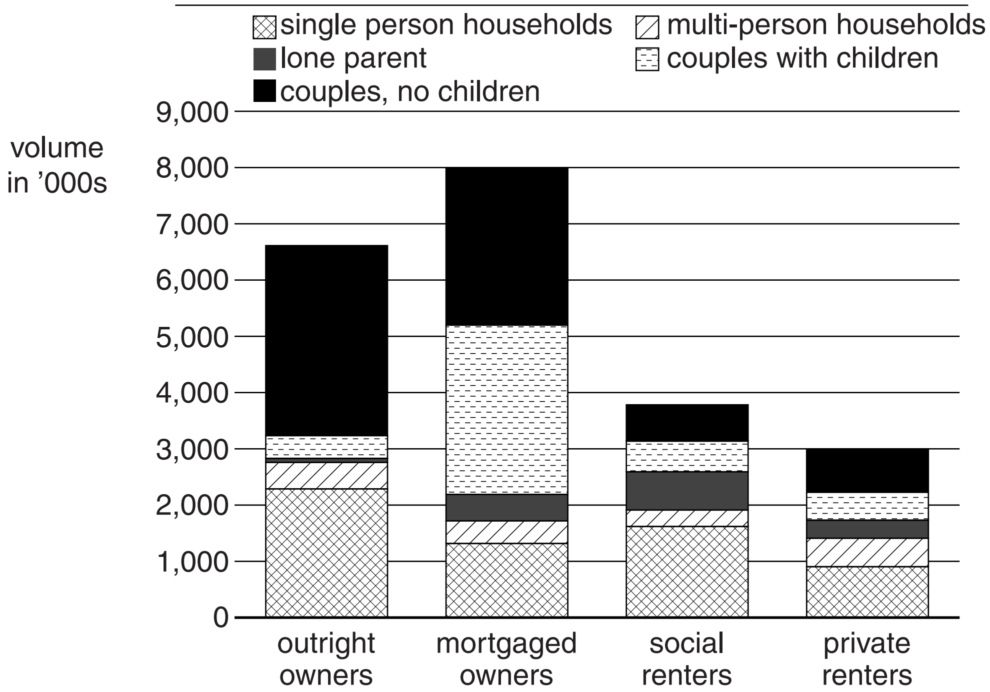
According to statistics from the Council of Mortgage Lenders (CML), the average first-time buyer is now putting down a deposit of £35 000. The estate agency, Savills, predicts that this high threshold will mean an increase in the percentage of Britons renting privately and a drop in the proportion lucky enough to be owner-occupiers.

By 2020, it forecasts that some 20% of households will be privately renting – up from about 15% in 2010 and a low of 9% in 1988. By contrast, it predicts that owner-occupied households will make up 62% by the start of the next decade – down from the 2010 figure of 67% and an all-time high of just under 71% in 2003.



Appendix 3

Analysis of UK housing market by occupancy:



Appendix 4

Demand for industrial units growing

The Worcestershire commercial property market reflects the national economic situation, with manufacturing improving and the services sector flat, according to John Dillon, Managing Director of specialist Worcestershire property consultancy, JP Dillon Commercial Property Consultants.

“Manufacturing is bouncing back across the county with an increasing number of industrial units coming onto the market and being snapped up,” said Mr Dillon.

“The general shortage of ready to go sites and lack of stock continues to push up industrial and distribution rents and freehold values, providing an opportunity for landlords and developers who can quickly bring the right sites and stock to market to meet the demand,” continued Mr Dillon.

“In Redditch, for example, we have had a very strong response from both developers and investors in the 2.6 acre Troy Industrial Estate on Jill Lane in Sambourne, which has come to the market for the first time in 30 years.”

Troy Industrial Estate presently has four industrial units and an office building covering more than 13 500 sq ft, and planning permission granted in 2005, for a further four industrial units totalling 20 000 sq ft.

Mr Dillon said: “At a guide price of £650 000, there have been many expressions of interest, especially when you consider that new small industrial freehold units in the area are going for around £95 per sq ft.”