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Oxford Cambridge and RSA

Level 3 Cambridge Technical in Business

05834/05835/05836/05837/05878

Unit 3: Business decisions

C424/1806

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Monday 11 June 2018 – Afternoon

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Pat-a-Cake Makers Ltd

The business

Pat-a-Cake Makers Ltd (*PACM*) is a cake manufacturer and retailer based in the West of England. The owners, Patricia Owen and Carlos Fuentes, pride themselves on being creative entrepreneurs. The company's cakes are only available from *PACM*; it does not supply any of its cakes to other retailers.

Patricia started the business in 2005 when she was made redundant from her job as a chef in a local restaurant. Patricia had enjoyed creating the restaurant's award-winning dessert menu and decided to put her redundancy payments towards starting her own business. The business, based in her own home, baked and supplied wedding cakes and other speciality cakes for parties and corporate functions. In 2008, the business outgrew Patricia's home kitchen and, partly to ensure Patricia could continue to meet food hygiene requirements, needed to move to larger premises. An opportunity arose in the summer of 2008 when a long-established bakery business, located on a busy high street in a nearby town, closed down. Patricia was able to secure the lease of the premises but needed financial support to fund the purchase of fixtures and fittings needed to convert the premises into a dedicated bakery and cake shop. A family friend, Carlos Fuentes, supplied the necessary funds in return for a 40% stake in the business. Carlos became Finance Director and Patricia took on the role of Operations Director.

In 2013 Carlos suggested that the business launch a website to sell the company's range of cakes to online customers throughout the UK. Initially the website was not very successful. However, in 2015 *PACM* began focussing on supplying gluten-free, sugar-free and dairy-free cakes online, and these have proved to be popular. Currently *PACM* devotes approximately 40% of its weekly production time to supplying the orders received online.

In addition to Patricia and Carlos, the business currently employs two full-time bakers to produce the cakes, three part-time sales staff who work in the shop and a part-time delivery driver who delivers cakes to weddings, parties and other functions.

The problem

Carlos has become increasingly concerned about *PACM*'s profit level. Profits are currently low and continuing to fall. Carlos believes that *PACM* needs to concentrate on operations that offer a higher level of profitability.

Currently, the most profitable aspect of the business is the supply of bespoke wedding and special-event cakes. The second most profitable aspect is the supply of traditional cakes sold in the shop. The least profitable aspect of the business is the online sale of cakes for special diets. Operating at full capacity has meant that a recent increase in online sales has reduced the ability of the business to supply cakes for weddings and special events, particularly for orders requiring delivery within ten days.

The business currently has very limited cash reserves, so any change in operations will require external funding. Carlos has identified three options which he believes will help the business grow and become more profitable. Patricia has agreed to implement one of these three options and the next step for the business is to choose which option to implement.

The options

Option 1: Open a second shop

PACM's shop is very busy and people travel to it from several nearby towns. Carlos has identified a possible property for a second shop. It is available on a five-year lease and would allow *PACM* to bake and sell cakes on the premises. The property would attract a lot of passing trade and there are several large offices nearby. However, Patricia is worried that managing both operations would be difficult for her because Carlos' chosen location for the second shop is in a town just under an hour's drive from the existing shop.

Implementing this option would require *PACM* to equip the new premises for onsite baking. Two full-time bakers, one full-time sales supervisor and three part-time sales staff would need to be hired. Patricia would manage the shop by liaising with the full-time sales supervisor. Carlos estimates that the costs of converting the premises to enable the baking and selling of cakes is £40 000. This could be financed through a five-year variable-rate bank loan with an interest rate of 4% above the UK base-rate. Ongoing revenue expenditure would be approximately £80 000 per year. The payback period for this option is likely to be four years, with an ARR of 12.5% over the first five years of trading.

Option 2: Dedicated production facility

PACM could move to larger premises. This would allow the company to increase its production of the more profitable cakes for weddings and parties while continuing to service the online orders. Carlos has identified a unit on an industrial estate on the edge of town. This site is currently empty but could be secured on a favourable ten-year lease. The existing shop would be retained for retail customers and the area dedicated to serving customers could be increased.

