Cambridge Pre-U

Cambridge Assessment International Education
Cambridge Pre-U Certificate

BUSINESS AND MANAGEMENT (PRINCIPAL) **9771/02**

Paper 2 Strategic Decisions **May/June 2019**

3 hours

Additional Materials: Answer Booklet/Paper

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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, graphs or rough working.
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.

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

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Next plc

Introduction

Next was established in 1982 as a clothing retailer. It has expanded rapidly to become a well-known high street brand with over 500 stores in the UK and the Republic of Ireland. The company is best known for its fashionable clothing in the mid-market price range. The group has diversified in recent years to include home and garden merchandise such as sofas, curtains, wardrobes and outdoor patio sets.

Company structure

The business has two core elements:

A) Next Retail: This is the portfolio of over 500 high street stores. In recent years the company has diversified by opening four larger out-of-town fashion and home stores in the UK. Next leases most of its stores and does not own them. The company prefers short leases compared to many of its competitors.

B) Next Directory: The online and catalogue part of the group. It publishes two catalogues per year at a price of £3.75 each. The summer 2016 hard-back catalogue had 770 colour pages. All of Next's products are also available to purchase online. Standard next-day delivery within the UK costs £3.99, or delivery is free to the customers' nearest store. Customers can now choose to pay £20 per year to qualify for a free next-day delivery service. This is a recent initiative called 'next unlimited'.

The Next Directory has been a great success (see Tables 1 and 2). In 2017 it had 3.88m active customers (3.79m in 2016). Slightly fewer (–3%) of customers are now using the credit account facility and prefer to pay for the items ordered at the time of purchase. Next is concerned with this trend as it loses the interest revenue from credit accounts (currently 22.9% APR). The company introduced a special offer for new credit account customers that involved 0% interest-free credit for 3 months and £10 off the first order. Other measures to increase Directory sales have included a revised mobile app, increased delivery options, 'refer a friend' incentives and further personalisation of the customer's website experience. Many other potential strategies to increase Next Directory sales are being implemented or considered and the company is currently prioritising these strategies. It has set aside £11m for increased investment in the Directory systems and content.

	Year ending January 2017 £m	Year ending January 2016 £m
Next Retail	2304.6	2373.5
Next Directory	1728.5	1658.7
International operations	64.2	144.7
Total revenue	4097.3	4176.9

Table 1: Sales by business division

	Year ending January 2017 £m	Year ending January 2016 £m
Next Retail	338.7	402.1
Next Directory	444.1	405.2
International operations	44.9	59.9
Operating profit	827.7	867.2

Table 2: Operating profit by business division

Inflation and cost pressures

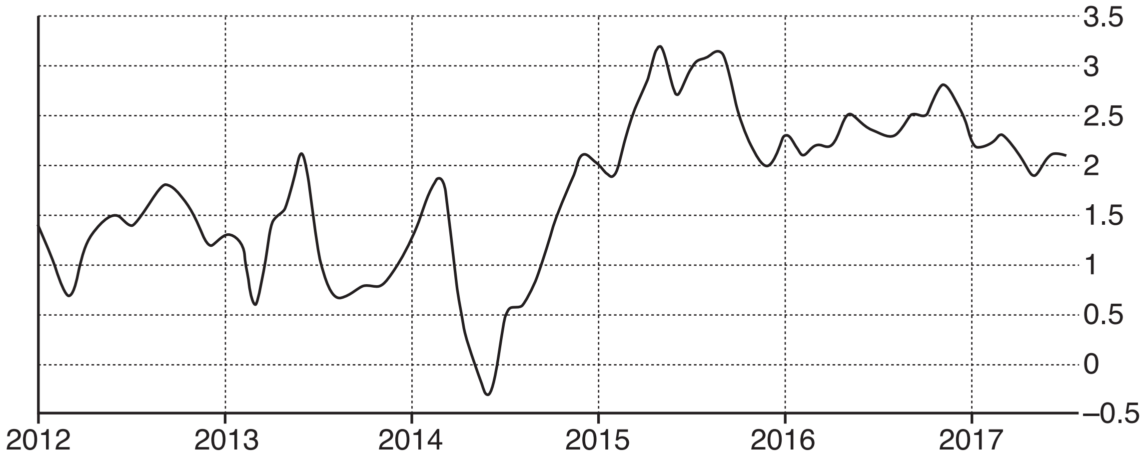
One of the key challenges facing Next is the recent reduction in consumers' real disposable incomes. Figure 1 illustrates the recent path of annual wage growth and in June 2017 this was 2.1%. As Figure 2 shows, inflation has started to increase and reached 2.9% in mid-2017. The squeeze on real consumer incomes has led to a fall in retail sales in the UK of over 2% in 2017. It also seems that UK consumers are changing their spending habits to favour experiences such as going out to a restaurant or spending on general entertainment.

