Cambridge International A Level

Cambridge International Examinations
Cambridge International Advanced Level

BUSINESS STUDIES **9707/31**

Paper 3 **May/June 2014**

CASE STUDY

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 an HB pencil for any diagrams or graphs.
Do not use staples, paper clips, glue or correction fluid.
DO **NOT** WRITE IN ANY BARCODES.

Section A
Answer **all** questions.
Section B
Answer **one** question.
The businesses described in this question paper are entirely fictitious.
You are advised to spend 40 minutes on Section B.

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 **5** printed pages and **3** blank pages.

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RAMOS SUGAR CORPORATION (RSC)

Carlo Ramos is Chief Executive Officer (CEO) of RSC, which is a public limited company. It is the largest sugar producing, food manufacturing and food wholesale business in the region. Currently, RSC owns 20 sugarcane farms but also buys in crops from another 50 farms. It owns 3 large sugar production factories, a transport division, 2 food factories and a large warehouse. This warehouse stocks RSC's and other manufacturers' products. Deliveries from the warehouse are made to food retailers and shops throughout the region.

The growth of RSC has been achieved despite competition from large foreign owned businesses. Carlo is often asked for the secret of the company's successful growth record. His reply is always the same:
'We believe in operating ethically with all our stakeholders. We have a generous employee profit sharing scheme. 5% of profits is given to charitable causes each year. I think we always try to 'do the right thing.' The support of the Government and the local communities that we are located in has also been crucial. Many of our suppliers like trading with us and offered us long credit periods as we expanded.'

Profit margins fall in Food Manufacturing Division

The divisional structure within RSC means that each part of the business operates as a separate profit centre. Each division is expected to contribute to RSC's overall profitability. Table 1 gives a summary of accounting data for the Food Manufacturing Division.

Table 1: Food Manufacturing Division

Year to 31st May	2012	2013	2014
Revenue $m	120	130	130
Cost of goods sold $m	80	90	104
Overhead expenses $m	15	16	14
Average unit selling price to retailers	$1.20	$1.15	$1.08
Gross profit margin %	33.3	30.8	See **Q2(a)**
Net profit margin %	20.8	18.5	See **Q2(a)**

At a recent Board meeting, Bill, the Director of Food Manufacturing, was asked to explain the downward trend in profit margins. He said that: 'I assumed our objective was to maintain market share. Sales volumes have held up well despite increased competition from well known international food brands. We have had to discount heavily though. Market research suggests that a high proportion of customers do not recognise RSC branded food products. We rely on retailers to promote our products, but they do not often display them effectively. Most of our food products (such as cakes, biscuits, jams and desserts) contain sugar or sugar by-products and health pressure groups are against the excessive use of these ingredients.'

RSC's Marketing Director announced that she was working on a new marketing plan for the products of the Food Manufacturing Division.

New technology in the Sugar Production Division

Originally, RSC produced sugar using small scale labour intensive plants. These have been replaced by much larger factories but the equipment used in these factories has not been updated for several years. Inventory control is still not fully computerised and the lack of computer operated equipment means that there is no automatic control over sugar production. There has also been no investment in enterprise resource planning (ERP). This means that there is often poor coordination between sugar production and demand levels from RSC's own

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food factories and other customers. Despite the old-fashioned methods currently being used, labour productivity is surprisingly high and this reflects the motivation and commitment shown by most RSC employees. Labour turnover is low and many RSC production employees have been with the corporation for many years.

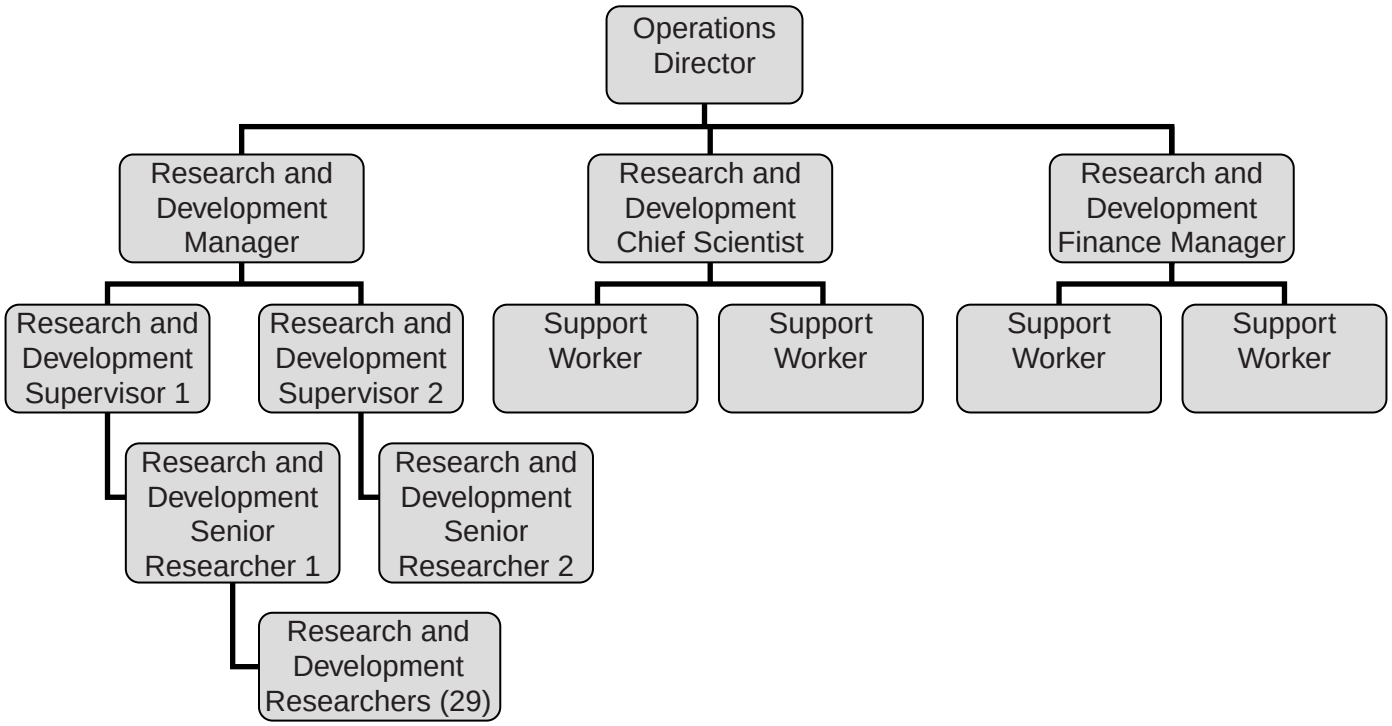
Organisational structure in the Research and Development department

