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International Baccalaureate®
Baccalauréat International
Bachillerato Internacional

BUSINESS AND MANAGEMENT
HIGHER LEVEL
PAPER 2

Friday 22 May 2009 (morning)

2 hours 15 minutes

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Section A: answer one question.
- Section B: answer two questions.

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SECTION A

*Answer **one** question from this section.*

1. Altair Incorporated

Altair Incorporated has been operating in the pharmaceutical industry for over 50 years. Over the past 5 years, it has been conducting research to try and develop a vaccine to minimize the effects of malaria. No cure currently exists.

Stakeholder anticipation has been considerable. Recent media reports suggest that *Altair Incorporated* is very close to manufacturing a prototype, called Zyra. Furthermore, the media speculation has revealed that *Altair Incorporated* is considering locating a new production facility in either one of two countries located in sub-Saharan Africa where malaria is most prevalent. If successfully patented, Zyra will guarantee *Altair Incorporated* substantial profits. Two potential countries have been identified as potential sites and have been code named Alpha and Bravo. The construction of each facility and product launch is expected to take one year, the patent will last for 5 years.

The cost of building the facilities in 2009 is as follows:

	$m
Alpha	240
Bravo	180

The estimated net cash inflow ($m) from Zyra is as follows:

2010	**2011**	**2012**	**2013**	**2014**
80	80	70	60	50

Alpha is a prosperous nation with a stable government, reliable infrastructure and a strong economy. Labour costs are higher than in Bravo and the unemployment rate is 4%. A competitor is already located there and this may give the potential for external economies of scale.

Bravo is in the middle of reconstruction after a civil war. Much of the country's infrastructure needs to be rebuilt. Some financial assistance may be provided by the *World Bank* to *Altair Incorporated.* The incidence of malaria in Bravo is much higher than in Alpha.

Because of the high research and development costs, shareholders want Zyra to be brought to market quickly. *Altair Incorporated* also wants to set a fixed price for Zyra globally. However, some international pressure groups have been critical of pharmaceutical companies that have refused to conduct price discrimination. They have argued that it is unethical to charge high prices to customers who are at the greatest risk of malaria infection, but who can least afford them.

(This question continues on the following page)

(Question 1 continued)

(a) Define the following terms:

(i) *patent* *[2 marks]*

(ii) *price discrimination*. *[2 marks]*

(b) (i) Calculate the payback, average rate of return and net present value, using a discount factor of 10 %, for *Altair Incorporated* for both production facilities in Alpha and Bravo. *(Show all your working)* *[8 marks]*

(ii) Comment on your results from part (b)(i) and other information from the stimulus material. *[3 marks]*

(iii) Explain **two** non-financial factors *Altair Incorporated* should also consider before selecting the location of the Zyra production plant. *[4 marks]*

(c) Analyse **two** possible conflicts that could arise between stakeholders if *Altair Incorporated* sets a fixed price globally. *[6 marks]*

2. Passionate Pizza

Passionate Pizza is a chain of over 30 franchised takeaway pizza outlets in New Zealand and has a market share of 15 % of all pizzas sold. It mainly targets the 18-30 year old single male market segment. *Passionate Pizza's* market share has been growing despite charging higher prices than its competitors.

Controversial use of below-the-line promotion has driven *Passionate Pizza's* success and growing brand value. The company does not use above-the-line promotion and has relied upon positive word of mouth to generate sales growth. It has won a number of awards for its point-of-sale material but the government's advertising regulator has received a number of complaints about *Passionate Pizza's* most recent customer newsletter.

Table 1: An extract from the profit and loss account for the year ended 31 December 2008:

Item	**$m**
Sales	10
Cost of goods sold	4
Gross profit	6
Advertising expenditure	2
Other indirect costs	2
Net profit	2

Cost of goods sold will increase or decrease by the same percentage as an increase or decrease in the number of pizzas sold. Independent market research commissioned by *Passionate Pizza* shows the following:

- Price per pizza: $10
- Price elasticity of demand for *Passionate Pizza's* pizzas: 0.5
- Advertising (above-the-line) elasticity of demand for *Passionate Pizza:* 1.0
- Cross-elasticity of demand for *Passionate Pizza* with respect to the market leader: 0.05.

Concerns about the increasing levels of obesity among young males have led *Passionate Pizza* to consider a more ethical marketing approach. There is also a threat that the economy may move into recession.

The directors are unsure of the next step. In order to increase market share, they may have to try and appeal to a new market segment. They are discussing a two-stage strategy to extend the brand:

1. reduce prices by 10 %
2. launch a new television advertising campaign costing $0.5 million.

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(Question 2 continued)

(a) Define the following terms:

(i) *below-the-line promotion* *[2 marks]*

(ii) *price elasticity of demand.* *[2 marks]*

(b) (i) Prepare a forecast profit and loss account, using the same format as **Table 1**, for *Passionate Pizza* for the year ended 31 December 2009, assuming that they implement the two-stage strategy at the start of the year. *(Show all your working)* *[8 marks]*

(ii) Comment on your results from part (b)(i) using your forecasts and other information from the stimulus material. *[3 marks]*

(iii) Explain **one** advantage and **one** disadvantage for *Passionate Pizza* of commissioning market research from an independent market research company. *[4 marks]*

(c) Examine **two** factors from the external environment that may influence the decision of the directors to implement the two-stage strategy. *[6 marks]*

SECTION B

*Answer **two** questions from this section.*

3. Kiva, the Acumen Fund and Corporate Social Responsibility

Lending to small businesses in the world's poorest countries is growing rapidly. An example is the *Acumen Fund*. Set up as a "venture capital fund for the poor" by Jacqueline Novogratz, the *Acumen Fund* uses e-commerce to link small businesses in the developing world with increased generosity from wealthy individuals in the developed world.

