Year 11 Business A level - head start activity

Welcome to those of you who are planning to study Business A level with us at Bay House Sixth Form. This head start activity is to give you an opportunity to have a go at some of the type of work you will be doing on the course. If you'd like me to look at any of the work you do, then please email it to me:
ldenzey@bayhouse.gfmat.org

Thank you.

Ms Denzey
Subject Lead for Business and Economics

In Business we always work from real life case studies, as far as possible. Here's one about Mr Sherrick's Shakes.

Task 1 - read the information about the business - don't worry about the questions yet.

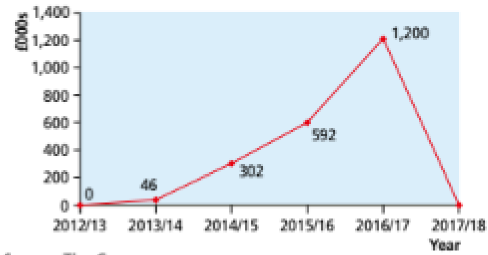
Business update
MARCH 2018
www.hoddereducation.co.uk/businessreview

Milkshakes, crowdfunding and failure

Just before Christmas 2017, Mr Sherick's Shakes Ltd went into liquidation. Assets were sold off, allowing some debts to be paid, but leaving shareholders and staff with nothing. **Ian Marcousé** explains how, even when a new business seems to be succeeding, problems can soon turn into crisis

Mr Sherick's Shakes began in 2013, founded by Andrew Sherick after 22 years as a food buyer at Marks & Spencer. Sherick believed he'd found a market for luxury milkshakes aimed at adults, with flavours such as 'cookies and cream' and 'strawberry Pavlova'. He described the product as 'offering indulgent texture, much like melted ice cream'. The price of £1.99 for 250ml was high but not outrageous. He quickly obtained distribution through Selfridges and Waitrose. Business boomed from £46,000 in Year 1 to £302,000 in Year 2 (Figure 1). But these impressive-sounding sales weren't yet generating profits, so Sherick wanted more cash to expand further.

In April 2015 Sherick used the Crowdcube site to raise £280,000 of extra capital to help fund the growth of the business. The extra capital allowed Mr Sherick's Shakes to expand rapidly, with distribution extending into WH Smith, Booths and catering giant Compass.



Source: The Grocer

Figure 1 Mr Sherick's Shakes: annual sales revenue

Next page

But towards the end of 2017, with the company talking of new listings in Morrisons and Asda, the challenge of rising input costs, especially milk, put the squeeze on profit margins. At the same time, the rapid growth of the business meant more capital was needed to provide the cash to keep going. Cash flow dried up, and with no further source of capital Sherick could turn to, a liquidator was appointed. The 228 crowdfunding investors will have lost every penny they put in.

Practice exam questions

40 marks, 50 minutes

1 What is meant by 'profit margins'? (2 marks)

2 One of Sherick's products had a £4 price tag and cost £1.60 in variable costs. The fixed costs on the item were £6,000 a week and Sherick expected to sell 3,500 units a week. For this item, calculate:

a the breakeven point

b the margin of safety (4 marks)

3 Explain how Sherick's focus on cash rather than profit may have led to financial difficulties. (4 marks)

4 Assess the attractions to a business such as Mr Sherick's Shakes of raising share capital using crowdfunding. (10 marks)

5 The causes of a business failure such as Mr Sherick's Shakes can be financial or non-financial, such as marketing.

Evaluate these two options and say which of the two was probably the more important in the failure of Sherick's Shakes. (20 marks)

Answers

1 Profit as a percentage of revenue, usually either gross margin or net margin.

2 **a** Breakeven = Fixed costs/Contribution per unit

£6,000/£2.40 = 2,500 units

b Margin of safety = Sales − Breakeven = 1,000 units

3 Cash is vital, but needs to come from business activities, not from investors. Ideally, a business should be profitable enough to ensure that positive cash flows are generated. Then, if there's a short-term need for extra cash (such as a big expansion) the regular profits made by the business can refill that cash flow hole over the coming months. If the business is never really profitable, then as soon as investors are no longer willing to put more cash in (and why should they?), the business collapses.

4 One attraction is crowdfunding's strange fusion of capital raising and creating fans. The original promotion of Sherick's posh shakes on Crowdcube would have been full of well-lit shots of milkshakes. Sherick will have hoped to generate hundreds of new customers as well as hundreds of investors. However, this can be a problem. Serious investors would want facts about the company's financial position and may get frustrated by the muddle between marketing and finance (and therefore not invest).

