



BUSINESS AND MANAGEMENT

9771/02

Paper 2 Strategic Decisions

May/June 2012

3 hours

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the Booklet.

Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Answer **all** questions.

At the end of the examination, fasten all your work securely together.

The number of marks is given in brackets [] at the end of each question or part question.



This document consists of **9** printed pages and **3** blank pages.



Redrow plc

Introduction

Redrow is a leading housebuilding company specialising in relatively low-cost residential housing. The company employs over 1300 people and operates from 9 regional offices throughout the UK. The business was formed in 1974 as a civil engineering company in North Wales before moving into private housebuilding in 1980. The company was floated on the stock market in 1994 and currently has a market capitalisation of nearly £400m. In 2001 Redrow acquired Tay Homes for £30m. Redrow is included in the FT250 and is one of many construction companies listed on the stock market. Competitors include Barratt, Bovis and Persimmon. Redrow is the smallest of these well-known housebuilders. Persimmon is the largest and has a market capitalisation of well over £1bn. 5

Redrow's mission statement is: 'We build our business and homes with pride'.

The objectives of the company are to:

- (1) achieve differentiation and value for money for customers
- (2) maximise shareholder value
- (3) build family homes with a traditional appearance which are designed for modern living. 15

Challenges ahead

It is November 2010. The housing construction industry has had a difficult few years since the pinnacle of house sales and prices in 2007. The housing boom had lasted a decade. Now the global financial crisis and resulting recession in the UK has created an extremely challenging environment for businesses such as Redrow. The data is almost universally negative for housebuilders and the outlook remains difficult. 20

Currently the number of people considering purchasing a newly built house is at its lowest for over a decade. It is estimated that 100 000 young people a year try to buy their own home and are unsuccessful. This is because they cannot get a loan (mortgage). The Council for Mortgage Lenders (CML) has commented on the weak home loan activity as banks have been less willing to lend money to some potential home purchasers. 25

Redrow has seen a steady rise in the number of cancelled home purchases to the current rate of 17%. One of the reasons for these cancelled purchases is that banks are requiring more substantial deposits (at least 10%) and detailed proof of personal earnings. Redrow is also finding that potential customers are demanding purchase incentives such as free carpets. 30

House prices have started to fall again after a surprisingly robust market in the first two quarters of 2010. In September 2010 the Halifax Bank of Scotland (HBOS) house price index recorded a 3.6% fall in average house prices. The Royal Institute of Chartered Surveyors (RICS) has indicated that a majority of its members are expecting prices to fall in the coming months and possibly years. Speculative demand for housing has reduced considerably as buy-to-let landlords are also finding it hard to get mortgage finance and do not want to see the value of their property portfolios decreasing. 35

