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BUSINESS **9609/32**

Paper 3 Case Study **May/June 2019**

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South West Farming (SWF)

SWF is a family controlled private limited company based in country Q. The current Managing Director, Lee Tae-woo is the grandson of the founder of this farming business. The core focus of SWF changed in the 1980s. Lee recognised an opportunity to increase profitability by shifting production from cereal products to milk from cows, in response to changing tastes in country Q. Sales of fresh milk now account for 70% of SWF's revenue. Other milk based products have also been introduced to increase sales and include cheese, butter and ice cream.

Using the SWF brand, products are sold direct to retailers, including a national supermarket group. SWF also supplies the government with milk for consumption in schools. SWF has established a reputation for high quality products and its mission statement is to:

- bring health to all our customers naturally
- ensure that our customers' needs and expectations are the starting point for everything we do
- maintain excellent long-term relationships with employees, retailers and customers.

Lee has transformed the business from being a small single farm to owning 20 large farms spread throughout country Q. The business has grown through acquisition. The structure of the organisation has only changed through the addition of levels of hierarchy. SWF has a centralised structure and is organised into functional departments.

A changing external environment

SWF is currently facing a difficult external environment. A falling birth rate in country Q has resulted in a decrease in milk consumption. The Association of Milk Farmers is pressurising the government to increase subsidies paid to farmers. In 2017 SWF started to export milk to country P but this has been difficult due to country P's different legal controls about the processing and packaging of milk. Country Q's currency exchange rate is appreciating against country P's currency. Table 1 provides some economic and market data affecting SWF.

Table 1: Economic and market data for country Q including forecasts for 2019–2021

	2016	2017	2018	2019	2020	2021
Consumer price inflation (%)	2	2.1	2.5	2.5	2.5	2
Increase in feed cost for cows (%)	2.5	3	3	5	5	5
Annual change in milk sales by volume (%)	–4	–5	–4	–1	–1	–1
Annual change in cheese sales by volume (%)	4	4.5	4.2	4	3	3
Annual change in butter sales by volume (%)	7	10	7	8	4	4

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Cutting costs to remain profitable

Kim Min-seo, the Operations Director, has proposed that SWF invest in automating the milking of cows in order to reduce costs. Farms in country Q are typically too small to invest in expensive automated machinery. However, Kim has reported to the Board of Directors that SWF has achieved sufficient scale to make the investment worthwhile. The total investment cost for equipping all 20 farms is $2m. She also highlighted reports that the government is considering increasing the minimum wage for agricultural workers. The cost savings to SWF would result from the reduced number of employees required. Kim estimates that the machinery would replace five employees per farm. The Human Resources Director is concerned about the impact of automation on employees. Kim has prepared an investment appraisal for the directors to consider. Table 2 is an extract from the appraisal. The finance department is concerned that further borrowing will increase SWF's already high gearing.

Table 2: Investment appraisal extract

Year	Net cash flow for all 20 farms ($)	Discount factors at 10%
1	200 000	0.91
2	710 000	0.83
3	780 000	0.75
4	650 000	0.68
5	600 000*	0.62

*including residual value of $200 000

Future sales

SWF branded milk is consumed by all age and income groups. There is no specific target market and milk consumption does not vary through the year. SWF conducts market research constantly to anticipate customer needs and collate product feedback. Industry market reports are also used to help plan for the future. The marketing department is responsible for making sales forecasts for all of SWF's products. Appendix 1 shows data on sales volumes for ice cream. The Marketing Director is currently in negotiations with another supermarket group in country Q to sell SWF products.

Reputation damaged

In April 2019, there were news reports that 250 people became ill after consuming contaminated milk produced by SWF. This was country Q's biggest case of food poisoning for over 10 years. After a week of confused press releases from SWF, an emergency Board meeting was held to consider SWF's options. Following this meeting, a public relations consultant was hired. A Ministry of Health investigation identified that bacteria had been allowed to accumulate in a production-line valve at one SWF farm. In a national television appearance, Lee apologised to the public and accepted full responsibility for the contamination caused by a failure of the quality control inspectors to identify the problem. He added that SWF has now introduced a quality assurance system and also contacted all those consumers affected to offer compensation.

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Organisational issues

The Board of Directors is to consider whether business growth requires a change to the organisational structure of the business. Lee is aware of a number of issues related to organisation:

- A lack of coordination between functional departments resulted in the delayed launch of a new product in 2018.
- There were shortages of cheese to meet increased demand due to poor communication between marketing, human resources and operations.
- Different products might need to be marketed in different ways.

Strategic options for growth

Lee wants SWF to grow. As a result of the demand changes already experienced and future anticipated changes, Lee commissioned reports into two strategic options.

Option 1: Organic production.
Demand for organic food products is increasing in country Q. This is a consequence of rising incomes, greater awareness of the environmental impact of non-organic farming and the possible health benefits of organic produce. Certification of organic standards takes at least five years for a farm to achieve.

