Cambridge International AS & A Level

Cambridge International Examinations
Cambridge International Advanced Subsidiary and Advanced Level

BUSINESS **9609/33**

Paper 3 Case Study **May/June 2016**

3 hours

No Additional Materials are required.

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READ THESE INSTRUCTIONS FIRST

An answer booklet is provided inside this question paper. You should follow the instructions on the front cover of the answer booklet. If you need additional answer paper ask the invigilator for a continuation booklet.

Section A
Answer **all** questions.
Section B
Answer **one** question.
You are advised to spend no more than 40 minutes on Section B.
The businesses described in this question paper are entirely fictitious.

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

This document consists of **6** printed pages, **2** blank pages and **1** Insert.

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CAMBRIDGE International Examinations

Xiang Mobile (XM)

Smartphones at a smart price

When XM released its first smartphone (a cell phone which connects to the Internet), the X1, in 2012 the industry could not believe its price. Consumers, in country Y where XM is based, could buy this high specification smartphone for just $350. This represented astonishing value compared to competitors' products, including the market leading brand, which sold for $800. XM quickly followed the X1 with an even lower priced line of smartphones starting at just $150. These offered a lower specification yet delivered high value. This helped XM to become its country's second largest smartphone brand within just two years.

The business was founded by Xiang Sen, an entrepreneur with a record of success in technology markets. To attract senior executives from other technology companies Xiang offered them the status of co-founders and shares in the business. Most potential investors were doubtful that a new brand could succeed in the crowded smartphone market. Entering the market would require large amounts of capital. Venture capitalists were approached for finance in return for equity.

Not all firms are the same

Unlike rivals, XM does not spend significant sums of money on traditional advertising. Marketing costs are less than 1% of revenue; the industry average is 6%. XM has targeted its products at technology enthusiasts. The company has kept costs low by selling most of its smartphones online through its own website and one of the country's largest online retail sites. XM has not opened any of its own shops. The company uses social media, public relations and its own customers to help promote its products. With limited availability of products, XM knows that every time it has something to announce customers will listen.

Creating scarcity

XM is still a relatively small business compared to the market leader. When the latest model of smartphone, the X2, went on sale in 2014 the first batch of 50 000 units sold out within minutes. XM only releases a limited quantity of smartphones each week. Inventory is kept low and orders are shipped directly from the contracted manufacturer in country Y. Xiang, the CEO, believes that through creating a scarce supply of products XM has raised brand awareness and achieved free publicity. Industry specialists believe that XM could sell many more units at prices significantly above those currently charged. However, there is concern that the manufacturer, in country Y, is operating near full capacity and that the proportion of defective products has increased to over 0.5% in the last year.

Cash shortages

Initially XM suffered significant net cash outflows despite early sales growth. To raise capital XM was listed on the technology stock market in 2013. However, Xiang, his co-founders and the venture capital company retain a majority shareholding in XM. The business has also financed its growth through borrowing from financial institutions. Appendix A contains further financial data.

Research and development (R&D)

Initially XM smartphones were criticised as just being copies of the leading brand. However, a recent industry article on XM's growth commented: 'Usually country Y companies have followed a strategy of simply copying products. In contrast XM seeks to build an innovative brand that compares favourably with the best in the industry.' Customers have been impressed by the user friendly features, build quality and processing power of the smartphones.

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The smartphone industry is dynamic and innovation is continuous. Individual products have a short product life cycle. However, XM keeps its smartphones on the market for up to two years compared to an industry average of one year. XM's expenditure on R&D is 7% of revenue; the global market leader spends 6.5%. XM sets the price for a new smartphone close to marginal cost. However, in this market, costs quickly fall as components become outdated. In the long term, XM aims to generate revenue through software sales and not just hardware. Although it is a highly competitive market, XM is also developing a range of software applications (apps) to complement its smartphones.

Soft human resource management

Human resource management of XM's 2200 employees is characterised by a 'soft' approach. The structure of the business is decentralised. Xiang has attempted to cultivate an informal atmosphere at the head office and within regional departments. Project teams work on product innovation. These teams are made up of employees from all parts of the business. Project leaders are encouraged to manage teams in a democratic manner. The Research and Development team is attached to a leading university with which XM has formed a strategic alliance. XM has invested heavily in training and developing employees. Employees at all levels are enrolled in a share option scheme based on loyalty and meeting targets. Ambitious targets are set for departments, teams and employees. Everyone is aware of the CEO's high expectations.