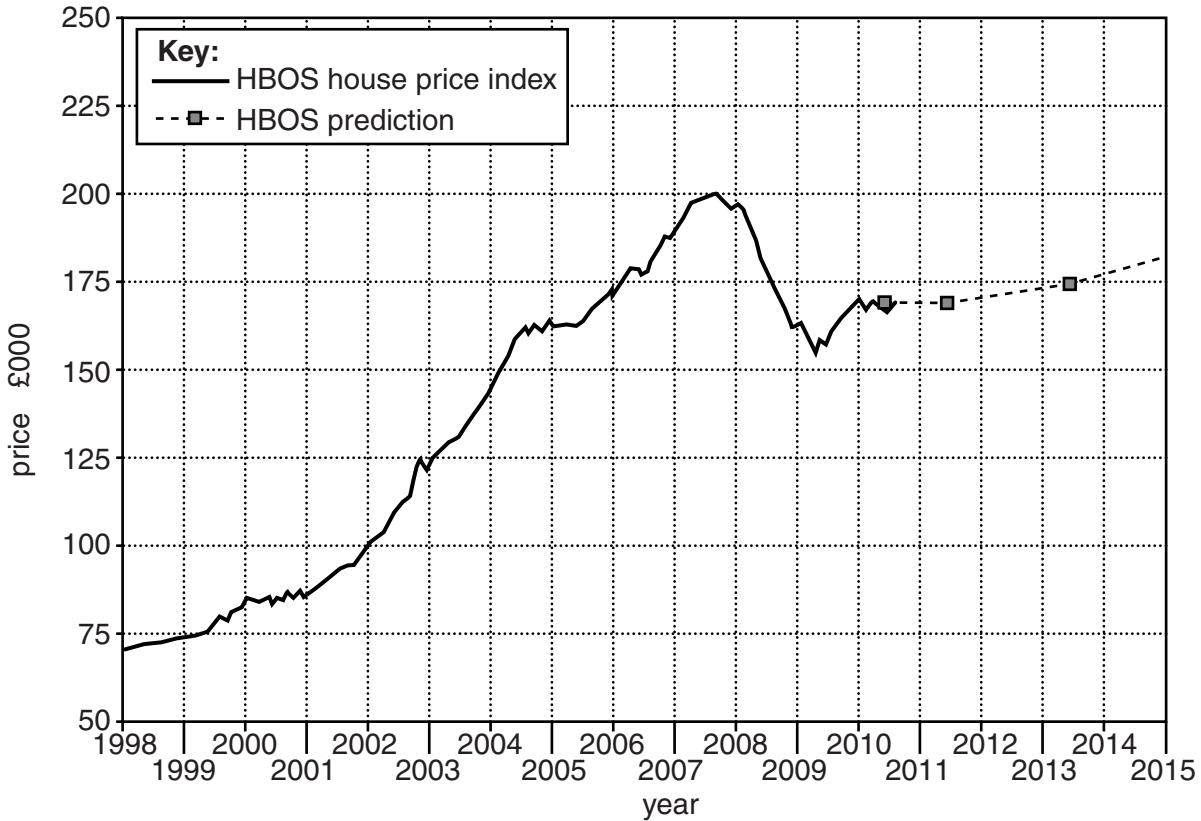


Figure 1: Average house prices and projection

The outlook for the economy does not look good for the housing market as the Government begins an austerity drive to reduce public spending. The rate of growth of average earnings is expected to be low as higher unemployment and public sector pay freezes occur. Household incomes are likely to suffer further as taxes rise and welfare payments are cut or withdrawn. Potential home buyers are expected to become even more price sensitive.

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Interest rates

However, low interest rates have helped some potential home buyers and companies such as Redrow. The base interest rate has been kept at 0.5% for many months but this may not continue into the longer term as the Bank of England is tasked with keeping inflation around 2%. Interest rates are likely to increase and this can be seen in Figure 2.

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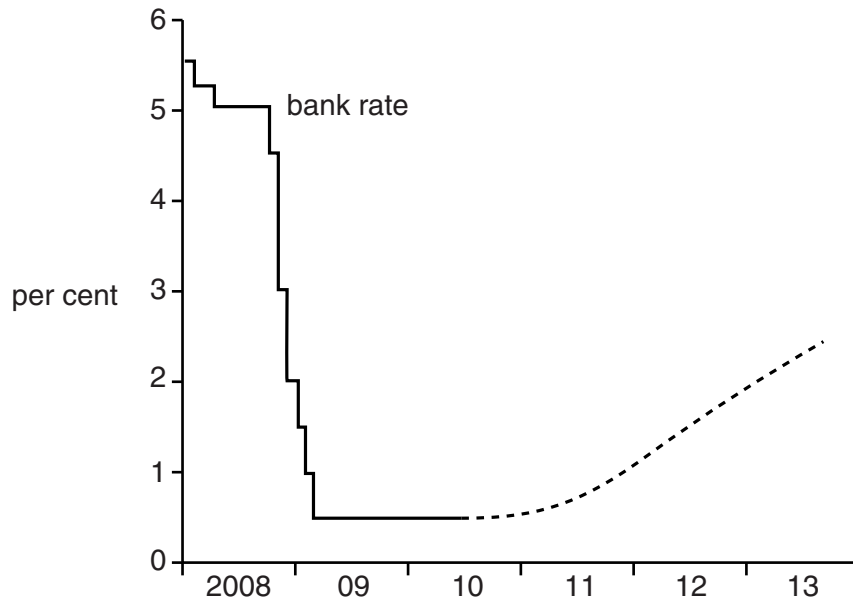


Figure 2: Bank of England interest rate history and projection (August 2010 Report)

A sustained increase in interest rates could have various consequences for Redrow and its potential customers. It would hinder the affordability of housing for customers as demand for 'new build' homes tends to be very interest rate sensitive. Redrow would need to be conscious of its gearing, interest cover ratio and interest payable on its debt. The recent rights issue of shares has helped reduce Redrow's debt and the company could take further measures to reduce its exposure to rising rates.

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Marketing in the spotlight

Redrow's directors are very keen to increase the company's margins and have increasingly focused on input cost reductions. In addition to this, all the functional areas of the business have become more accountable and have been put under increased scrutiny from shareholders and managers. As part of this process, the marketing budget has been reviewed and this department is increasingly required to quantify measures of success. The company is keen to introduce a new marketing plan with a particular focus on increasing profit margins which would help Redrow achieve its stated objective of maximising shareholder value. A new marketing audit has been started to review a feasible strategy that the company could implement. One success story for Redrow has been the launch of its digital and interactive Redrow TV as part of its website. The company is keen to develop this further as a key element of its promotional strategy.

