



## November 2017 Strategic case study examination

### Pre-seen material



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## **Steelcast**

You are a Senior Manager in the finance function at Steelcast. You report directly to the Board and advise on special projects and strategic matters.

Steelcast is based in Hiland where the currency is the H\$. Companies in Hiland are required to prepare their financial statements in accordance with IFRS.

## Company background

Steelcast makes mechanical watches for the luxury market. These watches have clockwork movements to track time and operate the hands. Strictly, the company's products should be referred to as "wrist chronometers" to reflect the fact they tell the time very accurately.



Steelcast was established in 1896 by Johan Mendl, a watchmaker who served his apprenticeship with the largest watchmaker in Hiland's East City. After learning his craft he opened his own shop, servicing, repairing and making watches of his own for sale. He established a reputation for producing reliable and accurate watches.

From these humble beginnings Mendl's business grew and in 1910 it was incorporated as Steelcast. By 1920 the company's watches had been certified as chronometers because of their accuracy. They were popular with sailors and pilots because the ability to tell the precise time was an important part of navigation in the days before satellite-based GPS navigation.

Steelcast capitalised on the popularity of its watches amongst the pioneers of aviation by



adding features that made them popular in other fields such as sport. The company developed its first chronograph in 1924. A chronograph is essentially a watch with additional dials and buttons that can be used to add a stopwatch facility to a traditional watch. This can be useful for timing sporting events or simply for aesthetic purposes. Chronographs still account for a significant proportion of Steelcast's revenue.

All of Steelcast's products have mechanical clockwork movements.

They are purchased as luxury goods by customers who wish to be associated with one of the world's leading luxury brands. The least expensive Steelcast watch sells for H\$2,500, but the company sells watches that retail for as much as H\$26,500. Steelcast watches are also popular with wearers who rely on having an accurate watch. For example, military officers often prefer to wear good quality mechanical watches rather than quartz watches that are dependent on battery power and Steelcast's watches are popular in that market.

Steelcast is regarded as one of the world's leading luxury brands. Its watches are designed to be stylish as well as functional. There is a thriving collectors' market for old Steelcast watches, especially when they were previously owned by someone famous.

Steelcast was listed on the Hiland Stock Exchange in 1982.

## Manufacturing process

Steelcast has a single factory in Hiland's East City. The production process combines the latest technology using Computer Numerical Control (CNC) for some tasks and skilled watchmakers for others. The mechanism is based on a brass 'base plate' that requires 53 holes to be drilled very precisely. Steelcast's CNC equipment can drill the holes in base plates more accurately than even the most skilled watchmaker. Other aspects of the assembly are better left to a skilled watchmaker to ensure that the various gears and other parts are fitted together perfectly. For example, the final assembly of the movement requires a highly skilled watchmaker to regulate the mechanism so that it tells the time as accurately as possible.

Each watch moves through the factory, directed from one workstation to the next by a software package that monitors progress. Each workstation is either an automated machine or a watchmaker's bench.

The factory is large, employing more than 1,000 people, but it is also relatively quiet and



peaceful. The CNC machines are located in separate rooms and are individually housed in soundproofed boxes. The watchmakers' workbenches are ergonomically designed and well lit. Parts and work in progress are moved around the factory by staff pushing trolleys. The watchmakers are not pressured to work at the pace dictated by a mechanical production line, even though they specialise in specific tasks.

The watches depend on the quality of the parts used and the precision with which they are assembled. Steelcast pays close attention to quality management in the design and manufacture of its products. For example, the case of each watch is airtight and the air is extracted when closing each case because the mechanism is more accurate when it operates in a vacuum.

There are more than 350 parts in a mechanical watch and Steelcast makes all of them in its factory. This enables it to manage quality and ensure that only the very best materials are used.

The selling price of each watch is largely a function of the materials that go into the case and the strap. Less expensive watches are made out of stainless steel, with straps made out of leather or stainless steel. The most expensive watches have solid gold cases and straps. All of Steelcast's watches are manufactured to the same high standards of precision and accuracy, although each model differs in terms of features, with chronograph watches tending to be more expensive than watches that simply tell the time because they have more parts and take longer to make.

## Retailing

Steelcast sells its watches through independent retailers. There are no direct sales to consumers. Retailers are selected on the basis of their ability to display and sell Steelcast watches in a manner that is consistent with the brand's luxury image.