There would be medium term costs to SWF as a result of lower milk yields before organic status is achieved. The reduction in profit is estimated to be $10m. However, this market segment is predicted to grow at 10% per year and organic products can be sold at higher prices. Currently 90% of organic milk products sold in country Q are imported.

Option 2: Diversify into frozen yoghurt products.
Market research indicates increasing demand for frozen yoghurt products. A successful entry into this market could compensate for the falling demand for fresh milk and increase SWF's product portfolio. Research would be required to develop new products. The production of frozen yoghurt is similar to ice cream manufacture. Capital investment of $3m would be required but the production of frozen yoghurts would increase capacity utilisation in the ice cream factory.

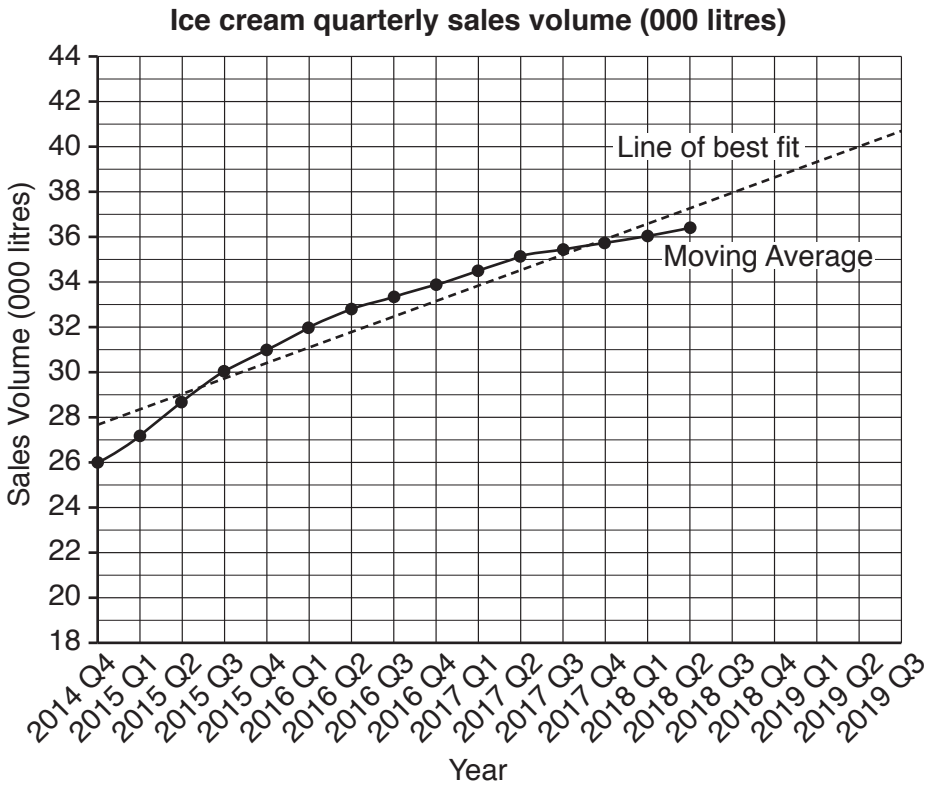
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Appendix 1: Ice cream sales data by volume (000 litres)

Year	Quarter	Sales volume	Centred quarterly moving average	Seasonal variation	Average seasonal variation
2014	2	25			
	3	35			
	4	25	25.88	–0.88	0.22
2015	1	16	27.13	–11.13	–12.09
	2	30	28.63	1.38	0.34
	3	40	30.00	**See Q4a(ii)**	11.97
	4	32	30.88	1.13	0.22
2016	1	20	31.88	–11.88	–12.09
	2	33	32.75	0.25	0.34
	3	45	33.25	11.75	11.97
	4	34	33.75	0.25	0.22
2017	1	22	34.38	–12.38	–12.09
	2	35	35.00	0.00	0.34
	3	48	35.38	12.63	11.97
	4	36	35.63	0.38	0.22
2018	1	23	36.00	–13.00	–12.09
	2	36	36.25	–0.25	0.34
	3	50	**See Q4a(i)**		11.97
	4	36			
2019	1	25			

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Ice cream quarterly sales volume (000 litres)
Sales Volume (000 litres)
44
42
40
38
36
34
32
30
28
26
24
22
20
18
Line of best fit
Moving Average
2014 Q4
2015 Q1
2015 Q2
2015 Q3
2015 Q4
2016 Q1
2016 Q2
2016 Q3
2016 Q4
2017 Q1
2017 Q2
2017 Q3
2017 Q4
2018 Q1
2018 Q2
2018 Q3
2018 Q4
2019 Q1
2019 Q2
2019 Q3
Year

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