1.3.5 Strategic and Economic Analysis Exercise Answers

Unit: Unit 1 – Treasury Strategy

Module: Module 1 – Corporate strategy

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Summary: A strategic analysis of a business from three approaches.

Answer 1
Porter's 5 Forces Analysis (Green Parrot)

Rivalry among existing firms
The chocolate, snacks and beverages industry has numerous industry leaders which have similar product offerings. Many of the leaders create new product lines and actively participate in advertising wars. There is intense rivalry.

The chocolate, snacks and beverages industry is a mature market that is growing slowly. This slow growth increases the rivalry among competitors.

The processed food industry has both high fixed costs and high storage costs. The industry's fixed costs consist of large amounts of equipment and huge facilities to house manufacturing operations. Although the industry consists of perishable foods and ingredients, which typically have a short shelf-life, the storage costs are high due to the precise storage environment needed. For example, both milk and chocolate must be kept at a proper temperature and humidity.

The differentiated products and moderate switching costs reduce the intensity of rivalry among competitors in the chocolate, snacks and beverages industry.

The chocolate industry has high exit barriers that increase the intensity of rivalry among the industry's competitors. The industry requires specialised assets that would be difficult to recover upon exit.

Although the chocolate, snacks and beverages industry has partially differentiated products, the industry's intensity of rivalry among competitors is high. The conditions discussed above lead to price wars, advertising battles & new product lines.

Threat of new entrants
Green Parrot is involved in the volume section of the market and benefits from significant economies of scale which deters smaller competitors from entering into this section of the market and reduces the threat of new entrants. (NB new entrants could appear in the Fragmented or Specialised sections of the Market Environment Matrix, but these are unlikely to be seen as a threat to Green Parrot's business.)

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Product differentiation is another entry barrier. There are many competitors in the industry. All have established brand names and strong customer loyalty, which creates a considerable entry barrier for new companies. A new entrant would have to incur significant marketing cost to overcome brand loyalty.

Large capital requirements create an entry barrier for new entrants because it requires the company to have a significant source of capital to get started.

There are few switching costs for the consumer in monetary terms, although brand loyalty is likely to reduce switching. Industrial chocolate buyers (if any) will face higher switching costs to ensure consistent flavour in their end products. New entrants may incur costs with suppliers to ensure quality and safety.

A new entrant must acquire distribution channels for their products. Further, new entrants have to compete for shelf space in stores.

Cost disadvantages independent of scale. Because the industry produces food for the end consumer, companies in the industry must meet various government standards. These regulations are a barrier to entry for new companies.

We can conclude that there is a low threat of new entrants in the Volume section of the chocolate industry.

Threat of substitutes

The chocolate, snacks and beverages industry must compete with numerous substitute products that can threaten the industry's profitability. Chocolate products and snacks are themselves substitutes. Many non-chocolate snacks are available, such as peanut butter, fruits, potato chips, ice cream, etc. There is no need to stick with a specific snack other than personal preference. Further, many consumers consider chocolate unhealthy and are willing to substitute it readily.

In addition to flavour and snack substitute products, the chocolate industry must compete with substitute products in the retail arena. Speciality chocolate products are used as gifts during numerous seasons and celebrations including Christmas, Easter, Valentine's Day, anniversaries and birthdays. Other types of gifts during these seasons are viewed as substitute products. These products include flowers, jewellery, soft toys, etc

Bargaining power of suppliers

The intermediaries supplying the chocolate industry have some bargaining power over the industry because of the limited number of these suppliers. Security of supply is also important because 1) the cacao tree is grown in areas which have a tropical climate and are at risk from natural disasters which can reduce the supply, and 2) the risk of civil unrest which can have an adverse affect on supply. This is less the case for milk and sugar.

The cocoa bean, sugar and milk are all necessary ingredients in the chocolate industry. This lack of substitutes increases the bargaining power of suppliers.

The cocoa bean is an important export of the countries that produce the cocoa bean. The bargaining power of the suppliers is reduced because of the importance of the chocolate industry as a customer. This is less true for milk and sugar.

The chocolate industry relies on suppliers to deliver high quality products that meet food regulations and consumer taste tests. To the extent that the industry relies on beans from a particular region, if the suppliers' product is not available or does not meet the quality expected, the industry will suffer. This dependency on the suppliers' product increases the suppliers' bargaining power. Not applicable to milk and sugar.

Within a region, if the beans meet grade guidelines, the product is relatively undifferentiated. Also applies to milk and sugar.

Suppliers to the chocolate industry do not pose a major threat of forward integration.
The bargaining power of suppliers is moderate to high because the supplier group is concentrated and there are no substitute products. Their power is offset by the importance of the chocolate industry to them.

