Ralph Black retires early

After Homejay announced its full year results for the year ended February 2003, at the end of May 2003, Ralph Black was criticised by both the financial media and the market analysts. He realised that his position was becoming untenable and he announced that he was retiring earlier than planned, and would leave the company at the end of September 2003.

Most of the senior employees of Homejay, and many market analysts, had expected Andy Mottram to succeed Ralph Black as Chairman, and felt that he had been preparing for the role for the last two years. However, Ralph Black considered that Andy Mottram was not suitable for the role and the Homejay Board agreed that the role should be filled by someone from outside of the company with more vision and better retailing skills.

A suitable candidate was quickly identified and the appointment was approved at a Board meeting. The new Homejay Chairman was Ken Kato, an entrepreneurial Japanese businessman who lived in the USA. He joined Homejay in early October 2003.

Homejay's new Chairman

Ken Kato had previously held the role of Chairman of a company which manufactured and retailed clothing and toys globally with a turnover equivalent to around $6 billion (1 billion equals 1,000 million). In the five years that he had been Chairman there, he had seen an increase in staff morale and staff loyalty. During that time the company's productivity had increased (measured by sales per employee) by over 150%. The company's share price had grown by over 45% in the last three years, despite the global recession.

Andy Mottram was disappointed that the Board did not have sufficient confidence in his abilities to take on the role of Chairman and was considering resigning.

Ken Kato met with Andy Mottram in early October to discuss how he saw the business developing, and the need to change the focus of the company. Ken Kato discussed with Andy Mottram the management skills required to make changes and his knowledge of Homejay's businesses. Ken Kato asked Andy Mottram to stay with the company to help implement the changes that he considered were required. However, Andy Mottram was reluctant to give a firm commitment to Ken Kato. Ken Kato is still deciding whether or not he wishes to retain Andy Mottram on a longer-term basis.

The new Chairman spent most of October and early November visiting some of Homejay's manufacturing plants and some of its retail outlets in the USA and Europe and learnt much from Andy Mottram of historical events within each business unit.

Funding limitations

In Maxine Gill's opinion, Homejay is more highly geared than it should be. She wants to reduce the current loans, but is unable to achieve this from operating cash flows. Furthermore, Maxine Gill does not consider a rights offer would be successful at the current time.

In the past, Homejay's business units have been able to obtain funding for capital projects that have been approved by the business unit's general manager up to a limit of $10 million per project. Up to now there has been little direct control from the Head Office finance department or from the Homejay Board, except for larger capital projects.

The Homejay Board agreed with Maxine Gill's recommendation to limit capital expenditure on all projects across the company to $50 million in 2004/05. It is anticipated that this policy of limiting capital expenditure to $50 million per annum would continue for the next few years. This would necessitate each business unit referring any project over $1 million to the Head Office finance department for approval.

The Homejay Board agreed that no further loan financing would be obtained, irrespective of the NPV on any proposed project or acquisition. Furthermore, the agreed company-wide capital expenditure limit of $50 million for the next financial year would have to cover all planned projects unless funds could be generated by divesting some areas of Homejay's businesses.

Planning review meeting

At the planning review meeting held on 3 November 2003, Ken Kato stated that Homejay had not recognised that a key objective of the company should be the creation of value for shareholders. He stated that he considered that it would be necessary for some major strategic changes to be made.

Ken Kato announced that he had appointed an independent management consultant to undertake a strategic review of Homejay. The management consultant was present at the planning meeting and was introduced to the general manager of each business unit. During the planning review meeting, the consultant merely observed and made notes on areas for further investigation.

Ken Kato had been liaising closely with Maxine Gill and Paul Simpson whose departments were working on Homejay's business plans for the next financial year and beyond. Ken Kato was concerned that even if all of the business units actually achieved the forecast increased sales and profitability, the company's earnings per share would grow very little. He was also very concerned that historically the company had failed to achieve its financial plans.

