CAMBRIDGE INTERNATIONAL EXAMINATIONS

Cambridge International Advanced Level

MARK SCHEME for the October/November 2014 series

9707 BUSINESS STUDIES

9707/31 Paper 3 (Business Studies), maximum raw mark 100

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1 Using the data in Appendix A, analyse the benefits to AF of its current pricing structure. [10]

	Knowledge 3 marks	Application 3 marks	Analysis 4 marks
Level 2	3 marks Good knowledge shown of price discrimination e.g. definition and two or more benefits identified	3 marks Issues well applied to AF	3–4 marks Good use of reasoned argument or theory to consider benefits of price discrimination
Level 1	1–2 marks Knowledge shown of price discrimination e.g. definition and benefit identified	1–2 marks Some attempt to apply price discrimination to AF	1–2 marks Some use of reasoned argument or theory to benefits of price discrimination

Answers could include:

- Identification of pricing structure indicated in Appendix A as price discrimination
- Definition of price discrimination: where a firm charges different groups of consumers different prices.

Benefits include:

- AF is able to take advantage of different price elasticities of demand between different groups of consumers. AF charge a higher price to members that wish to have access to the health club at all times relative to those desiring an off-peak membership. For example, working customers may only be able to use facilities outside of normal working hours and will therefore be prepared to pay a higher price than non-working customers. This will therefore increase revenue.
- They are able to use a lower price to attract younger members who have less disposable income but will in time become full paying adult members.
- A more efficient use of facilities will be encouraged. By offering off-peak membership better use will be made of the facilities that AF has invested in. Without price discrimination there would be times of the day when facilities were being underused. AF has invested heavily in facilities, fixed assets are valued at $95m, and thus should seek to ensure that they are used efficiently to generate revenue and profit. Off-peak membership will also help reduce potential overcrowding during peak times which would otherwise cause customer dissatisfaction.
- The offer of a reduced price 12 month contract will tie members in for a full year and thus reduce turnover of members.

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2 Discuss the importance to AF of investing in the development of good customer relations. [12]

	Knowledge 2 marks	**Application 2 marks**	**Analysis 4 marks**	**Evaluation 4 marks**
Level 2	2 marks Good knowledge shown of customer relations and benefits	2 marks Issues recognised well applied to AF	3–4 marks Good use of reasoned argument or theory to explain the issues involved	3–4 marks Good judgement shown in answer and conclusion
Level 1	1 mark Knowledge shown of customer relations and/or benefits	1 mark Some attempt to apply issues to AF	1–2 marks Some use of reasoned argument or theory to explain the issues involved	1–2 marks Some judgement shown in answer and/or conclusion

Definition of CRM: using marketing activities to establish successful customer relationships so that existing customer loyalty can be maintained.

The key aim of CRM is to retain existing customers rather than to win new customers. At the root of CRM is customer information. The first stage of improving customer relations is to understand what customers want. Undertaking research would enable Salika to adapt the 4Ps to meet the needs of customers with regard to matters such as:

- Facilities at the health clubs
- Quality of customer service e.g. personal trainers
- Membership options
- Booking systems
- Methods of communication with customers
- Changes to product and other aspects of the marketing mix that might encourage members to stay with AF

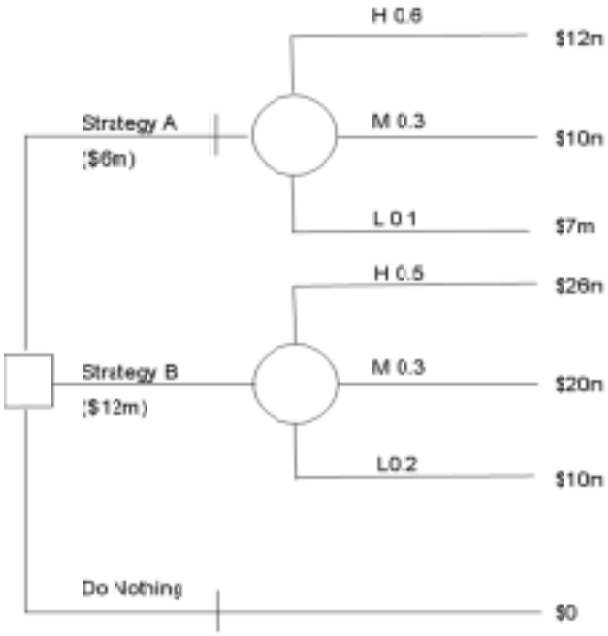
The benefit of such an approach is that:

- Recruiting new members to the health clubs can require significant marketing expenditure in terms of advertising and/or promotions. It can be difficult to identify potential customers so marketing expenditure is partly wasted on a significant number of people who are not interested in health clubs. AF is spending $60 to recruit each new member thus the total cost of replacing the 61 500 members lost each year is $3.69m.
- Building a long-term relationship with existing customers is more cost effective.
- CRM will reduce member turnover and therefore reduce the need to attract new customers.
- Reduces the need for staff to spend time selling AF to potential customers.

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3 Using the data in Appendix C:

(a) (i) draw and label a decision tree for the proposed growth strategies [5]



1 mark = nodes

1 mark = capital cost

2 marks = structure

1 mark = probability / pay-offs

Some recognisable attempt at decision tree 1 mark

(ii) calculate the expected monetary value for strategy A and for strategy B. [4]

Strategy A = $(0.6 \times 12 + 0.3 \times 10 + 0.1 \times 7) - 6$
= 10.9 – 6
= $4.9m (2 marks)

Strategy B = $(0.5 \times 26 + 0.3 \times 20 + 0.2 \times 10) - 12$
= 21 – 12
= $9m (2 marks)

1 mark if some use of probabilities

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(b) Using your answer to (a)(ii) and other information in the case, which growth strategy would you recommend Hanif to choose? Justify your answer. [14]

	Knowledge 2 marks	Application 2 marks	Analysis 5 marks	Evaluation 5 marks
Level 2	2 marks Good knowledge shown of DTA and relevant factor(s)	2 marks Points well applied to AF	3–5 marks Good use of reasoned argument or theory to explain factors influencing choice of strategy	3–5 marks Good judgement shown in answer and conclusion
Level 1	1 mark Knowledge shown of decision tree analysis or relevant factors	1 mark Some attempt to apply to AF	1–2 marks Some use of reasoned argument or theory to explain factors influencing choice of strategy	1–2 marks Some judgement shown in answer and/or conclusion

Note: Limit to Level 1 Analysis & Evaluation if only use answer to (a)(ii) or other information.

Based on the quantitative data in the decision tree Strategy B should be chosen as there is a greater expected profit of $9m compared to $4.9m. However:

- Strategy B requires double the investment of Strategy A. Can AF raise the extra finance to proceed with Strategy B. AF already has significant debt finance.
- There is a greater risk of low membership and should that occur Strategy B will make a loss. How risk averse is Hanif?
- Hanif prefers Strategy B – has this influenced the figures in the decision tree
- How reliable are the figures – the decision tree is for an 8 year period and figures are unlikely to be accurate over such a long time frame
- Strategy A is market development, so may be more risky as AF does not have experience of the budget market. However, this may be counterbalanced by the recent recruitment of Salika Aziz
- AF has experience in taking-over existing clubs in the premium sector and improving their performance
- Market growth in the budget sector has been greater than the premium sector. Will this trend continue?
- To what extent will either strategy cannibalise sales from existing health clubs owned by AF
- As Budgetgym has entered administration AF may well acquire its assets at below their true value.