Generally, retailers are high-class jewellers located in upmarket locations in city centres and airport duty free areas. Steelcast is happy for its watches to be sold alongside those of other luxury watch brands. Retailers must meet sales targets if they wish to continue to sell Steelcast products.



Each retailer must also ensure that every member of its sales staff completes an online training course that is assessed at its conclusion. Sales staff must be able to explain the various features of each of Steelcast's watches and be able to answer technical questions in order to enable customers to make an informed decision.

Retailers must also have the necessary facilities to offer proper aftercare for every watch that it sells. It must, for example, have a properly equipped

workshop with skilled watchmakers who can adjust watches at the time of sale and assess any repairs that are required during the watch's lifetime. For example, most of Steelcast's watches have metal bracelets that must be sized to fit each customer's wrist.

Mechanical watches must be serviced regularly if they are to retain their accuracy. Retailers act as the first point of contact with the customer, to make the process of servicing a watch as convenient as possible. Steelcast's watches must be serviced once every two years. Retailers will assist customers, regardless of where they bought their watch. They pack watches securely and forward them to Steelcast by courier. The watch is then serviced in the factory by the watchmakers, before being returned via the retailer. The customer pays a fee for this service.



### **Mission statement**

Steelcast's mission is "We make watches for leaders, who wear them with pride".

This mission statement was adopted in the early 1930s, when the company was becoming recognised as the maker of the durable and accurate watches that were popular with leading figures in sports and adventure activities such as motor racing, aviation and yachting. The company was proud of the fact that many records for speed and endurance in these fields were set by wearers of Steelcast watches.



## Industry background

There are several manufacturers of luxury watches. The defining characteristic of luxury watches is that they are expensive. Some of these watchmakers are part of larger groups that sell jewellery and other aspirational products.

Steelcast's Chairman has been quoted as saying that luxury watchmakers sell an image and that they do not compete with one another, or with less expensive watchmakers. He sees the company's direct competitors as the tailors who sell expensive bespoke suits or the auction houses who sell beautiful antique furniture.

Steelcast's retailers report that many of their customers buy more than one luxury watch and some have several. They are not necessarily repeat customers for Steelcast. Some wealthy customers wish to change their watch to match their clothing.

Luxury watchmakers tend to make and promote their products on the basis of the image or persona that the customer aspires to. Steelcast's watches are generally associated with sport and action. The watches themselves are rugged and are frequently equipped with additional dials that are of value, for example, in timing laps, navigation and other activities.

Some watchmakers make finer watches, with smaller cases which are designed to be less noticeable on the wrist. Others make far more ornamental watches, with cases and dials that are inlaid with precious stones.



Luxury watchmakers promote themselves through advertising in upmarket magazines and through sponsorship. Steelcast has its own polo team that plays in major competitions and it sponsors an annual race for ocean-going yachts. Laine, another major manufacturer that promotes a more subdued image, sponsors opera performances in major cities round the world. Balarra, which aims for bright and eye-catching watches has a link with the maker of the world's fastest supercar and the watch carries the car's name.

There are watchmakers who sell expensive watches that are not in the same class as those made by Steelcast, Laine or Balarra. Generally, customers who aspire to owning a luxury watch have no interest in buying a cheaper watch from an otherwise reputable manufacturer.



There have been two major changes in the technology of watchmaking since Steelcast was founded. The first of those was the introduction of quartz watches in the late 1970s. These watches are battery powered and rely on what is effectively a small computer that counts electronic vibrations to tell the time. The time is then displayed on a digital display or on a conventional watch face with the hands being driven by a small motor that is synchronised to the computer. The vast majority of watches in

the mainstream market use quartz movements because they are far cheaper to make than clockwork movements and they are generally very accurate. Some luxury watchmakers offer a range of quartz watches, but most prefer the aesthetic quality of clockwork. Indeed, Laine's Glasback watch has a glass on the back of the watch as well as the front so that its owner can see the watch's intricate mechanism in operation.

The other major change has been the introduction of so-called 'smart' watches. These generally have the ability to communicate with their owners' mobile phones and display information, such as signalling the receipt of an email or a text message. Some can also



gather data and transmit it back to the phone as an input to an app. For example, some smart watches can measure the wearer's pulse rate and can be used to track an exercise session. Others combine that data with movement sensors to measure the wearer's sleep patterns, again for analysis on a phone app. The smart watch is a relatively new product and there is a wide variety of watches on offer. Some look like conventional watches and gather basic data or have very discreet messaging systems such as using a tiny LCD

light to signal the receipt of a message. Other smart watches are essentially small display screens that can be used to operate a mobile phone remotely using a combination of buttons and voice recognition.