Bargaining power of customers
The chocolate, snacks and beverages industry has several large volume retailers, primarily the major supermarkets, which have significant bargaining power. These large volume retailers can bargain for lower prices and reduce the industry's profits. (Note – the major supermarket chains have significant bargaining power over even suppliers of a similar size.)
However, Green Parrot has differentiated products which reduce the power of buyers. Brand identification and customer loyalty makes it hard for buyers not to use Green Parrot. This is probably true even though one of Green Parrot's customers accounts for 25% of sales.
The buyer's switching costs in the chocolate industry is probably low assuming Green Parrot has few industrial-use buyers.
The bargaining power of buyers is low to moderate. Although buyers have significant buying power which will be reflected in the terms they negotiate, this is limited by significant product differentiation.

Answer 2
Swot Analysis Brainstorm – possible solution (Green Parrot)

Strengths
- Strong name
- Leading brands
- Product innovation
- Leading European Market Position
- Diversified products (not all chocolate)
- Strong customer relationships

Weaknesses
- High cost production locations
- Reliance on retail market

Opportunities

- Product offerings – Green Parrot has the option to expand its product portfolio by introducing more brands & moving beyond retail
- ***Economic***
    - Production of cocoa in new areas, eg Jamaica
    - Price decline of sugar
    - Bio-fuel production from chocolate by-products
- ***Global***
    - Increase in global trade
    - New countries becoming industrialised
    - Relocate factories to cheaper labour locations

Threats

- Competition – Nestle and Kraft are much bigger
- Changing consumer trends
    - Rising prices of raw materials and fuels, and in turn, increasing packaging and manufacturing costs. Green Parrot may not be able to pass on the full burden of these onto customers.
- ***Socio-cultural / Demographic***
    - Peanut allergies
    - Increasing obesity
    - Greater environmental concern
- ***Political / Legal***
    - Food labelling – nutritional (fat, sugar) content
    - Minimum price legislation for ingredients
- ***Technological***
    - Lack of government support in and to developing countries (poor education of new technologies)
- ***Economic***
    - Steady increase of minimum wage in future years
    - Steady price increase of milk
    - Steady price increase of energy
- ***Global***
    - Farming areas being used for residential, commercial, industrial developments
    - Natural disasters (i.e. hurricanes) disrupting growth of chocolate ingredients
    - Fluctuation of exchange rates

Answer 3
Suggested business analysis (Green Parrot)

INDUSTRY

	ITEM / FACTOR	VALUE / DESCRIPTION	IMPLICATIONS*
1	Propose your top three most important commercial factors based on the company overview resource and any industry-related research you have time to perform.	1. Commodity pricing and availability 2. Investment in production processes and new products 3. Brand protection and growth via quality and marketing	Covered below
2	Propose your top three key value drivers and key strategic risks for Green Parrot.	Value Drivers: 1. Minimise material input costs 2. Reduce operational expenses via more efficient production processes 3. Drive sales revenue by enhancing brand awareness	1. Huge issue – links to hedging, security of supply, actions taken by competitors and environmental factors outside company control 2. Requires investment in R&D which may take some time to translate into improved operational performance 3. Linked to quality and marketing activity
		Strategic Risks: 1. External shocks to the industry which competitors may be better placed to withstand 2. Problems in product quality, resulting in recalls and loss of customer confidence 3. Long-term consumer trends and changing tastes (more health-conscious for example)	1. Such as geo-political factors influencing price and availability of commodities 2. Investment and training in quality control required 3. Research needed to identify trends well in advance and be able to respond to changing consumer tastes
3	Propose two criteria for a firm to achieve sustainable competitive advantage in this industry.	Criteria 1: Strong brands which build and encourage a high level of customer loyalty	Allows the company to benefit from profitable products
		Criteria 2: R&D: develop new products, improve the quality of existing products, improve and modernise production processes, and develop and implement new technologies to enhance the quality and value of both current and proposed product lines.	Crucial in order to maintain competitiveness, however requires sizeable investment to achieve this, and larger competitors have an advantage in terms of scale