The second attraction is related to the first: the fact that people invest in crowdfunding on the basis of image and empathy rather than cold financial logic. Sherick raised £280,000 without any evidence that the business was — or would ever be — profitable. The investors clearly liked the idea of posh shakes and

Next page

handed over their cash. For an early-stage business such as Mr Sherick's Shakes, such an uncritical approach is wonderful. What a shame the business didn't repay the trust.

If Sherick had gone to a venture capital investor, every fine detail of the finances would have been investigated — perhaps to Sherick's benefit. The uncritical approach of crowdfunding investors allowed Sherick to blunder on with profitless growth. By the end, jobs are lost and investors' money is lost.

5 There are several possible financial causes of failure. They revolve around profit or around cash. The key issues regarding profit are whether the business was ever operating above its breakeven point (we don't know) and what the exact profit margins were over the short life of Mr Sherick's Shakes. A kind interpretation would be that Sherick himself may have been so committed to product quality that he allowed (or even pushed) for ingredients that were too expensive for the price of £1.99 to be profitable. A less generous interpretation could be that Sherick was lax at cost control — allowing costs to slide upwards with no benefit to customer or shareholder.

Financial failure also occurs if you simply cannot pay the bills — a crisis of cash flow/liquidity. There are no published accounts for the business, so we don't know what its liquidity or acid-test ratios were. But ultimately it ran out of money, so its final days would have seen a liquidity crisis.

But it could be argued that finances are not really a cause of failure, they are an effect of other failures, such as not selling enough product to get past the breakeven point. Non-financial factors should therefore be looked at with care. The pricing and therefore the gross profit margin the business operated with could have been an issue. The price of £1.99 might be okay if machines are pumping out thousands of products and supermarkets are lapping them up. But if volumes are quite low, perhaps the price was insufficient to be profitable. It is important to remember that a shop price of £1.99 is by no means the price achieved by Sherick's. The shops will require

a considerable discount, to provide them with their own gross margin. If Sherick was a poor negotiator, he might have achieved perhaps only £1.20 per unit (leaving the shop with a 79p gross profit per unit). This might have left Sherick's margin quite thin.

For a small business with £280,000 of cash injected in 2015, going under in 2017 seems worse than careless. The underlying issue may have been poor negotiations and inadequate prices realised, but the direct cause seems to have been a financial failure. The fact that Sherick was talking of 'new listings with Morrisons and Asda' highlights an apparent denial of the realities of cash flow management. Of the two, financial failings seem to have been the main cause of the failure.

Taken from 'Topical Cases' at www.a-zbusinesstraining.com, *Ian Marcousé's site for CPD, topical cases and business worksheets.*

Use the internet or your own knowledge if you've studied business at GCSE and explain the following key terms:

Capital
Cash Flow
Profit margins
Crowdfunding
Equity

Task 2 - looking at crowdfunding in more detail.

Crowdfunding is an alternative method of raising equity finance for a business, project or idea.
Unlike business angel investment, in which one person typically takes a larger stake in a small business, with crowdfunding an entrepreneur or business can attract a 'crowd' of investors – each of whom takes a small stake by contributing towards an online fundraising target.

Activity:

Watch this video:

https://www.tutor2u.net/business/reference/crowdfunding

Example 3 = equity crowdfunding. There are 2 types of crowdfunding, equity and reward (sometimes known as gift)

Activity

Explain the difference between the two types - you'll have to do some research.

Activity:

Visit https://www.crowdcube.com/investments

If you had some spare cash which would you invest in and, very briefly, why?

Task 3

Look at the questions included in the case study about Mr Sherrick's Shakes. Before you look at the answers, have a go yourself. Check with the actual answers to see how you did.

Task 4

Use the following link to learn about the bank of England and what is known as the base rate. The Bank of England has responded to the Covid-19 crisis by reducing the base rate to 0.1%.
What does this mean for anyone who wants to borrow money at this time?

What does this mean for anyone who has money saved in their bank?

Extension Task:

Watch the following video:

https://www.tutor2u.net/economics/reference/coronavirus-pandemic-business-impact-and-business-response

Write me a brief report about how the pandemic is affecting businesses in your local area.
Which have been forced to close down?
Which are thriving?
Which have managed to adapt to survive?