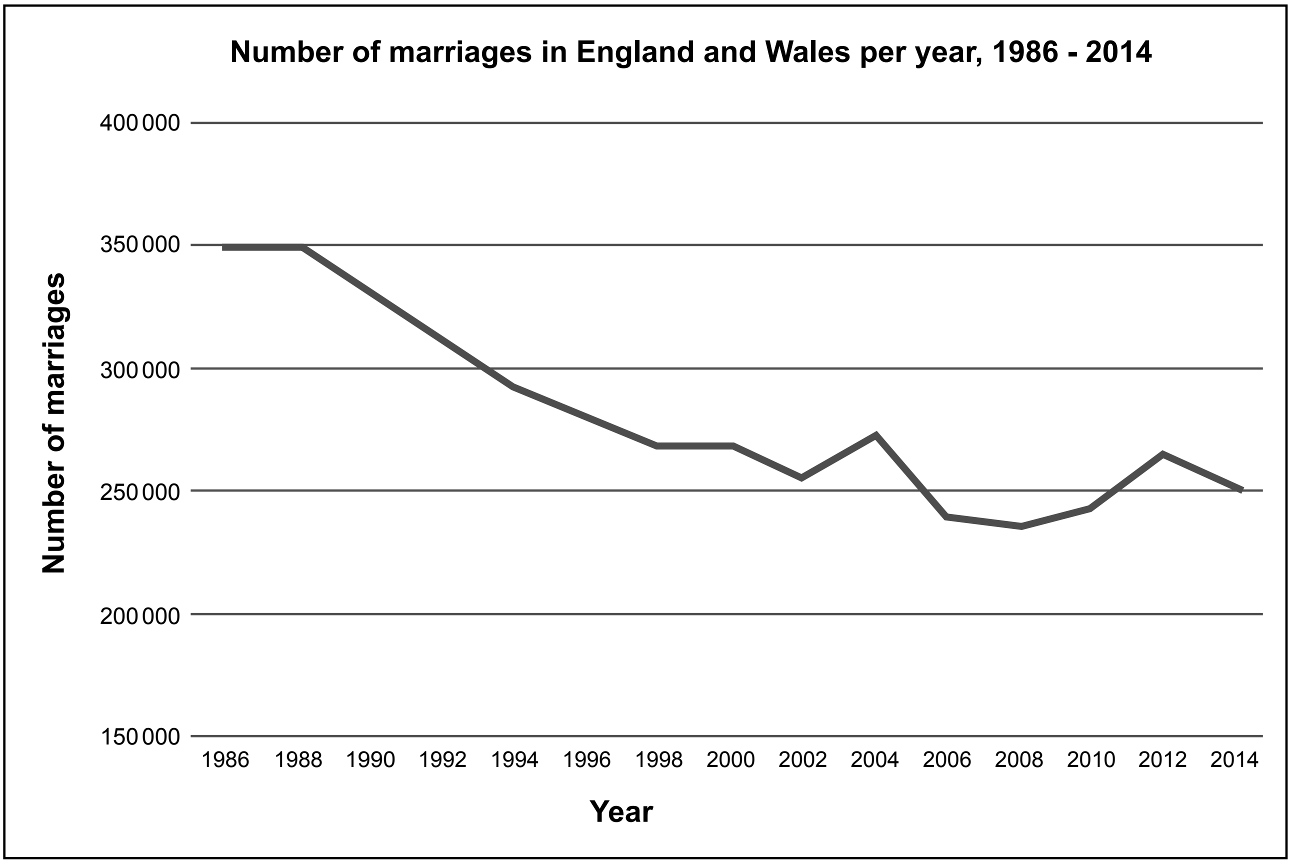
Implementing this option would require *PACM* to equip the new premises for production. Carlos has estimated that the move to the new premises would cost £200 000. Two full-time bakers as well as a second part-time delivery driver would also need to be hired, incurring ongoing revenue expenditure. In addition, another delivery van would be required. This option could be financed by a ten-year fixed-rate business loan at an interest rate of 5%. Carlos estimates the payback period for this option to be seven years.

Option 3: Convert part of the existing shop into a café

Carlos has noticed that profit margins in cafés are generally higher than the profits that can be earned selling food to take away. Customers are willing to pay extra for good service in comfortable surroundings. Carlos believes that there is a gap in the local market for a café serving high quality cakes and hot drinks. If the existing shop and production area were both re-designed, Carlos estimates that space for at least a dozen tables could be created.

The existing shop and production area would need to close for a period of at least four weeks whilst the refurbishments were being made. In addition, existing part-time staff would need to be retrained to provide table service to café customers. At least one of the existing staff has said that they do not wish to provide table service and so they may need to be replaced. The total cost of this option would be approximately £10 000. A three-year variable-rate bank loan to fund the capital costs is available at a current interest rate of 4.5%. Carlos estimates the payback period for this option to be three years, with an ARR of 3% over the first five years of trading.

Appendix 1



Appendix 2

In recent years there have been many changes in the UK food and drink sector. These include:

- an increase in the number of coffee shops offering well-known brands of drink in relaxed surroundings
- an increase in the number of cafés serving hot and cold food
- an increase in the number of customers ordering afternoon tea (sandwiches, cakes and pots of speciality tea or coffee)
- a steady decline over many years in the number of traditional cafés serving cooked breakfasts and mugs of tea.

In addition, food and drink outlets can be very sensitive to changes in the local business environment.