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4 Evaluate AF's approach to human resource management (HRM). [16]

	Knowledge 3 marks	Application 3 marks	Analysis 5 marks	Evaluation 5 marks
Level 2	3 marks Good knowledge shown of HRM	3 marks Points well applied	3–5 marks Good use of reasoned argument or theory to explain the advantages and disadvantages of AF's HRM	3–5 marks Good judgement shown in answer and conclusion
Level 1	1–2 mark Knowledge shown of HRM	1–2 mark Some attempt to apply	1–2 marks Some use of reasoned argument or theory to explain the advantages/ disadvantages of AF's HRM	1–2 marks Some judgement shown in answer and/or conclusion

Note: Limit to Level 1 Analysis if one-sided argument.

Answers could include:
AF appears to take a soft HRM approach. Management is democratic and the role of employees is valued as indicated by the payment of competitive wages and provision of training to acquire vocational qualifications. This approach will have a number of benefits:

- AF will be able to retain talented staff as they will feel more appreciated and their views are taken into account. Labour turnover will be reduced and recruitment costs will be lower.
- Employees may be more motivated to provide good customer service and thus members are more likely to maintain their membership of AF – this will increase revenue and profit
- As AF competes in the premium health club market customers will expect high levels of service and individual attention from gym instructors.
- Staff may adapt the AF offer to reflect local circumstances
- Labour turnover = 230/2700 =7.1%
- Reference to approach being soft or democratic is example of application.

However:

- Decision making may be slowed by the consultation that occurs
- The $52m cost of staff salaries to the business, approximately 30% of costs compared to 10% in the low cost sector, is partly the result of their approach to HRM. The training offered will also add to the overall cost of staff
- Low labour turnover reduces the influx of new ideas into the business
- Staff having greater influence over the running of individual health clubs could lead to a dilution of AF's brand.

Evaluation:

- In the premium market sector it may be more important to have experienced and motivated staff than to reduce staff costs.

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5 Refer to Appendix B.

(a) Calculate the gearing ratio for AF in 2014. [3]

Gearing = Non-current liabilities/Capital Employed (1)

= 45/89 (2)

= 0.506 or 50.6% (3)

Accept gearing = NCL/Equity = 45 / 44 =102%

(b) Refer to your answer to (a) and other information in the case. Which source(s) of finance would you recommend AF to choose for the acquisition of Total Fitness? Justify your answer. [16]

	Knowledge 3 marks	Application 3marks	Analysis 5 marks	Evaluation 5 marks
Level 2	3 marks Good knowledge shown of sources of finance	3 marks Issues recognised well applied	3–5 marks Good use of reasoned argument or theory to explain possible sources of finance	3–5 marks Good judgement shown in answer and conclusion
Level 1	1–2 mark Knowledge shown of sources of finance	1–2 mark Some attempt to apply issues to	1–2 marks Some use of reasoned argument or theory to explain possible source(s) of finance	1–2 marks Some judgement shown in answer and/or conclusion

Note: Limit to Level 1 Analysis & Evaluation if only use answer to (a) or other information.

- Gearing is currently 45/89 = 0.506 or 50.6% and is therefore already high
- If AF borrows $12m to finance the takeover of Total Fitness then gearing will rise to 57/101 = 56.4%. Will banks be willing to lend more to AF?
- AF has fixed assets of $95m which could be used to secure further borrowing
- There is risk associated with borrowing $12m as the debt will need to be serviced. AF already pays $3.6m in interest suggesting a borrowing cost of 8%. However, net profit is more than 4 times this amount which indicates that AF is easily able to cover the servicing cost of its loans
- AF has an authorised share capital of 20m share at a nominal price of $1. Issued share capital is only 16m shares. Therefore they could raise finance through issuing more shares, would Hanif or other shareholders wish to purchase these shares? At what price could the shares be sold?
- It might be possible to raise part of the finance through better control of debtors. Accounts receivables total $7m as at 31st May 2014. However, using part of their working capital could leave the business short of liquidity. Liquidity is currently 11/17 = 0.65

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- Retained profits may provide part of the finance. In 2014 net profit before tax was $14.5m. Some of this may be available but it should be noted that tax must be deducted and dividends might be payable to shareholders. Some of the profit is likely to have already been spent so it is unlikely that retained profits would be sufficient to finance the whole deal.