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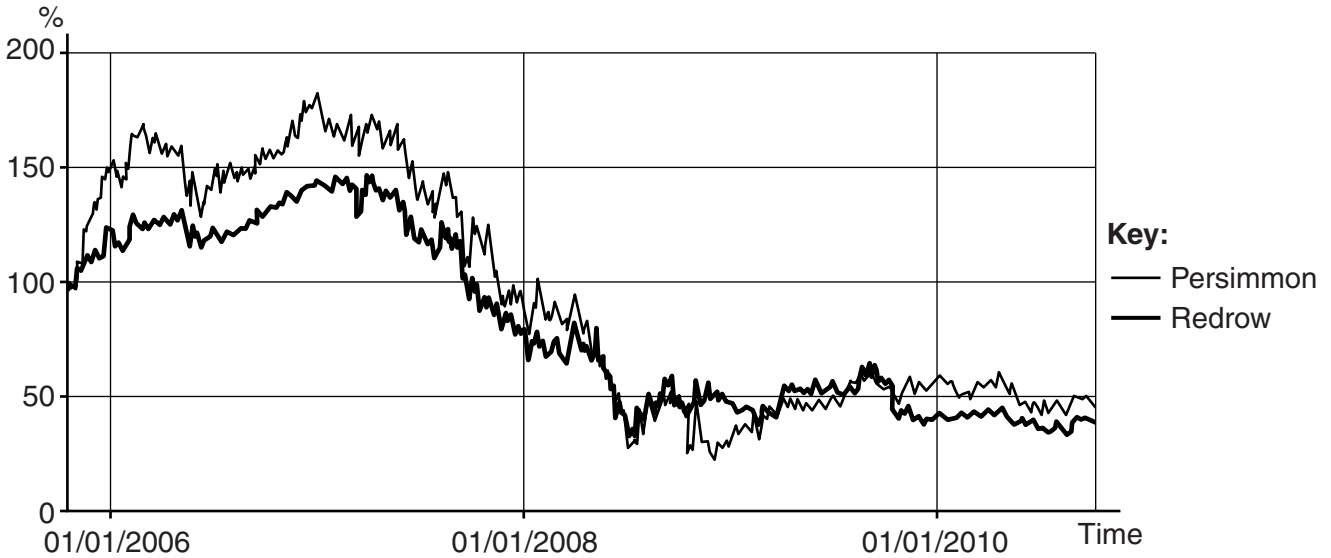


Figure 3: Share price performance Redrow v Persimmon (5 years)



Figure 4: Share price performance Redrow v FT250 (5 years)

Shareholder opinions

The difficult macroeconomic climate has resulted in some shareholders becoming unhappy with the performance of their investment in Redrow. At the recent Annual General Meeting (AGM) some shareholders put considerable pressure on the Board of Directors to increase returns to shareholders. The dividend has been suspended in recent years while the company has tried to improve its financial position. The Board stated that they would implement strategies to improve shareholder returns but this will be difficult in the current economic climate.

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Good times ahead?

Whilst the general outlook for the economy and housebuilders is relatively gloomy, there are some reasons to be optimistic about the future. Redrow's Chairman, Steve Morgan, thinks the worst times are in the past and the company could emerge as a leaner and potentially more profitable business in the future. A sign of his increased confidence was shown by his wife's purchase of 100 000 shares at the start of 2010 for £131 500 and this brought the couple's combined stake in the company to 29.95%. The successful rights issue in October 2009 raised £150m and this substantially strengthened the balance sheet, reduced gearing and improved the ability to acquire and develop additional sites. The funds have been used to purchase Harrow Estates and more development sites. Redrow now has 13 170 building plots for future development. 75

The Chairman is keen to deliver a much improved return on capital employed. The tide may well have turned as the company has seen an increase in its average selling prices (average selling price in 2010 was £149 300 compared to £137 400 in 2009) and house sales (Redrow expected to complete 2587 sales in 2010 compared to 2113 in 2009). 80

In the future Redrow is likely to rely on maximising margins to offset poor sales growth. Gross margins have recovered from 2009. The sluggish rate of economic growth has meant that Redrow has been able to reduce its operating expenses such as raw materials. Costs have fallen by approximately 15% from their recent peak. The biggest expense in house construction is land and this has fallen by as much as 46%. The company has reduced its construction activity and concentrated on selling its stock of finished houses and apartments. 85

Redrow realises that it needs to concentrate on margins through cost minimisation to offset the uncertainty of house price movements. The 2010 annual report also emphasises the key strengths of the business as being the strong and successful management team (recently restructured and reduced), the award-winning and popular 'New Heritage Collection' of houses (based on character homes of the 1920-30s), strategic land buying, high customer satisfaction and an excellent health and safety record. 90

A new direction?