The market for luxury watches is limited by the number of consumers who are able to afford thousands of H\$ for a watch. There are occasional opportunities for growth when a particular country or region enjoys a period of economic growth, thereby increasing the number of high net worth individuals who can afford to buy luxury watches for personal use or as lavish business gifts. There can also be periods when economic austerity discourages such displays of wealth and sales may decline slightly.

The strength of the Steelcast brand means that there are significant opportunities for brand extension that have yet to be exploited. For example, some luxury car manufacturers with a strong brand image have introduced concierge services and advance access to each "new season's" branded clothing.



## Steelcast's strategy

Steelcast's basic strategy is to make watches to the very highest standard of quality and accuracy. The company is very protective of its reputation as the luxury brand associated with action and adventure and it promotes that quietly. For example, retailers are permitted to grant a substantial discount to serving military officers, with the cost of that discount being borne by Steelcast. The discount is not widely promoted, but eligible customers learn about it through word of mouth and it does provide excellent publicity when an officer who is, say, interviewed on television, is seen to be wearing a Steelcast watch.



Steelcast promotes itself by sponsoring a successful polo team. Spectators at polo matches are often wealthy individuals and potential Steelcast customers. Polo is an expensive sport because it is necessary to fly horses round the world in order to compete at the very highest levels, but Steelcast spends heavily in order to ensure that its team has the best horses and all of the support necessary to succeed.

Steelcast rarely launches new models. The company has seven models of watch, each coming with a small range of options, such as stainless steel or gold for the case or whether the watch will have a leather strap or a metal bracelet that matches the case. These seven models have all been on sale for several years, with very subtle changes being made to the basic shape in response to fashions or new technology. For example, the development of a new material made it possible to make the watch glasses thinner without compromising strength.

Steelcast's Brawn was launched in the late 1970s. The model remains on sale today. The 2017 model is recognisably the same watch as the original, although a close comparison reveals many subtle differences.

All of Steelcast's watches have a 'rugged' feel to them. Steelcast dominates the market for luxury watches that are suited to sport. Many wearers enjoy this association, even if they simply wish to own a luxury watch for everyday use. For example, the Steelcast Flight model has functions that assist in aircraft navigation, but fewer than one third of this model's owners can fly a plane.

All of Steelcast's watches are mechanical with automatic winding mechanisms. This means that the watch has a clockwork movement that tells the time and moves the hands. That movement is powered by a spring that stores energy. The spring is wound by a weight that rotates with the movement in the wearer's wrist.

Paradoxically, the advent of quartz movements made it possible to create battery operated watches that are just as accurate as those made by Steelcast's watchmakers. Steelcast has always argued that wearers prefer the aesthetic benefits of clockwork movements that have been created by hand.

## **Steelcast's Board of Directors**

### **Executive directors**

#### *Alain Trubb – Chief Executive Officer (CEO)*

Alain has had a long and distinguished career in the luxury goods industry. He trained as a bootmaker with a leading bespoke shoemaker. He worked his way up to a senior management position in that company before being appointed to the board as Marketing Director. He subsequently served on the board of a leading luxury retailer before being appointed as Steelcast's CEO in 2008. He is an avid motor racing fan.

#### *Sandra Daull – Finance Director*

Sandra is a qualified accountant. Before joining Steelcast she had worked for a leading electronics manufacturer and for a civil engineering company. She joined Steelcast as Finance Director in 2012.

#### *Arthur Lim – Marketing Director*

Arthur has a degree in Business Administration. After graduating from university he joined the marketing department of a famous chain of department stores that specialises in prestigious brands. He spent most of his career to date with that company, being promoted to its board as Sales Director in 1997. He left that company to join Steelcast as Marketing Director in 2007.

#### *Dr Alexa Syme – Production Director*

Dr Syme studied engineering at university, completing both a Masters degree and a PhD before teaching computer-assisted manufacturing at Hiland State University. She left the university in 2002 to work in engineering management at Hiland Atomic Laboratory. She left that position to take up her present role at Steelcast in 2014.

### **Non-executive directors**

#### *Viktor Kijec – non-executive chairman*

Viktor has had a long and distinguished career in business. He has served on the boards of three quoted companies. He stepped down from his role as executive director of a major oil company in 2014, at which time he joined Steelcast as non-executive director. Viktor also serves as a board member of Hiland Opera and of the charity Hiland Aid.

