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**BUSINESS AND MANAGEMENT**

**9771/02**

Paper 2 Strategic Decisions

**May/June 2014**

**3 hours**

Additional Materials: Answer Paper/Booklet

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**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.**

Answer **all** questions.

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.

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This document consists of **7** printed pages and **1** blank page.

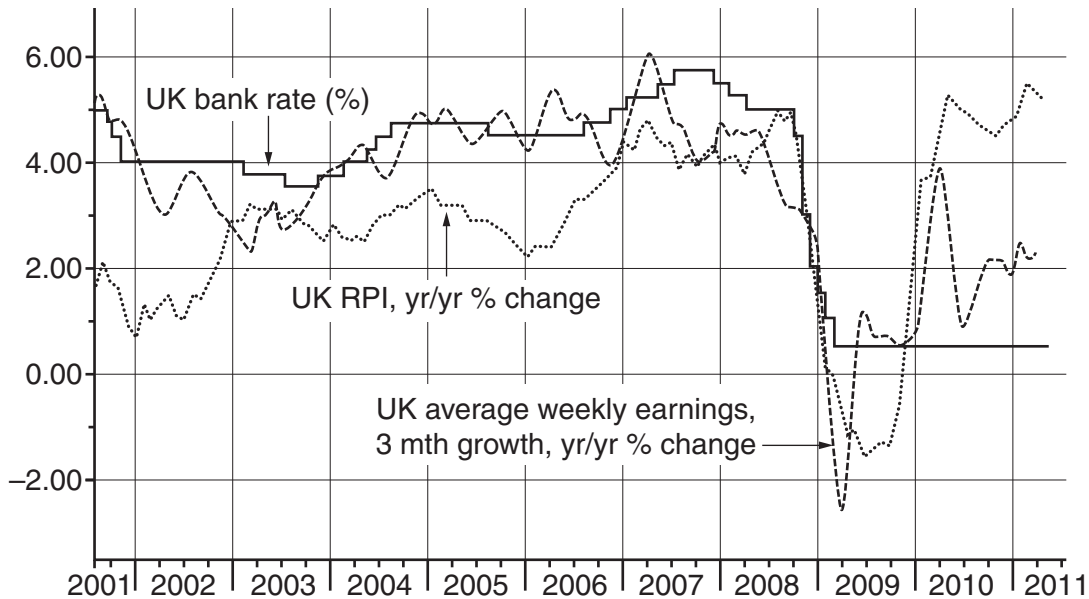
**Home Retail Group plc (HRG)**

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## Retail sector under pressure

The entire UK retail sector is currently under pressure and HRG is no exception. It is facing threats from increased competition and a downturn in consumer spending and confidence. Competition is intense for both of the main businesses within the group. Argos is competing against established Internet companies such as Amazon but is also facing new competition from the big retailers such as Tesco. This retailer is broadening its product ranges, offering a catalogue format and establishing an online presence. Customers are also becoming more sophisticated in their search for value. Online price comparison sites mean that the customer has the ability to quickly compare prices between major retailers.

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**Figure 1: Economic data**

Profits have been under pressure at HRG and both Argos and Homebase face many problems. Consumer real disposable incomes are falling, as are HRG's sales. HRG has a large number of stores and rental costs alone amount to £363m a year. These fixed costs are a burden on a company with falling sales. Clearly HRG will need to focus on cost reduction and maximising revenues to preserve margins. There are several strategies HRG could pursue including further differentiation and cost reductions. Another potential strategy would be to close some Argos and Homebase stores. In several towns there is more than one Argos store, which is seen as extravagant by some business analysts in the current economic climate. A key issue with store closures is rental agreements. Breaking a rental contract can be expensive. 230 Argos stores have rental renewals that are due in the next 5 years and non-renewal of some of the leases could be a potential cost cutting strategy for HRG. However, cutting the number of stores would present its own problems and may weaken the position of HRG when an economic recovery arrives.

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## Shareholder concern

HRG's share price has been underperforming in recent years. As at 21 May 2012 the price per share is £0.76 and the company has a market capitalisation of £629m with just over 800m issued shares. Its performance has been in line with some competitors but below that of the general FT350 index of which HRG is a member (see Figure 2). This historically low share price has led some value investors to view HRG as a potential share purchase. The majority of share brokers do not reflect this optimism (see Table 2). Whilst most shareholders are interested in the share price, many are also acutely aware of the importance of dividends. Over the past 5 years the average dividend yield has been 5.5% and the forecasts for 2013 and 2014 are 5.2% and 5.3% respectively. Dividend cover (the relationship between net profits and dividends) has been worsening steadily from 2007 to 1.45 in February 2011. The financial accounts for HRG help potential investors to see whether HRG has strong financial underpinnings. HRG is exposed to external events and the retail sector tends to reflect the general state of the economy.