RSC established a small Research and Development department 6 years ago. Its primary purposes are to develop:

- new non-food products such as plastics from sugar
- low calorie sweeteners using less sugar.

This Research and Development department is led by the Operations Director. It employs 40 researchers, scientists and support staff. The organisation chart for this department is shown below.

Figure 1: Organisation Chart



The 'new product' success rate has not been high. Researchers and scientists complain about lack of independence and excessive controls from senior managers.

Further expansion planned

The CEO and most of the RSC directors want to see the corporation expand rapidly in the next few years. 'The global slow-down has created great opportunities for strong companies like ours to buy assets cheaply, but we need to act quickly to take advantage of them' Carlo reported to the Board. 'I have identified two growth strategies. I believe we could go ahead with them both and they would give us real market power.'

The Finance Director warned the Board about the possible risk of over rapid expansion beyond the financial resources of the business. 'I just want to make it clear that, with the proposed technological investment in sugar production and these two growth strategies, shareholders will see a short term fall in returns and we may be forced to increase borrowing. The corporation's gearing ratio is already 36%.'

Carlo has produced an outline of the following two growth strategies. *70*

Strategy A: Expansion into food retailing

- Buy and renovate 15 vacant shops in city centres – capital cost $36m.
- Create a RSC Food Retail Division.
- Sell only RSC branded food products in the new shops.

Forecasted net cash flows from this strategy for the first 4 years of operating the shops are shown in Table 2. *75*

Table 2: Food retailing strategy

	Year 1	Year 2	Year 3	Year 4
Net cash flows ($m)	20	24	30	32

10% Discount factors: Year 1 = 0.91; Year 2 = 0.83; Year 3 = 0.75; Year 4 = 0.68 *80*

Strategy B: Take over Coral Sugar Production (CSP)

- CSP owns one large factory. This is operating at 50% capacity since an accident in early 2014 that seriously injured 2 workers who had not been fully trained.
- Some of the latest technology equipment is used.
- CSP marketing staff have been accused of bribing customers. *85*
- Labour productivity is low.
- Customer complaints over quality have risen recently.

Further data regarding this proposed takeover is contained in Table 3.

Table 3: The proposed takeover of CSP – additional data

Value of CSP's total assets (before the accident)	$65m
Gearing ratio (as at 31 May 2014)	43%
CSP Profit (before tax), year ending 31 May 2013	$15m
CSP Profit (before tax), year ending 31 May 2014	$1.5m
Carlo's valuation of the CSP business (as at 31 May 2014)	$23m
Forecast average rate of return if CSP purchased for $23m (based on 85% capacity working in CSP factory)	12%
Expected probability of CSP factory reaching 85% capacity within 6 months of takeover	65%

90 *95*

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Section A

Answer **all** questions in this section.

1 Analyse the likely benefits to RSC of operating ethically towards its stakeholders. [10]

2 **(a)** Using the data in Table 1, calculate for 2014:

(i) gross profit margin [3]

(ii) net profit margin. [3]

(b) Recommend a marketing plan which could increase profit margins for RSC's Food Manufacturing Division. Justify your recommendation. [14]

3 Discuss the likely impact on employee efficiency of increased use of technology in the Sugar Production Division. [16]

4 **(a)** Using data in Table 2, calculate for Strategy A:

(i) payback period [2]

(ii) net present value (NPV) at the end of the first 4 years. [4]

(b) Using your results from **4(a)** and any other information, assess whether RSC should go ahead with Strategy A. [14]

5 Recommend an improved organisational structure for the Research and Development department. Justify your recommendation. [14]

Section B

Answer **one** question in this section.

6 Assess the usefulness to RSC directors of the data in Table 3 and the other information provided when making the strategic decision whether to take over CSP. [20]

7 Discuss how Carlo could change the corporate culture of CSP if RSC takes over the company. [20]

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