#### *Maria Bell – independent non-executive director*

Maria has served on the boards of three major corporations, covering a range of industries. She now serves on the board of Steelcast as a non-executive director and sits on the Senate of Hiland State University.

#### *Lukas Marten – independent non-executive director*

Lukas spent his career with a major firm of accountants, being promoted to partner in 1995. He retired from the firm at the age of 55 and has served as an independent non-executive director for a number of companies. At present, he serves on the boards of Steelcast and of Hiland Cement.

#### *Walter Dane – independent non-executive director*

Walter is a lawyer. He left the legal profession shortly after qualifying to spend a career in politics. He has held high political office, both as a member of government and of the opposition. Walter stood down from politics in 2010 in order to pursue other interests. He has served on Steelcast's board as an independent non-executive director since 2015.

## **Board committees**

### **Remuneration Committee**

The Remuneration Committee comprises:

- Maria Bell
- Walter Dane

The committee's remit is to:

- Approve Steelcast's remuneration policy for executive directors.
- Set the principles and measurements that are input into the calculation of elements of remuneration.
- Ensure that none of the directors are involved in determining their own remuneration.
- Review the effectiveness of Steelcast's remuneration policy.

### **Nomination Committee**

The Nomination Committee comprises:

- Viktor Kijec
- Lukas Marten
- Walter Dane

The committee's remit is to:

- Conduct succession planning in anticipation of vacancies on the Board and on Board committees.
- Review the size, structure and composition of Steelcast's Board.
- Identify and nominate potential appointees to Steelcast's Board.
- Lead the process associated with making appointments to the Board.

### **Audit Committee**

The Audit Committee comprises:

- Lukas Marten
- Walter Dane

The committee's remit is to:

- Oversee the management of the system of internal controls.
- Manage Steelcast's internal audit function.
- Liaise with Steelcast's external auditors.
- Ensure the quality of Steelcast's published financial statements.



The following information has been extracted from Steelcast's financial statements for the year ended 30 September 2017

**Steelcast**

**Consolidated statement of profit or loss**

**For the year ended 30 September**

	<b>2017</b>	<b>2016</b>
	<b>H\$m</b>	<b>H\$m</b>
Revenue	5,556	4,723
Cost of sales	(2,415)	(2,198)
Gross profit	3,141	2,525
Other operating expenses	(2,305)	(1,773)
Operating profit	836	752
Finance costs	(138)	(150)
Profit before tax	698	602
Income tax expense	(195)	(169)
Profit for year	503	433

## Steelcast

### Consolidated statement of financial position As at 30 September

	2017 H\$m	2016 H\$m
<b>Non-current assets</b>		
Goodwill	150	150
Other intangible assets	197	212
Property, plant and equipment	3,890	3,840
	<u>4,237</u>	<u>4,202</u>
<b>Current assets</b>		
Inventories	279	254
Trade receivables	855	727
Cash and cash equivalents	647	632
	<u>1,781</u>	<u>1,613</u>
<b>Total assets</b>	<u><u>6,018</u></u>	<u><u>5,815</u></u>
<b>Equity</b>		
Share capital and share premium	2,000	2,000
Retained earnings	2,105	1,830
	<u>4,105</u>	<u>3,830</u>
<b>Non-current liabilities</b>		
Loans	1,380	1,500
Deferred tax	64	58
	<u>1,444</u>	<u>1,558</u>
<b>Current liabilities</b>		
Trade payables	284	266
Current tax	185	161
	<u>469</u>	<u>427</u>
	<u><u>6,018</u></u>	<u><u>5,815</u></u>



## Extracts from a competitor's financial statements

### Laine

#### Consolidated statement of profit or loss

For the year ended 30 September

	2017	2016
	H\$m	H\$m
Revenue	7,223	6,573
Cost of sales	(3,333)	(3,133)
Gross profit	3,890	3,440
Other operating expenses	(2,956)	(2,673)
Operating profit	934	767
Finance costs	(87)	(87)
Profit before tax	847	680
Income tax expense	(237)	(190)
Profit for year	610	490