Paul Simpson's department had received forecast financial data from each business unit for the next three years and a further estimate for later years. The forecast cash flow data from each business unit were discussed at the planning review meeting. Maxine Gill was concerned that these forecasts did not address all of the problems that the business units were experiencing, particularly in respect of quality control in Electryco. Paul Simpson also wanted to review more closely the underlying forecast increases in sales volumes, as he felt that some of the forecasts had not addressed the competitive nature of the markets in which the businesses operate. Therefore, overall, it was considered that the forecasts might be overly optimistic.

Paul Simpson was also concerned that the capital expenditure required for the refurbishment programme of 25 Fixitco stores had *not* been included in the plan for 2004/05. Instead, Barry Milo had planned that this would be deferred a further year and not take place until 2005/06. In his plan for 2005/06 he had included capital expenditure of $45 million and an additional cost of around $8 million for increased marketing spend to relaunch the refitted stores. There was some discussion at the meeting as to whether the sales targets were too high in these 25 stores (which recently had seen sales declining further), if the refurbishment programme was deferred for at least another 15 months.

The level of communication between corporate Head Office and each of the business units' general managers is not very effective at present and there is a lack of corporate identity.

The level of corporate Head Office costs was also discussed. Joseph Logan was very critical of the high level of corporate Head Office costs that were allocated to business units, over which each general manager had no control. Andy Mottram stated that he had been looking at several ways to reduce the corporate Head Office costs, which were forecast for 2004/05 to be over $330 million.

Andy Mottram stated that one way of reducing corporate Head Office costs that was under consideration was the relocation of the Homejay Head Office. The proposal was for Homejay to relocate from the current site in a prestigious American city centre, to a lower cost, regional location. This would be expected to save $40 million each year. However, it is estimated that only 50% of Head Office staff would elect to stay with Homejay. In the short term, the proposed move could incur around $15 million on redundancy, recruitment and relocation expenses.

A further corporate Head Office cost that was planned for 2004/05, in addition to the $330 million corporate Head Office costs, was Mark West's corporate marketing campaign *(as detailed on pages 12 and 13 of the pre-seen material)*. Mark West stated that he considered the time was right to publicise the Homejay brands to make the company more visible in the public eye and to enhance its profile. He was highly confident that the planned campaign would generate additional sales. These additional sales would increase the forecast gross margin in 2004/05 by between $100 and $110 million, over all five business units.

Maxine Gill was concerned at the high level of management bonuses that had been paid in recent years, particularly since earnings per share had not grown. She informed the general managers of the business units that Catherine Barnes was planning to change the basis for calculating managers' performance-related pay. The current system is based around achieving a target ROCE for senior managers and individual performance targets for junior managers. Catherine Barnes is considering changing the management performance bonus scheme so that bonuses are linked either to Homejay's share price or to the company's earnings per share.

Ken Kato concluded the meeting by thanking the business unit general managers for their input into the business plans. He undertook to advise all of the business unit general managers of any proposed strategic changes for the company after he had had further discussions with the management consultant.

Review of Homejay's strategies

A week after the planning review meeting, Ken Kato met with the management consultant on his own to discuss ideas for change. A number of alternative strategies were identified at this meeting. Ken Kato considered that Homejay should concentrate on its core competencies, which were the Fixitco and Woodyco businesses only.

Ken Kato briefed the management consultant about the early discussions that Andy Mottram had held with a number of companies that Homejay could acquire. At this stage only one company looked like a promising acquisition. It was another company in the DIY business that would be complementary to Fixitco, called Makeitco. Ken Kato asked the management consultant to review this proposed acquisition (*see Option D below).*

The Cosmetco business unit was discussed and Ken Kato commented that the forecast cash flow data for the Cosmetco business unit looked attractive. He was also very impressed by the recent growth in Cosmetco's sales and profitability. Furthermore, he liked the management style of its general manager, Jayne Reed. Both Ken Kato and the management consultant agreed that Homejay should retain Cosmetco in the short term and that this business unit should be reviewed in 18 months.