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Strong Buy	3
Buy	1
Neutral	2
Sell	3
Strong Sell	12
Total	21

**Table 2: Sharebroker views on HRG**

## Performance and pay

The group has 3 executive directors and their salary details can be seen in Table 3. This raises the issue of executive pay and performance. HRG uses a benchmark index of similar companies to set its directors' pay. In recent months the emergence of the 'Shareholder Spring' has led to votes at some company Annual General Meetings (AGM) for a reduction in the salary and bonus packages of certain directors. HRG seeks to maintain a balance between allowing meaningful incentives whilst aligning directors' interests with shareholders' interests. HRG directors are expected to hold a significant number of shares in the company and the incentive schemes are organised so that undue risks are not taken. There are clearly arguments in favour of and against substantial salary packages.

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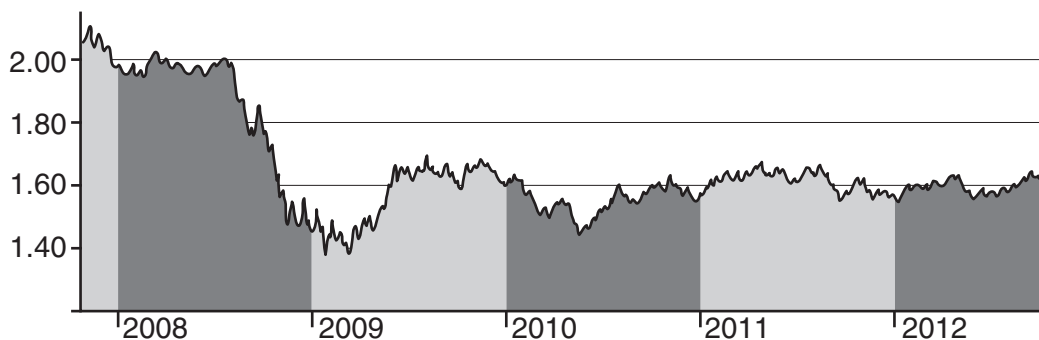
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## Imports and exchange rates

HRG derives all of its revenue from the UK and the Republic of Ireland (ROI). The ROI uses the Euro which exposes the company to currency fluctuations although this market only accounts for a small proportion of sales. The group also imports more than 33% of its products. HRG imports the majority of its goods from Asia with most of the contracts based on payment in US dollars. The volatility of the world economy and exchange rates is causing some difficulties for HRG. The Annual Report clearly identifies currency exposure as a key risk. The accounts division within the company continually monitors exchange rates and factors that influence them and gives the directors advice on how to reduce the risks involved. The company uses forward purchase contracts (hedging) to reduce its exposure to currency fluctuations. The cost of doing this can be substantial. The group is also keen for its prices to reflect changes in costs but this is not easy in a competitive market. The directors of HRG are keen to review its sourcing contracts. They are evaluating alternative suppliers, some of whom are based in the UK. Reducing 'currency risk' is a crucial part of the group's strategy.

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**Figure 3: £ sterling v US dollar exchange rate**

**Future prospects**

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Revenues could be enhanced by increasing HRG's presence in Internet retailing. In the current market the companies with effective Internet sales are doing well relative to their rivals. Amazon has steadily increased sales even in the economic downturn. Selling via the Internet reduces some costs and improves margins. HRG currently has a competitive advantage over Amazon as customers can choose home delivery or 'click and collect'. This means consumers do not pay postage and can collect the item almost immediately from their local store. Tesco has also seen the opportunities present in the online market and is enhancing its own online strategy.

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Read all the case study material and then answer all the following questions.

### Section 1

- 1 (a) Using the financial statements as at 26 February 2011:
- (i) calculate the asset turnover ratio for HRG [3]
  - (ii) calculate the acid test ratio for HRG. [3]
- (b) With reference to part (a), comment on the usefulness of **one** of these ratio values to HRG. [6]
- (c) Using any **two** elements of Porter's Five Forces model, analyse the competitive position of HRG. [13]

### Section 2

- 2 Evaluate how HRG could respond to the continuing prospect of volatile exchange rates. [25]
- 3 Evaluate whether current director remuneration packages are appropriate given the performance of HRG. [25]
- 4 Recommend and justify a strategy which could enable **Argos** to improve profitability. [25]

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*Copyright Acknowledgements:*

Case Study Table 1	© Home Retail Group Annual Report; <a href="http://www.homeretailgroup.com/ar/2011/">http://www.homeretailgroup.com/ar/2011/</a> ; 2011.
Case Study Figure 1	© Money Week; <a href="http://www.moneyweek.com/news-and-charts/economic-indicators/inflation">http://www.moneyweek.com/news-and-charts/economic-indicators/inflation</a> ; 2012.
Case Study Figure 2	© HRG main website; <a href="http://www.homeretailgroup.com/ar/2011/">http://www.homeretailgroup.com/ar/2011/</a> ; 2012.
Case Study Table 2	© The Share Centre; <a href="http://www.sharecentre.com">www.sharecentre.com</a> ; 2012.
Table 3	© Home Retail Group Annual Report; <a href="http://www.homeretailgroup.com/ar/2011/">http://www.homeretailgroup.com/ar/2011/</a> ; 2011.
Figure 3	© Reuters; <a href="http://www.reuters.com">www.reuters.com</a> ; 2012.
Table 4	© Home Retail Group Annual Report; <a href="http://www.homeretailgroup.com/ar/2011/">http://www.homeretailgroup.com/ar/2011/</a> ; 2011.

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