Evaluation:

- Long-term finance is likely to be recommended. Attitude to risk is important as is the availability to AF of further long-term loans. A combination of sources might be suggested depending on the availability of retained profits and whether Hanif or the venture capitalists wish to invest further capital into AF.
- Short-term sources of finance unlikely to be the main source of finance given current liquidity.

6 Discuss the importance to Hanif of using PEST and SWOT techniques as part of AF's strategic analysis. [20]

	Knowledge 3 marks	Application 3 marks	Analysis 4 marks	Evaluation 10 marks
Level 3				7–10 marks Good judgement shown in answer and conclusion
Level 2	3 marks Good knowledge of issues shown	3 marks Issues well applied to case	3–4 marks Good use of reasoned argument or theory to explain answer	4–6 marks Some judgement shown in answer or conclusion
Level 1	1–2 marks Some knowledge of issues shown	1–2 marks Some attempt to apply issue	1–2 marks Some use of reasoned argument or theory to explain answer	1–3 marks Limited judgement shown in answer and/or conclusion

SWOT/PEST are part of the strategic management process and help determine where you are at present to help make decisions about where you wish to go.

Answers could include:

- Explanation of PEST – analysis of external constraints and other factors that could influence future strategic decisions
- Explanation of SWOT
- Can help a business plan for the future
- Political – legislation regarding qualifications for fitness and crèche staff
- Economic – rising number of competitors. Impact of recession economic growth on patterns of demand. Would AF be affected to a greater extent by recession as it is at the premium end of the market?
- Social – public attitudes towards fitness and demand for 24 hour gyms
- Technological – developments by competitors such as online management of accounts by customers themselves.

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Evaluation:

- PEST/SWOT should be continuous to be effective
- It is not a decision making technique – it analyses the external environment
- AF is currently operating in 3 countries and would need an analysis for each country.

7 Evaluate the strategic decision making techniques that AF's directors could use when making the choice between strategy A and strategy B. [20]

	Knowledge 3 marks	Application 3 marks	Analysis 4 marks	Evaluation 10 marks
Level 3				7–10 marks Good judgement shown in answer and conclusion
Level 2	3 marks Good knowledge of issues shown	3 marks Issues well applied to case	3–4 marks Good use of reasoned argument or theory to explain answer	4–6 marks Some judgement shown in answer or conclusion
Level 1	1–2 marks Some knowledge of issues shown	1–2 marks Some attempt to apply issue	1–2 marks Some use of reasoned argument or theory to explain answer	1–3 marks Limited judgement shown in answer and/or conclusion

Answers could include:

- Strategic choice – Ansoff, force field analysis and decision trees but other techniques might also be appropriate e.g. investment appraisal
- Strategy A might be seen product development as it involves AF altering its product mix but selling it in the existing health club market. This is more risky than Strategy B
- Depending on how market is defined Strategy B could also be seen as market development with AF attempting to appeal to a different market segment
- Strategy B is market penetration as AF is aiming to increase its market share of an existing market of which it has good knowledge
- Ansoff identifies risks but does not provide a decision making solution
- Decision trees – explanation of how they could help make the decision in this case – but there are many uncertainties especially with calculating the probabilities and pay-offs from the product development strategy
- Investment appraisal – provides a numerical "result" and these can be compared, but how reliable would the cash flow forecasts be?
- Strategic decision making techniques should follow on from effective strategic analysis of AF's current position.

Evaluation:

- Hanif might choose a non-scientific approach – would this be more or less likely to succeed than using techniques of strategic analysis?
- No one method is adequate – many factors and decision making approaches need to be weighed up
- Final judgement could come down to cost and time span – how important is it to opt for a strategy which will be likely to give quicker results?

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