GCE

# Business Studies

Advanced GCE **F297**

Strategic Management

# Mark Scheme for June 2010

Oxford Cambridge and RSA Examinations

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**Question 1 (a)**

**Calculate, correct to two decimal places, FOUR appropriate profitability ratios for LCL in 2009 [13]**

| Ratio | Formula | Data | Outcome |
|---|---|---|---|
| Return on Capital Employed | PBIT x 100%<br>CE<br><br>*NP x 100%*<br>*CE* | 23,360 x 100%<br>124,340<br><br>*16,815 x 100%*<br>*124,340* | 18.79%<br><br><br>*13.52%* |
| Return on Equity | NP x 100%<br>Equity | 16,815 x 100%<br>100,340 | 16.76% |
| Gross profit margin | Gross profit x 100%<br>Sales | 223,615 x 100%<br>638,900 | 35.00% |
| Net profit margin | PBIT x 100%<br>Sales<br><br>*NP x 100%*<br>*Sales* | 23,360 x 100%<br>638,900<br><br>*16,815 x 100%*<br>*638,900* | 3.66%<br><br><br>*2.63%* |

***NB. Accept either version of ROCE (RONA) and NPM***

| | | |
|---|---|---|
| Level 3 | The answer contains analysis of the data to determine the outcome of the technique(s)<br>1 mark for each correct ratio | 13-9 |
| Level 2 | Applies understanding of the data and technique(s) in attempting to assess the options<br>1 mark for each ratio attempted using the case data. | 8-4 |
| Level 1 | Demonstrates some knowledge of the technique(s).<br>1 mark for each formula | 3-1 |

**Question 1(b)**

**Recommend a strategy which would enable LCL to increase its profitability. [18]**

*NB. The question is about profitability, not profits. The better candidates will distinguish between profits and profitability, either implicitly or explicitly.*

*If 2009 values are compared with Table 1 then one can argue that ROCE is falling, as is ROE, so something needs to be done. Similarly, gpm and npm are also falling, but at a less severe rate. To increase profitability, need to either increase profits, with the same level of inputs, or maintain profits but with reduced inputs. To increase profits the routes are reduce costs or increase revenues. Compared to industry averages LCL is down on gpm but thereabouts in npm. This suggests that a cut in the cost of sales is needed. Can LCL increase prices, we're told it's a competitive market, do they have a sufficiently robust USP to allow them to squeeze more from customers. Reduce costs, balance sheet shows that it has both short term and long term debt. Reducing either would reduce interest expense in the P&L so boosting profits and reducing inputs. LCL seems to have little focus on costs – three people see a customer – could cut backs be made here?*

*Appendix 1 has 5 slots when a customer visit is being made. If this is typical then in a 3 week period capacity utilisation is (55/ 60) 91.7%. Hence there is an opportunity to boost output at no additional capital outlay but change the current arrangement whereby a production line worker visits a potential customer. We're not told in the case what the two on the team do whilst their colleague is away – if they're not producing, then this is a wage cost with no compensating income stream, so negatively impacting on profitability. However, the loss of the worker input may have an impact on "build-ability" and sales. Further would George be able to implement this change now that has been inbedded?*

*Reduce debtors (currently take 68.7 days to pay) or stock turnover (62.2 days) cash cycle is 40.1 days, if this could be reduced then less need for working capital, so costs fall. Could LCL source cheaper raw materials? Reduce the engineering in products? Some might argue that the products are over engineered (line 50) and as such there is scope for a less robust case. But, whilst this might boost short term profits there is the possibility that as quality falls so will sales, so in the longer term this approach carries risk.*

***The validity of choice determined by the synthesis of case and subject. There is no single strategy possible in this situation so the mark will reflect the skill shown in putting forward the proposal. "Increase profitability" by how much and over what time period? Similarly, which measure of profitability is the priority?***

| | | |
|---|---|---|
| Level 4 | Discussion is balanced in evaluating recommendation as to how the business might best increase its profitability. | 18-12 |
| Level 3 | Analyses case material supports possible method(s) of increasing profitability | 11-8 |
| Level 2 | Possible method(s) of increasing profitability is supported by descriptive use of the material | 7-4 |
| Level 1 | Demonstrates possible method(s) of increasing profitability but without explanation or reasoning. | 3-1 |