The company is currently undertaking a strategic review of its operations. Redrow is primarily a residential housebuilder, but some analysts have suggested Redrow should consider diversifying into commercial property construction. This could involve the construction of buildings from small retail units to large office blocks. The Board of Directors and key shareholders are divided on the relative merits of this diversification. It could make the business less reliant on the housing market, but the commercial construction sector is very competitive and the difficult economic climate has had a negative impact on demand for commercial property. 95

| | 2010 £m | 2009 £m | 2008 £m | 2007 £m | 2006 £m |
|---|------------|------------|------------|------------|------------|
| Revenue | 396.9 | 301.8 | 650.1 | 834.3 | 770.1 |
| Net operating profit/(loss) | 12.7 | (22.4) | 84.5 | 136.6 | 132.8 |
| Net operating profit/(loss) as a percentage of turnover | ? | (7.4%) | 13.0% | 16.4% | 17.2% |
| Net operating profit/(loss) before financing costs | 12.7 | (119.0) | (174.9) | 136.6 | 132.8 |
| Profit/(loss) for the period | 0.5 | (100.4) | (139.9) | 84.4 | 84.1 |
| Net assets | 435.9 | 293.5 | 404.6 | 577.8 | 513.8 |
| Debt | (47.1) | (214.6) | (223.3) | (177.6) | (129.8) |

| | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|--------|---------|---------|--------|--------|
| Number of house sales | 2587 | 2113 | 3925 | 4823 | 4735 |
| Gearing – as a percentage of capital and reserves | 10.8% | 73.1% | 55.2% | 30.7% | 25.3% |
| Return on capital employed | 1.5% | (2.9%) | 10.3% | 19.4% | 22.0% |
| Earnings per ordinary share | 0.2p | (47.9p) | (66.7p) | 40.3p | 40.3p |
| Dividends per ordinary share | - | - | 9.3p | 15.6p | 13.0p |
| Net assets per ordinary share | 141.3p | 183.4p | 252.9p | 361.5p | 322.0p |

Table 1: Redrow five year financial summary

| | 2010 £m | 2009 £m |
|------------------------------------|------------|------------|
| Revenue | 396.9 | 301.8 |
| Cost of sales | (355.2) | (399.6) |
| Gross profit/(loss) | 41.7 | (97.8) |
| Administrative expenses | (29.0) | (21.2) |
| Net operating profit/(loss) | 12.7 | (119.0) |

Table 2: Extract from Redrow income statement as at end of financial year 2010

| | 2010 | 2009 |
|--------------------------------------|--------------|--------------|
| | £m | £m |
| Non-current assets | | |
| Intangible assets | 1.8 | 0.3 |
| Plant, property and equipment | 14.6 | 14.5 |
| Other non-current assets | 86.8 | 87.9 |
| Total non-current assets | 103.2 | 102.7 |
| Current assets | | |
| Inventories | 542.0 | 570.2 |
| Trade and other receivables | 12.2 | 13.9 |
| Cash and cash equivalents | 21.9 | 17.5 |
| Total current assets | 576.1 | 601.6 |
| Total assets | 679.3 | 704.3 |
| Equity | | |
| Issued capital | 30.9 | 16.0 |
| Share premium | 58.7 | 58.7 |
| Retained earnings and other reserves | 346.3 | 218.8 |
| Total equity | 435.9 | 293.5 |
| Liabilities | | |
| Bank loans | 50.0 | 165.2 |
| Other non-current liabilities | 30.8 | 37.3 |
| Total non-current liabilities | 80.8 | 202.5 |
| Bank overdrafts and loans | 19.0 | 66.9 |
| Other current liabilities | 143.6 | 141.4 |
| Total current liabilities | 162.6 | 208.3 |
| Total liabilities | 243.4 | 410.8 |
| Total equity and liabilities | 679.3 | 704.3 |

Table 3: Extract from Redrow consolidated balance sheet as at end of financial year 2010

Read all the case study material and then answer all the following questions.

Section 1

- 1 (a) Calculate the gross profit margin in 2010. [3]
- (b) Calculate the net operating profit margin in 2010. [3]
- (c) Comment on the usefulness to Redrow's directors of the results obtained in 1(a) and (b). [6]
- (d) Analyse the main elements of a **marketing** plan that Redrow could use to attempt to increase profit margins. [13]

Section 2

- 2 Evaluate the impact of a sustained increase in UK interest rates on Redrow. [25]
- 3 Discuss the extent to which the Board of Directors should respond to shareholder pressure for increased returns. [25]
- 4 Redrow is considering two alternative strategies:
- continue with the current strategy of only building residential houses
 - diversify into the construction of commercial property as well as residential houses.
- Recommend which of these strategies Redrow should adopt. Justify your recommendation. [25]

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- © *Redrow*; www.redrowplc.co.uk; 13 October 2010.
- © *Halifax*; www.houseprices.uk.net; 13 October 2010.

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