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**Practice exam questions**

## **Pricing, strategy and the UK car market**

**Mark Hage**

Check your answer to the question on pp. 18–20 of the magazine.

### **Sample answer**

One reason why margin of safety may be useful in helping Dacia to maximise sales is that it can allow the business to take corrective action if a sales forecast is overly optimistic. Even though Dacia has seen a 16% growth in car sales in Europe, external factors such as Brexit may mean weaker sales than forecast. Margin of safety allows Dacia to set a level of sales that is above its break-even output, which ensures it has 'early warning' of a dip in actual sales that is still above its fixed and variable costs. Dacia can then act to either increase sales, such as lowering the price of the Sandero, or lower its costs. Consequently, Dacia may be able to avoid a situation where sales fall below the total costs incurred in producing models such as the Sandero, such as the £425 million fixed costs in 2018. This would therefore avoid a negative cash flow situation and is perhaps achieved by lowering the £6,995 sale price of the Sandero to increase the numbers sold, thus reducing the average fixed costs and making it more likely for break-even output to be reached. This can all be achieved before the sales drop to a point that is below the margin of safety.

However, margin of safety only records the level of output Dacia wishes to achieve and does not consider external factors. It could be that the margin of safety has been set at an unrealistic level and does not realistically consider the external slowdown in the global economy and the contraction in sales of 4 million in 2019. Dacia may incorrectly believe that global growth of its car sales from 700,000 in 2018 will continue at rates such as the 16% shown in Europe. Dacia may be unrealistic about this assumption and therefore set a margin of safety that is based on a 16% growth in sales. This may be based on the need to recoup its €2.8 billion investment in manufacturing technology as quickly as possible, to satisfy its owner, Renault. Renault may see Dacia as a brand that can buck the trend in lower sales and fill the gap in revenues that Renault's own cars may be suffering due to the 4.1% decrease in UK sales.

As a result, sales may fall well below the margin of safety set by Dacia, particularly with the recent rise in the price of the Sandero by 17% being seen by its customer base as a move away from its traditionally cheap offering. Sales may dip so quickly that by the time Dacia has looked at its margin of safety, the number of Sanderos sold will already have fallen below the level of break-even output, meaning that revenues are unable to cover fixed and variable costs, placing Dacia in a negative cash flow position, from which it may be difficult to recover. By the time Dacia has put in place promotional and other strategies to rectify the negative cash flow it may have already suffered from a significant loss in its customer base, who may switch to other brands that now are a price substitute. An unrealistic margin of safety may therefore cause increases in unit costs due to lower sales, and as the

manufacturing plants produce a car every 54 seconds, Dacia may have a significant number of unsold vehicles.

There is a risk that Dacia may become complacent when setting its margin of safety unrealistically high — based on its 16% growth in Europe — that the external influences showing a contraction in global sales mean that sales dip quickly below the break-even output set. This would mean Dacia would not be able to benefit from the margin of safety's ability to act as a cushion and early warning system to amend its pricing and cost strategy, ensuring sales revenue stays above the break-even point.

However, the global contraction of car sales of 4 million in 2019 is not affecting all brands. Premium products such as Tesla appear to be bucking the trend and only mainstream manufacturers such as Ford are seeing reductions in sales. It may be that Dacia's prediction of sales and its margin of safety will be set realistically enough to allow it to take into account any small dips in sales. It may be the case that those customers who bought Fords are now considering buying substitute cars, with Dacia well placed to benefit from an influx of new customers. Margin of safety may allow Dacia to fine tune their pricing strategy to maximise sales as they may be regarded as a brand that is affordable to customers with less spending power.

## Sample examiner comment

Mark: 12/12 (Level 4 — an excellent response fully focused on the question)

The answer gives a benefit of Dacia using margin of safety to help maximise its sales. The answer then develops a benefit and drawback in detail using relevant analysis and evaluation of qualitative and quantitative data. Each point analyses the data in context and the effectiveness of the suggested approach. The conclusion gives a detailed evaluation of the value of using margin of safety including a recommendation as to how Dacia could develop this approach to be more useful.

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