**Question 2**

**Discuss how a rise in UK interest rates might affect LCL's ability to meet its objectives. [18]**

*Rise – by how much and how quickly? The stated objective is to maximise the book value of LCL by 2012*

*Gearing is 19.3% so increase in interest rates will increase interest payable in P&L account. Given the current borrowing (£53,000 + £24,000) and interest expense in the P&L account (£6,545) LCL seem to pay an average rate of 8.5%. If this is variable then as base rates rise then profits will fall. With less profit available then objectives become harder to achieve. Impact on interest cover ratio - which is likely to fall as profits fall and interest expense rises, meaning creditors less willing to extend finance due to their greater risk if the business defaults on its loan. Might put pressure on the business to convert its short term bank borrowing onto a longer term, more secure basis. LCL's CR is 1.2 and Acid Test is 0.76 so there is not a lot of spare liquidity, but the firm has traded for the last 4 years with these values, although they are below the industry average. With higher interest rates suppliers cost of capital will rise, so their invoices to LCL will have a higher opportunity cost and so they may well start to press for more speedy payment. If so, the working capital might need to come from elsewhere, either an injection of capital from new equity or new debt (either short or long term).*

*Rising interest rates will also impact on customers. Customers varied, some will be interest sensitive, other less so. So reaction might be to focus on those who are still able and willing to buy at a time of high interest rates. Does George know who these are, given the company has a host of different customers? Increasing interest rates may also dampen down customer confidence and so there may be a fall off in orders for what are essentially a fixed asset, capital, purchase.*

*Rising interest rates might feed through to the value of sterling. With 40% of value of output exported growth in this market would be more difficult so impacted negatively on sales, profits and ultimately book value. However, if raw materials are imported then the rise of sterling may be offset to some extent – although cost of sales will include production wages so not all of the £415,285 is materials (imported or otherwise).*

***Impact on objectives will depend on how much interest rates rise by and over what time period. Consideration, and development, of these factors offer a possible route to evaluation.***

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|---|---|---|
| Level 4 | Discussion is evaluative in balancing different possibilities | 18-12 |
| Level 3 | Case material is subject to analysis the possible affect of rising interest rates upon the business' objectives. | 11-8 |
| Level 2 | Describes how objectives might be affected by a rise in UK interest rates | 7-4 |
| Level 1 | Demonstrates knowledge of interest rates/ objectives | 3-1 |

**Question 3**

**Evaluate how LCL's stakeholders might view the approaching retirement of George Lyte. [18]**

*Stakeholders – people with an interest in the business.*

*Employees – good place to work, George's attitude to marketing/ quality means they get task variety etc. which may not continue after he's gone if LCL becomes more functionally based rather than people centred. Suggestion he's paternalistic in his management approach so this view many not be shared by his senior managers. Similarly, it was his insistence that holidays are at set times – this may not suit all employees who will have different individual circumstances. A new owner may allow more flexibility.*

*Customers – George's ethos puts them at the core of what LCL does, which whilst nice now may not continue post George. They'd probably not be too fussed because if things change there are many other businesses the customers could turn to. Was the chaos that once ruled when he was away real or imagined by George?*

*Suppliers – seem to allow LCL to have a huge amount of credit compared to industry average. Might they worry that post George the slack approach to payment might not only continue but get worse?*

*Bank – what happens to LCL after George has gone? He offers the guarantee for the loan – what happens to this after his retirement. Bank therefore nervous about the risk it is facing in a post George era. Also, if sales fall after George has gone because his successor is less customer/ quality focused then LCL becomes a less attractive customer to them, so again the bank will be getting nervous.*

*Shareholders – LCL generates decent returns but we don't know who they are of what the dividend policy is. The suggestion is that that with George as major shareholder the others can go whistle – indeed they may not have a view about post-George LCL. Indeed, some minority shareholders might be pleased if George's departure means LCL's financial performance (e.g. profitability) rises to industry standard.*