The *Acumen Fund* has invested $20 million in firms varying from an ambulance service in Mumbai to a mosquito net factory in Tanzania. It provides venture capital funds from the United States for socially responsible businesses with potential to expand rapidly and become financially independent. It particularly targets health care, housing, water and energy.

Another example is *Kiva*, which has been operating as an e-commerce source of funds for developing start-ups for two years. Investors can provide as little as $25 to help fund start-ups, from Kenya to Vietnam. Again, socially responsible projects are targeted.

However, despite much needed funds reaching these projects, concerns surrounding venture capital remain. This capital is essentially short-term, volatile and investors can be impatient for quick returns. The "dot-com" boom of 1999-2000 highlighted that it can be removed very quickly if external factors change with devastating consequences for the business start-up. Some analysts have argued that other more sustainable sources of finance may be more appropriate for the developing world.

[Source: adapted from *The New Zealand Herald*, 18 September 2007]

(a) Define the following terms:

(i) *corporate social responsibility* *[2 marks]*

(ii) *e-commerce.* *[2 marks]*

(b) Explain **one** advantage and **one** disadvantage for an organization such as *Kiva* of becoming more socially responsible. *[6 marks]*

(c) Examine **two** difficulties faced by new business start-ups in the developing world. *[6 marks]*

(d) To what extent is "venture capital" from the developed world an appropriate source of finance for new business start-ups in the developing world? *[9 marks]*

4. Pacific Blue

In 2007, the low cost airline *Pacific Blue* entered the New Zealand market with an initial offer to sell 70 000 tickets at low prices on flights between Auckland, Christchurch and Wellington. Almost half of the $29 tickets were booked online within hours. Chief executive Brett Godfrey expressed his surprise: “It almost caused our website to crash”.

Air New Zealand and *QANTAS*, the established market leaders were quick to respond to the new competitor by cutting prices to $49. A director of *Air New Zealand* doubted whether *Pacific Blue* could sustain these prices as part of its long-run strategy to enter the New Zealand market. She also questioned whether the company could satisfy demand with only 2 planes for 11 scheduled flights per day between Auckland and Wellington, the most popular route. By contrast, *Air New Zealand* uses 7 planes on the same route. A *QANTAS* director has commented that *Pacific Blue* could face significant capacity utilization problems.

Brett Godfrey accepted that *Pacific Blue* might run at a loss initially, but he was also confident about penetration pricing: “we have done this before in Australia and we have money in the bank to survive and hope to offer more routes, subject to government approval and the support of the New Zealand public.”

Air New Zealand and *QANTAS* promised to remain competitive.

[Source: adapted from *The Age*, 4 September 2007]

(a) Define the following terms:

(i) *capacity utilization* *[2 marks]*

(ii) *penetration pricing.* *[2 marks]*

(b) Explain **two** capacity utilization issues that *Pacific Blue* may face. *[6 marks]*

(c) Examine **two** problems that *Pacific Blue* could face when using penetration pricing. *[6 marks]*

(d) Evaluate **two** potential opportunities and **two** potential threats which *Pacific Blue* could face when entering into a new international market. *[9 marks]*

5. Scholastic

Although more than 325 million copies of the Harry Potter books have been sold worldwide since 1997, market analysts claim that the publishing company has failed to take full financial advantage. Some have argued that *Scholastic*, the privately owned publisher of the Harry Potter books, has not used the high levels of working capital held by the company to further develop their business and boost profitability.

One analyst has estimated that with the release of the final and seventh book in the series, "Harry Potter and the Deathly Hallows", *Scholastic* will earn an additional $325 million for the financial year 2007-8. The company will also earn an additional $10-15 million per year for the next three years from special editions, two more movies and paperback copies.

Some market analysts have argued that *Scholastic* should not remain a private limited company, and that a change in leadership, away from the Robinson family would benefit *Scholastic* significantly. However, Richard Robinson, *Scholastic's* chief executive officer and son of the founder disagrees: "we have no need to float the company on the stock market. Our investors have achieved great results and do not need to sell the company". Robinson would prefer to retain his level of control and maintain the original objectives and vision.

[Source: adapted from www.bloomberg.com, August 2007]

(a) (i) Define the term *working capital*. *[2 marks]*

(ii) Identify **two** characteristics of a private limited company. *[2 marks]*

(b) Explain **one** advantage and **one** disadvantage for a firm such as *Scholastic* of holding high levels of working capital. *[6 marks]*

(c) With reference to the product life cycle, analyse why firms such as *Scholastic* undertake extension strategies. *[6 marks]*

(d) Evaluate whether the leadership of *Scholastic* should be taken away from the Robinson family. *[9 marks]*