## Laine

### Consolidated statement of financial position As at 30 September

	2017 H\$m	2016 H\$m
<b>Non-current assets</b>		
Goodwill	430	430
Other intangible assets	348	317
Property, plant and equipment	3,745	3,538
	<u>4,523</u>	<u>4,285</u>
<b>Current assets</b>		
Inventories	385	362
Trade receivables	1,111	1,011
Cash and cash equivalents	732	897
	<u>2,228</u>	<u>2,270</u>
<b>Total assets</b>	<u><u>6,751</u></u>	<u><u>6,555</u></u>
<b>Equity</b>		
Share capital and share premium	2,400	2,400
Retained earnings	2,758	2,626
	<u>5,158</u>	<u>5,026</u>
<b>Non-current liabilities</b>		
Loans	900	900
Deferred tax	72	66
	<u>972</u>	<u>966</u>
<b>Current liabilities</b>		
Trade payables	391	369
Current tax	230	194
	<u>621</u>	<u>563</u>
	<u><u>6,751</u></u>	<u><u>6,555</u></u>

### Extract from Risk Report in Steelcast's Annual Report

Risk description	Risk mitigation
Steelcast's watch designs are iconic and may be subject to copying.	<p>All designs are protected by copyright law. Furthermore, other luxury watchmakers aim to make watches to their own unique designs and would be unlikely to mimic Steelcast designs closely.</p> <p>Less prestigious brands may attempt to capture the essence of Steelcast designs, but could not offer the association with the Steelcast brand.</p>
Steelcast is a luxury brand that may attract forgeries.	Forged watches are unlikely to be mistaken for genuine Steelcast products.
Steelcast is heavily dependent upon the retention of its skilled watchmakers.	Steelcast demonstrates its desire to retain its staff by rewarding them with excellent remuneration packages and working conditions.
Changing technologies may affect demand for traditional watches with clockwork movements.	<p>Customers enjoy the aesthetic appeal of traditional timepieces.</p> <p>Alternatives such as quartz have been available for many years without an undue impact on demand for Steelcast's mechanical watches.</p>
Currency risks – most of Steelcast's costs are incurred in H\$, but most revenues are in foreign currencies.	Steelcast pays close attention to the management of currency risks.

## **Steelcast's Corporate Social Responsibility Report for the year ended 30 September 2017**

Steelcast regards itself as a good corporate citizen. The Board is keen to maintain the highest standards of behaviour.

### **Health and safety**

Staff safety is of paramount importance. All employees receive formal safety training upon joining the company. Members of staff are subsequently required to participate in structured training that is appropriate to their jobs. For example, training is provided to address the risks of repetitive strain injuries to employees whose jobs require constant manipulation of small watch parts.

All production methods are designed to ensure that hazardous substances are not released into the air or water and that employees are protected from contact with any such materials.

### **Sourcing policy**

Steelcast uses precious metals and gems in manufacture. All materials are obtained from ethical sources that are conflict free and that comply with all relevant legal requirements.

Leather for watch straps is sourced ethically, from animals that have been farmed humanely. All of Steelcast's leather comes from sustainable species.

### **Energy consumption**

Steelcast aims to minimise the use of energy in manufacturing and distribution.

Steelcast's premises are energy efficient, with excellent insulation and lighting provided using highly efficient bulbs.

All manufacturing equipment is modern and is serviced to minimise wasted power.

### **Employment**

Steelcast prides itself on its training programme for apprentice watchmakers. Most of the company's production staff joined Steelcast straight from school and many will remain with the company for the whole of their working lives.