***Clearly there will be different views between stakeholder groups, and also within stakeholder groups, for example employees are not a homogeneous group, different employees (shop floor workers v managers) will have different view, This is a possible route into evaluation, as is the idea of SR view v LR view. George's imminent retirement might cause anxiety in the SR, but in the LR things may well continue - "meet the new boss, same as the old boss"***

| | | |
|---|---|---|
| Level 4 | A view of the possible link between LCL's future and the owner is reasoned explicitly in the context of different stakeholders. | 18-12 |
| Level 3 | Consideration of how different stakeholder(s) might see the possible link(s) between the business' future and the owner is supported by analysis of case material | 11-8 |
| Level 2 | Describes how different stakeholders might view the business' future in the light of George's retirement. | 7-4 |
| Level 1 | Demonstrates knowledge of stakeholders. | 3-1 |

**Question 4**

**Should LCL accept the order from Rupert Doodes? Justify your answer. [23]**

*Order will take one cell three weeks to fulfil. Three week schedule is full so need to consider the opportunity cost of bumping an existing order off line. Gpm of the order is 38.7%, whereas LCL's existing gpm is 35% (allow OFR) so on this basis the order looks more attractive than existing plans. But, the average covers both customer and stock orders so it may well be that the Doodes order, whilst higher than the average, could be less than some customer orders. So, need to delve a bit deeper into the value of the orders. Could also press Doodes on how insistent he is on the 3 week delivery time. If changing the schedule, need to think about the impact on existing orders. Of the 60 slots available, 32 slots taken by stock orders, 5 customer visit and 23 making orders for customers. If the Doodes order needs a full cell for three weeks that is 15 slots of manufacturing time, so can the schedule be rearranged so that the 32 slots of making for stock are replaced by this one off order. If so, is there a danger of running out of some stock items? So, need to consider the impact on "regular" customers, especially given LCL's pride in its customer service. Can capacity be increased temporarily, for example overtime working (but it will damage the gpm!).*

*Issue of objectives and ethics. Does LCL want to expand into this market – there is the suggestion of repeat orders if all goes well but this could just be bluster to get LCL hooked. But, should a business take any order it gets regardless? Major is retired – just who does he represent? Deliberately shifty – can't really see the UK defence industry suddenly pitching up at a small business and placing such a vague order with such a tight time scale – hardly sensible procurement policy and hopefully not MOD practice! So, is the Major a mercenary, a terrorist or neither? But, does it matter what the cases are for, does the issue become clearer if they are for medical equipment? Even so, should LCL care what their customers do with the products they make? Cases are hardly offensive weapons in themselves, but could be used to help wage conflict. What is the worst case scenario – the Major is a terrorist and so LCL are associated with terrorist activity (however innocently) they stand to lose the whole business. NB. Many existing customers have ethical codes of practice (line 26). Reverse is that the case is indeed for medical equipment, so might LCL get some positive PR and possibly future sales through humanitarian association?*

*What is George's view? He seems to be at the centre of the web – if he says "no" is that it? Impact on the morale of the other three senior managers who are all up for it, would they become de-motivated if what to them seems a good deal is turned down by George – but he is MD and Chairman after all – does he spend too much time acting tactically and not strategically – case mentions growth by serendipity.*

***Clear route to evaluation is to consider both possibilities, weighing up case evidence and subject awareness to reach a justified judgment.***

| | | |
|---|---|---|
| L4 | Achieves an overall view having evaluated different possibilities. Complex ideas have been expressed clearly and fluently using a style of writing appropriate to the complex matter. Sentences and paragraphs, consistently relevant have been well structured, using appropriate technical terminology. There may be few, if any, errors of spelling, punctuation and grammar. | 23-17 |
| L3 | Analysis of material supports discussion of whether or not the contract should be accepted. Relatively straight forward ideas have been expressed with some clarity and fluency. Arguments are generally relevant, though may stray from the point of the question. There will be some errors of spelling, punctuation and grammar, but these are unlikely to be intrusive or obscure meaning. | 16-11 |

| | | |
|---|---|---|
| L2 | Describes the case material in seeking to offer a reason for acceptance/ rejection of the contract.<br>Some simple ideas have been expressed in an appropriate context. There are likely to be some errors of spelling, punctuation and grammar of which some may be noticeable and intrusive. | 10-5 |
| L1 | Offers an unsupported view.<br>Some simple ideas have been expressed. There will be some errors of spelling, punctuation and grammar which will be noticeable and intrusive. Writing may also lack legibility. | 4-1 |

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