Market development

XM has decided to enter the market in country Z in 2017. In preparation for this, the overseas expansion team commissioned research on the market. Appendix B gives details of this research. Developing a marketing strategy for this new market is now a priority. XM's objective for 2017 is to sell a total of 2 million smartphones in this new market rising to 4 million the following year. These objectives will contribute to XM's corporate goal of becoming the fourth biggest global smartphone supplier by 2020. Appendix C contains further data about this market.

Diversification

The Board of Directors is also considering diversification. Two options are currently under review.

Option 1: Take over a 'smart' TV subsidiary of a well-known multinational electronics group. (A 'smart' TV is a television capable of connecting to the Internet.)
Key points:

- Market share of this TV subsidiary has fallen in the last two years.
- The TV subsidiary's factory is modern and its products are of good quality.
- The TV subsidiary has made losses for three consecutive years. Consequently the likely purchase price will be low.

Option 2: Develop tablets (portable computers that use a touchscreen).
Key points:

- Use XM's strengths in product design and development to enter the tablet market.
- Launch of products would be one year after the decision to enter the market.
- This market is predicted to continue to expand rapidly over the next three years.
- It is a competitive market with several well established brands.

At the next Board Meeting XM's directors will choose which strategic option to invest in. Appendix D contains a summary of strategic choice data to be presented at the meeting.

Appendix A: XM financial data

	2014	2015
Number of issued ordinary shares	100m	100m
Total equity	$3bn	$3.5bn
Non-current liabilities	$1bn	$1.1bn
Operating profit	$167m	$244m
Profit after tax	$150m	$220m
Revenue	$1.5bn	$2bn
Dividends	$20m	$25m
Share price (as at 31 December)	$10	$15
Acid test ratio	0.87	0.82
Current ratio	1.03	0.95
Dividend yield	2%	See Q3(a)(i)
Price earnings ratio (as at 31 December)	6.7	See Q3(a)(ii)

Appendix B: Market research data for smartphones

	Country Y	Country Z
XM market share 2015	20%	
Market share of market leading brand	40%	55%
Forecast sales 2016 (units)	25m	36m
Forecast sales growth 2017	5%	11.11%
Percentage of sales through online selling	40%	10%
Smartphone ownership (percentage of population)	40%	20%
Median household income	$10 000	$8000
Percentage of population aged 20–34	35%	40%
Percentage of households with Internet access	70%	30%

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Appendix C: Forecast data for country Y and country Z

	Country Y	Country Z
Annual real GDP growth rate 2016–2020	2.5%	4.6%
Inflation 2017	2%	3%
Exchange rate index 2017 (2016 =100)	98	102
Annual population growth rate 2017–2020	0.5%	2%
Change in interest rate in 2017	0%	+1%

Appendix D: Strategic choice data for Option 1 and Option 2

	Option 1: 'Smart' TV	Option 2: Tablets
Decision tree analysis	Chance of failure: 30% Expected Monetary Value: $25m per year	Chance of failure: 25% Expected Monetary Value: $50m per year
Force field analysis	Forces for change: 12 Forces against change: 10 Main force for change: Offers a manufacturing facility for low capital cost Main force against change: XM management does not have manufacturing experience	Forces for change: 14 Forces against change: 10 Main force for change: Similar technologies to smartphones Main forces against change: Cash flow and financing
Investment appraisal	Capital cost: $180m Net present value = $50m	Capital cost: $400m Net present value = $100m

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[Turn over

Section A

Answer **all** questions in this section.

1 Analyse the benefits to XM of using a 'soft' approach to human resource management. [10]

2 Discuss the importance of research and development (R&D) to XM's future success in the smartphone market. [14]

3 **(a)** Refer to Appendix A. Calculate for 2015:

(i) dividend yield [3]

(ii) price earnings ratio. [5]

(b) Refer to your answers from **(a)** and other relevant information. To what extent should the shareholders of XM be pleased with the company's financial performance in 2015? [16]

4 Refer to Appendix B and other information. Discuss the changes that XM might need to make to its current marketing strategy when entering the market in country Z. [16]

5 Discuss the extent to which external factors, such as those shown in Appendix C, could influence the future success of XM. [16]

Section B

Answer **one** question from this section.

6 Refer to the strategic choice data in Appendix D and other information. Recommend to the Board of Directors of XM which one of the two options for future growth should be chosen. [20]

7 XM operates in a dynamic market. Evaluate the importance of corporate planning for XM's future profitability. [20]

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