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GREEN PARROT

	ITEM / FACTOR	VALUE / DESCRIPTION	IMPLICATIONS*
4	Succinctly analyse Green Parrot's financial performance over the past two years: profitability, asset management, capital structure including credit and shareholder issues plus sustainability of cash flows	Sales growth and profitability: Healthy net profit margin, increased from 7.7% to 8.1%. Materials costs represent 30% of sales, unclear what comprises operating expenses (35% of sales). YOY sales growth very high at 15%	Based on limited information, healthy income statements, however vulnerable to material cost increases
		Asset management - working assets, fixed assets and capital expenditure: Inventories at 13.9% of sales compared to 14.0%, no change. Receivables at 28.7% of sales compared to 30.6%, this is an improvement but seems quite high, possible improvement here. Accounts payable 8.1% compared to 8.2%, no change. Capex at 5.4% of sales compared to 5.6% no change.	The asset situation is very stable from year to year, indicating good management. However, receivables seem very high, at about 30% of sales or about 110 days and this might be structural in the industry but might equally be an opportunity. Payables (assuming purchases are also 30% of sales like costs) are 98, on a similar basis. Recession may make credit risk in receivables an issue.
		Capital structure: Net cash	Possible under use of capital but may lack investment opportunities. Credit crunch unlikely to encourage further borrowing but cash distribution possible.
		Credit issues: CHF100m bonds and CHF47m bank debt. No data for MV of equity, book gearing is low (147/1,158 = 13%). Based on MV's, gearing is likely to be even lower.	Although the business has specific strategic and operational risk, there could be scope for increasing its financial risk arising from its level of debt, thereby benefiting from a more efficient capital structure. Further analysis would be necessary in order to conclude on this but unlikely in credit crunch times.
		Shareholder issues: Increase in EPS, accompanied by an increase in the dividend paid increased of 25%	No data on share price or total shareholder returns, however based on the limited data shareholders have reason to be positive. Confectionery is relatively recession resistant
		Cash flow: Very stable YOY cash flows by category with free cash flow used to both repay debt and pay a dividend. Significant cash investment in working capital in both years but ratios stable as shown above.	May benefit from a review of working capital management, given cash invested

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	ITEM / FACTOR	VALUE / DESCRIPTION	IMPLICATIONS*
5	Taking Green Parrot as a whole (both business and financial dimensions) within its global industry setting, what are its principal strengths, weaknesses, opportunities and threats?	Strengths 1. A number of globally-recognised brands 2. Balance sheet 3. Several licence agreements extendible long term at company's option	1. Brands are important as they foster customer loyalty and allow products to be priced accordingly 2. Low level of debt, gives scope to gear up to either return cash to shareholders, or consider acquisition opportunities should they arise (subject to credit crunch availability of debt, but Green Parrot is a good credit risk) 3. Secured future cash flows with respect to these products
		Weaknesses: 1. Smaller than some competitors, with fewer resources	1. Less able to sustain environmental shocks (such as commodity availability/prices) and unable to invest as much in product development
		Opportunities: 1. Take advantage of occasional quality problems by competitors 2. Utilise balance sheet strength 3. Scope for more efficient working capital	1. Win market share if competitor has quality issues and adverse publicity 2. Look to expand business into value-enhancing areas 3. Will release cash for use in the business, or for return to shareholders
		Threats: 1. Quality control 2. Disruption to material supply and/or increase input prices 3. Given the significant sales in America and ROW, volatility in the foreign exchange markets is likely to be relevant 4. Pension liability	1. Cadburys recently had to recall a huge amount of stock due to health concerns which was very costly 2. Vulnerable to commodity prices and supply – hedging can only afford limited protection 3. More information is required on the size of FX exposures and the associated risk management policies 4. The pension liability is CHF 143m, similar to total debt, and so must be a priority for treasury

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	ITEM / FACTOR	VALUE / DESCRIPTION	IMPLICATIONS*
6	Briefly critique Green Parrot's treasury-related policies.	Organisation: 1. De-centralised group with local autonomy for management of FX and commodity risk 2. Centralised systems for recording, consolidating and managing group-wide positions, despite decentralised management system	1. Local autonomy require understanding and adherence to group risk management policies 2. Systems and communication must be adequate in order for this system to work properly
		Controls: 1. Limited data available	
		FX Policy: 1. Group wide aggregate exposures are monitored on a weekly basis 2. Sensitivity analysis, scenario analysis and VAR are applied to analyse the risks arising from FX exposures 3. Some confusion in policies which say that options are used but that company is not a party to instruments with prepayment features, which would include options with their up-front premia.	1. Weekly analysis needs to be sufficient, with measures in place to identify any significant intra-week movements and to act accordingly 2. Application of these tools requires treasury expertise, especially with respect to VaR 3. Confusion to be cleared up re options.
		Interest Rate Policy: 1. Not considered a major risk, however interest rate swaps may be used if considered appropriate 2. No data available on whether policy is to fix or float, or what may determine a combination of these	1. A clear policy should be established, against which the treasury department can be assessed 2. If immaterial to the results, policy could be to allow rates to float, thereby requiring bond debt to be swapped to floating
		Commodity Risk Policy: 1. Forward purchasing to cover future manufacturing requirements for 3 to 24 months 2. Futures contracts in combination with forward purchasing of cocoa and other commodities 3. Fuel oil futures contracts are used to minimize price fluctuations associated with transportation costs	1. Commodity procurement practices are intended to reduce the risk of future price increases and provide visibility to future costs, but also may potentially limit the ability to benefit from possible price decreases 2. The risks of entering into derivative instruments must be fully understood, and only performed be experienced and professional staff –controls must be adequate 3. Derivative instruments must be properly accounted for under IFRS

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