After much discussion, Ken Kato and the management consultant agreed that Homejay has four strategic options at present (which are not necessarily mutually exclusive). These are:

Option A: improve profitability within the existing business units

Option B: divest the Electryco business unit

Option C: divest the Cardco business unit

Option D: acquire Makeitco

Option A – improve profitability within the existing business units

Ken Kato has asked the management consultant to consider ways in which the company could improve its profitability. He has requested the management consultant to undertake a strategic review of each of the existing business units and to consider any changes that would help to improve profitability throughout the company.

Option B – divest Electryco

Electryco has reviewed its pricing policy and product ranges and has decided not to make substantial changes to its range of products and their features, nor to alter many of the current prices materially, although some individual products have been reduced in price to remain competitive with similar products offered by competitors. It is expected that any sales volume increase achieved would be eroded by reduced prices to remain competitive.

A competing electrical appliance manufacturer, Kitbeco, which is planning to expand its manufacturing capacity, has expressed its interest in acquiring Electryco. It plans to use some of Electryco's manufacturing capacity to build its own brand products and also to continue to manufacture selected ranges of Electryco's more successful products.

Kitbeco has had a series of detailed meetings with Homejay's senior management and has expressed a firm commitment to acquire Electryco. However, Kitbeco has stated that it would not require around 20% of the current workforce of Electryco.

The forecast net operating cash flows for Electryco (in nominal terms) are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Electryco	39	40	41	42

Kitbeco has now made a cash offer to Homejay of $310 million. However, this offer excludes the potential cost of future warranty claims on current year sales.

Option C – divest Cardco

Some enquiries have been made to companies competing with Cardco and it has been established that Cardco would be a particularly attractive acquisition, as the business owns or leases valuable retail sites in high streets that are difficult for other companies to obtain. Initial enquiries have found two companies that are interested. They have indicated that they would offer around $160 million.

The forecast net operating cash flows for Cardco (in nominal terms) are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Cardco	16	18	20	20

Option D – acquire Makeitco

Barry Milo has identified a chain of DIY stores in the USA named Makeitco which he considers would be a good acquisition for Homejay. If it were to be acquired, it would allow the company to expand Fixitco's geographic coverage. It would also provide further retail outlets for Woodyco's products.

The founding family members own the majority of shares in Makeitco. They have agreed that they want to enjoy the benefits of the success of Makeitco and to sell the company for cash. If Makeitco were to be acquired, it would be a friendly take-over and at present no other companies are competing to acquire Makeitco. Makeitco is a listed company and is currently valued at $350 million.

Makeitco has made available to Homejay its future plans and forecast of net operating cash flows (in nominal terms). These are as follows:

	Year 1 2004/05	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	$ million	*$ million*	*$ million*	*$ million*
Makeitco forecast cashfows	33	34	35	36

It is expected that there would be synergy benefits of a further $5 million per year. There would also be a one-off re-branding cost of approximately $10 million.

Maxine Gill's initial reaction was that as the cost of acquiring Makeitco exceeded the agreed funding limitation, it could not proceed. However, Ken Kato is keen to build upon Homejay's core business competencies, and, in principle, is in favour of the acquisition. Maxine Gill considered that this business was very similar to Fixitco's business and should be assessed using Fixitco's discount rate of 10%.

For the purposes of evaluating all of the net operating cash flow data, taxation should be ignored.

Discount rates

Homejay has assessed the betas for each business unit based on suitable proxy companies. Maxine Gill has assessed the following discount rates as being suitable for each business unit, taking into account both business risk factors and exchange rate risks.

Business unit	*Discount rate*
Fixitco	10%
Woodyco	11%
Electryco	13%
Cosmetco	10%
Cardco	16%

The company's current weighted average cost of capital is 11%.

End of unseen material