Cambridge International A Level

Cambridge International Examinations
Cambridge International Advanced Level

BUSINESS STUDIES **9707/31**

Paper 3 **October/November 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, graphs or rough working.
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.
You are advised to spend 40 minutes on Section B.
The businesses described in this question paper are entirely fictitious.

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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Active Fitness (AF)

AF is one of a growing number of operators in the health and fitness market in the Asia Pacific region. The company was incorporated in April 2003 and began trading in October 2003 with 6 health clubs bought from HG Health. These clubs had strong repeat subscription revenue but this was insufficient for HG Health to continue operating them as part of its group. In order to buy the clubs, AF's Managing Director, Hanif, obtained the finance from venture capitalists.

AF invested heavily in upgrading the 6 clubs. With the support of the venture capitalists and finance from the banking sector AF was able to expand rapidly. Organic growth and a number of targeted strategic acquisitions helped AF establish its position at the premium end of the market. By the end of 2013 AF was operating 89 clubs, with a combined membership of 410 000, across 3 countries.

Hanif is proud of his achievements since 2003 and is determined that AF should continue to grow. However, the health club market is competitive as there are many established businesses and new clubs are emerging each year. AF's strategy has focused on operating multi-use facilities. This means a typical AF club offers not only a fully equipped gym and a range of fitness classes but also:

- swimming pool and spa
- personal trainers
- club lounge and restaurant
- health and beauty salon
- shop selling leisure equipment and accessories
- childcare.

The role of employees

Hanif has always considered employees to be central to the success of AF. Many of the employees at AF have vocational qualifications relevant to their role; for example, chefs, childcare assistants and personal trainers are all required to have appropriate qualifications. Employees at AF are paid highly competitive salaries and have flexible working patterns. In 2013 AF had 2700 employees at a cost of $52m. AF aims to attract the most talented people into the business and then invest in their development to ensure that they are the best in the industry. Many employees joined the business immediately after completing their education and have worked their way up the well defined career ladder. Feedback in the annual employee survey is generally positive. Employees, through the existence of workplace groups, appreciate the opportunity to influence decisions and the operation of individual clubs. Hanif was pleased that in 2013 labour turnover compared very favourably with the industry average of 16%; at AF only 230 employees left the business during the year.

A more challenging environment

The global economic crisis following 2008 has had a significant impact on the health and fitness market. Although market demand has continued to grow, there have been an increasing number of low cost competitors entering the market offering membership prices that are one third of AF's prices. To drive down costs these competitors have eliminated many of the facilities associated with traditional health clubs such as swimming pools and childcare. This has the effect of significantly reducing labour costs to, in some cases, just 10% of total costs. Technology is used, where possible, to increase the efficiency of the business; for example members sign up online and manage their own accounts. Unlike AF, many low cost competitors operate 24 hours a day. Typically a low cost competitor has twice as many members as an AF club of similar size. The consequence of these market developments is that AF has been losing market share to these competitors. In recent years revenues have grown slowly whilst profitability has fallen (see Appendix B).

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AF responds

In response to these external threats AF appointed Salika as the new Marketing Director. Salika was recruited from a low cost competitor. She quickly identified that AF was losing 15% of its members each year. AF needs to attract new members and this costs $60 for each new member. Salika is concerned at the marketing cost of maintaining stable membership numbers and has decided to refocus marketing expenditure. In 2014 Salika invested in a new marketing programme to improve customer relations. This programme has led, among other things, to AF improving customer communication and a more efficient booking system. There has also been a significant increase in the use of social media to demonstrate what it is like to take part in some of the fitness classes.

Future Developments

The Board of Directors is now considering two potential strategies for growth.

Strategy A: Enter the low cost market through a takeover of Budget Gym (BG).

> BG is a group of 10 gyms that has recently failed due to a lack of liquidity caused by poor financial management. BG experienced financial difficulties when it expanded more quickly than its cash flow would allow. Actual subscriptions were 20% lower than forecast. Costs of refurbishing the gyms and marketing them exceeded forecasts. AF has been in discussions with BG and Salika strongly believes that a takeover represents an excellent opportunity at a cost of $6 million.

Strategy B: Market penetration.

> This is favoured by Hanif who wishes to continue the current strategy of penetrating existing markets by opening new clubs in Asia. This could be achieved by taking over Total Fitness (TF), a chain of 9 health clubs with an established presence in the premium market segment. This will cost $12 million.

In preparation for making a decision between strategy A and strategy B, Hanif instructed that a relevant PEST and SWOT analysis should be conducted. Hanif also prepared a decision tree analysis – details are provided in Appendix C.

Appendix A: AF's pricing structure

Membership Type	Price (per month)	Comments
Under 18	$25	No access to facilities at weekends
18–25	$35	Minimum 6 month contract
Off-Peak Health & Fitness	$30	Access to facilities limited to off-peak times
Health & Fitness	$42	Minimum 12 month contract
Flexible Health & Fitness	$50	No minimum contract

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Appendix B: Summary accounting data for AF

	Year ending 31 October 2014 ($m)	Year ending 31 October 2013 ($m)
Revenue	186.9	182
Profit before interest and tax	14.5	15
Interest payable	3.6	3.8

	As at 31 October 2014 ($m)	As at 31 October 2013 ($m)
Non-current assets	95	97
Inventory	2.8	3
Trade receivables	7	6
Cash	1.2	1.4
Current liabilities	17	18
Non-current liabilities	45	47.4
Shareholders' equity	44	42
Authorised Share Capital (20m ordinary shares at $1)	20	20
Issued Share Capital (16m ordinary shares at $1)	16	16

Appendix C: Forecasted probabilities and economic pay-offs (over 8 year period) from growth strategies

	Probabilities of success	Forecasted economic pay-off
Strategy A Capital cost $6m	0.6 probability of high membership	$12m
	0.3 probability of medium membership	$10m
	0.1 probability of low membership	$7m
Strategy B Capital cost $12m	0.5 probability of high membership	$26m
	0.3 probability of medium membership	$20m
	0.2 probability of low membership	$10m

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Section A

Answer **all** questions in this section.

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

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

3 Using the data in Appendix C:

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

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

(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]

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

5 Refer to Appendix B.

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

(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]

Section B

Answer **one** question in this section.

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

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

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