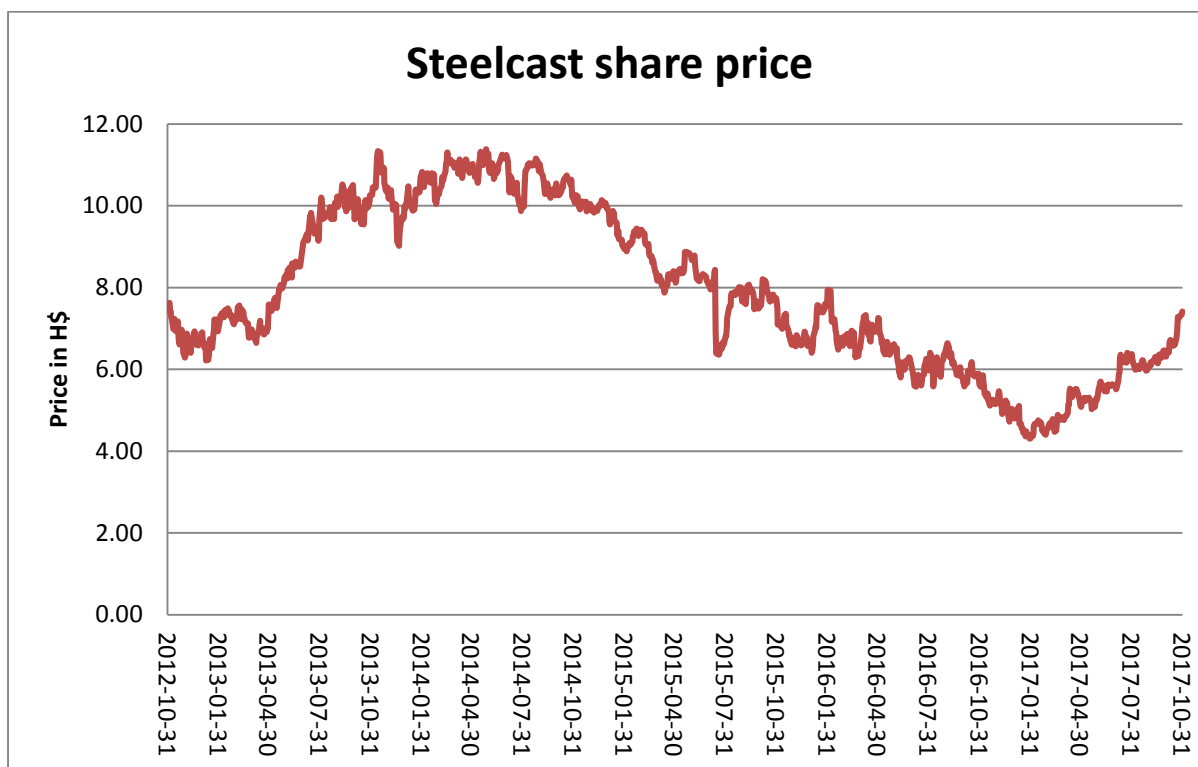
The production process gives staff a sense of pride in the creation of a high-quality product.

Staff satisfaction is regarded as being of paramount importance. Management meets regularly with staff representatives.

### **External engagement**

Steelcast supports a number of charities. The company will also match funds raised by staff through either donations or other activities.

## Steelcast's share price





## Press clippings

# Hiland Business Times

## Lavish gifts frowned upon in difficult times



In many cultures it has been traditional to give an expensive gift as a mark of respect at the conclusion of a successful negotiation.

Generally, these gifts have been lavish enough to demonstrate the giver's prosperity, without being quite large enough to constitute a bribe. There is, in any case, a degree of transparency because these gifts are generally reciprocated and exchanged when the principals meet to sign the contract.

Difficult economic conditions and concerns about corruption have led to this practice being curtailed, or at least scaled back. Whereas the counterparty would once have received a solid gold watch or pen set, now the gift is more likely to be a silk tie. Gifts are still valuable, but now they cost hundreds of H\$ rather than thousands.

This change in practice is bad news for the former recipients of such gifts. It is also a potentially significant loss of revenue for the manufacturers and retailers of luxury goods.

# Hiland Business Times

## Smartwatches start to look smart



The first smartwatches were encased in black polymer resin. That had a variety of advantages. It was cheap and easy to work with, it was also lightweight. It did not distract the wearer's attention from the important information being presented on the face.

Most smartwatch manufacturers are paying more attention to the aesthetics of their products. At first, smartwatches were regarded as novelties, to be worn while jogging. Now they are being viewed as useful accessories that can be used in work and social settings and so appearance is becoming more of an issue. Watch ranges now include stainless steel cases and bracelets.

A similar progression occurred in the 1970s with the development of quartz watches. Early models looked cheap and functional, but they sold to those who wished to adopt the technology. As demand grew, plastic cases gave way to metal and design became a crucial part of the product.

# Hiland Daily News

## Prince Sebastian captains polo team at charity match



Prince Sebastian was the centre of attention yesterday when he captained Steelcast's polo team to victory in front of the team's home crowd.

Steelcast's annual Polo Charity Cup attracts teams from around the world, who play in front of an audience of wealthy individuals who pay significant amounts for tickets.

Prince Sebastian provoked criticism by agreeing to play for the host team. Many commentators believe that his playboy image is damaging to the Prince himself and to his Royal Family.

Regardless of the controversy, the competition raised several million H\$ for a selection of charities.