One of the driving factors increasing inflation has been the depreciation of the pound sterling against most other major currencies. This was largely due to the referendum vote to leave the European Union (Brexit). Approximately 60% of Next's total purchases are made in US dollars and in recent years the pound has rapidly depreciated against the US dollar. This has led to an increase in costs as Next imports a considerable proportion of its clothing and home-garden range.

Another potential inflationary pressure for Next is the implementation by the UK Government of increases in the minimum wage. This is in addition to wage rises agreed with employees earning above the minimum wage. In total, wage costs grew by £22m at Next in the year to January 2017. This increase in costs could accelerate as the National Living Wage is set to rise at a level above inflation for the next few years. Workers earning above the minimum wage are likely to try to negotiate higher wages to offset the impact of inflation.

Other cost pressures include new taxes such as the Apprenticeship Levy, energy taxes and further investment in online systems.

Next's Annual Report 2017 states that: 'cost savings must come through innovation and efficiency rather than any compromise to our product quality or service'. Proposed areas for savings include: management costs, staff incentives, warehouse and distribution efficiencies, higher productivity and lower branch costs.



Source: Office for National Statistics

Figure 1: Nominal wage growth in the UK Economy (%)

Source: Office for National Statistics

Figure 2: Consumer Price Inflation (CPI) in the UK (%)

Prices and Competition

Mid-market fashion clothing is a highly competitive market. Competitors include Marks & Spencer, Debenhams, Matalan, House of Fraser and Zara. Recently, competition from low price stores such as Primark and online only stores such as boohoo.com has increased.

Price is a key element in this sector. Average prices in Next stores increased by an average of 4% in 2017. Richard Chamberlain (retail analyst) stated that: 'sales in Next stores were down more than 10% suggesting the price elasticity of demand has been higher than the Directors expected.'

Competition is not purely about price. Getting new high street and fashion trends into the retail shops is yet another challenge. Next is hoping to do this within an eight week time frame. The situation is further complicated by choosing which fashion trends are most likely to appeal to the company's target customers.

Next shares

Money Week magazine stated, in August 2017, that Next shares may be worth considering for investors looking for long term value (see Table 5). The share price has more than halved since late 2015. It has partially recovered in recent months. Next is returning surplus cash to shareholders in the form of 'special dividends' on top of the regular dividend. In 2017 this equated to an additional £1.80 per share. The company does face many challenges such as falling sales in its retail stores, lower consumer real incomes and fierce competition. However, perhaps this bad news is already reflected in the current share price.

	Year ending January 2017 £m	Year ending January 2016 £m
Revenue	4097.3	4176.9
Cost of sales	(2710.7)	(2724.2)
Gross profit	1386.6	1452.7
Distribution costs	(345.1)	(351.6)
Administrative expenses	(213.8)	(233.9)
Operating profit	827.7	867.2
Finance cost	(37.5)	(31.1)
Profit before tax	790.2	836.1
Taxation	(154.9)	(169.3)
Profit for the year	635.3	666.8

Table 3: Next Income Statement

Assets and liabilities	As at January 2017 £m	As at January 2016 £m
Non-current assets	744.2	687.9
Current assets	1660.6	1642.2
Total assets	2404.8	2330.1
Current liabilities	(725.0)	(1170.6)
Non-current liabilities	(1169.3)	(847.7)

Table 4: Next Balance sheet (selected data)

Dividend per share (2017)	£1.58
Share price (average for 2017)	£43.80
Price/earnings ratio (average for 2017)	10.8

Table 5: Shareholder data for Next, 2017

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

Section 1

1 **(a)** Calculate the asset turnover ratio as at January 2017. [3]

(b) Calculate the interest cover ratio as at January 2017. [3]

(c) Comment on the usefulness to Next's directors of the result obtained in **either 1(a) or 1(b)**. [6]

(d) Richard Chamberlain (retail analyst) stated that: 'sales in Next stores were down more than 10% suggesting the price elasticity of demand has been higher than the Directors expected.' (Lines 60–62)

Analyse **two** implications of this observation for Next in the short to medium term. [13]

Section 2

2 Recommend a potential strategy that Next could implement to deal with rising inflation. [25]

3 Evaluate a potential marketing strategy to increase profits from the Next Directory. [25]

4 Discuss whether Next shares would be a good investment for a long term investor.
Your answer should include some appropriate calculations. [25]

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