Strategic

Management

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"When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact." - Warren Buffet

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FOREWORD

Strategy is challenging and fascinating. It is the defining attribute of General Management: those who are responsible for running a business unit or function and especially for those responsible for the whole organisation as the CEO.

Strategy requires a general management perspective: ability to perceive the entire operations, to make sense of complex situations and to develop pathways forward.

Such a holistic or systems approach to operating in complex environments requires an understanding of a wide range of disciplines.

Mastery of all disciplines is not expected – the scope is far too wide to expect complete mastery. Rather you need some understanding of all these disciplines to be able to synthesise the various components into a cohesive system. Also, you need to know when you lack sufficient expertise and so utilise experts to fill such gaps.

You need some understanding of the 3 core functions of most organisations:

- Marketing
- Operations
- Finance

Some psychology and other tools will help in understanding people and behaviour.

A little economic theory will help with understanding market forces and with your forecasting.

Ethics and some knowledge of law may help curb aberrant behaviour and keep you out of jail. It may even have stopped Volkswagen from installing software to cheat emissions tests on its vehicles.

Intelligence gathering and some skill with statistics will help in understanding competitors and markets.

Broad understanding of technology and its current and future impacts in your arena is essential.

Then add some framework for strategic analysis to help you put it all together so you can frame the preferred strategic pathways. Simple!

You may be surprised by how much you already know and understand. Remember, you are not expected to be an expert in all these fields – just know enough to understand, ask experts if needed, and to synthesise.

It is challenging and very rewarding to make sense of what appears to be an incomprehensible and overwhelming world. Then to devise a pathway towards your goals and to implement such plans is more than satisfying. It is edifying and worthy of esteem.

In this book, we will look at the art and tools of strategic analysis and of strategy formulation. We will inevitably be drawing on, or assuming some knowledge of, marketing, finance, psychology, and economics and so on. We are concentrating on their implications for strategy though and are not aiming to be a treatise on psychology or economics, or whatever.

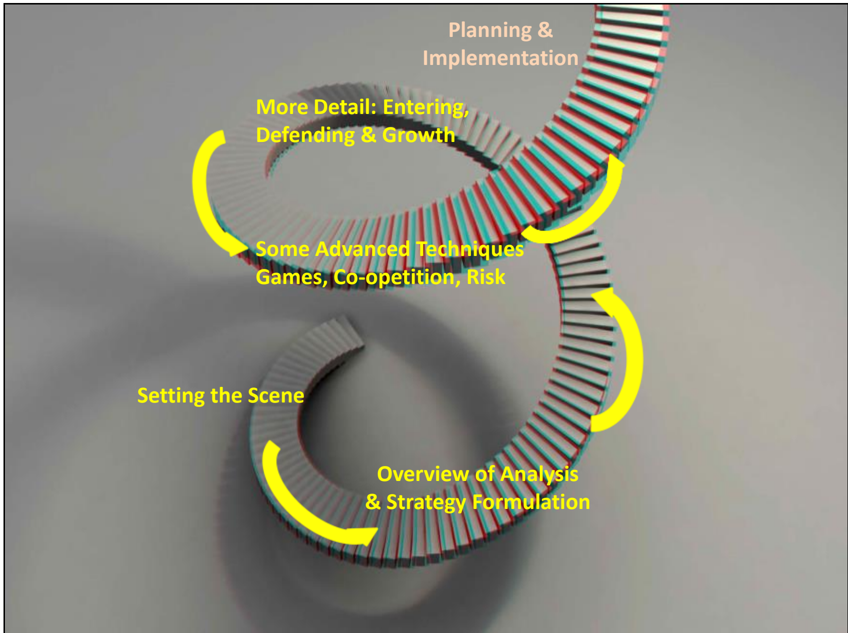
Due to the holistic nature of strategy it does not readily lend itself to learning in stages or steps. It is best to dive in.

Our approach is to do the basics quickly to gain a fundamental overview of the whole process. We will then return to fill in gaps. Later we will consider advanced refinements such as entering new markets, defending our position, game playing and more.

This will be evident in the text as we return to some models to make additional points or extend our understanding.

Our approach is depicted by the spiral staircase below.

We step on the stairs at the bottom by setting the scene with what goals we want to achieve. We then gain the fundamental overview before climbing back for more detail and mastery. We move on to advanced techniques and up to plans and implementation.



This is the pedagogical format you will find in these notes. Extraneous material that would slow down a quick grasp of the "big picture" has been stripped out and put in later chapters or appendices for digestion if you are interested.

Consequently, much of the historical development of strategy is found in the appendices. While most of us have a passing knowledge of operations and marketing and even people, there is often a blind spot in finance. So there is some information in the appendices about finance – enough for how strategy affects finance and vice-versa.

Our approach to strategic tools and frameworks is eclectic. We take what works from wherever it can be found. Despite attempts, no expert in strategy has yet devised a unified theory of everything that is workable. We use whatever tools best do the job.

Alas, there are many "snake oil salesmen" touting the latest quick fix or cure-all. Real life is not that simple. So there is an appendix warning about fads and how to pick them when some consultant comes knocking on your door.

Whenever you are feeling lost or confused, it helps to realise that all you are trying to do is answer just 3 fundamental questions:

1. What is happening, and where is it going?
2. What are our capabilities?
3. What can, and should, we do about it?

That is all it is! If you want to sound more impressive, you can use formal terms such as:

1. Environmental or external scanning and analysis
2. Internal or capability assessment
3. Strategy formulation

Our approach is to use whatever tools help us make sense of a complex world in order to answer our 3 fundamental questions. No tool is sufficient in itself. You still need to wield the tools and move beyond their limitations. Consequently, much of your development as a strategist is to build competency in many tools. Often the choice of tools is determined by the availability of data and of time limitations rather than our preference in tools. There is little point in conducting extensive time series surveys over several years if technology means our environment is fundamentally changing every few months.

Given the pace of many factors today, we cannot wait for perfect information. It will be out of date before we use it. Rather, we might use

several tools to triangulate an approximate position and then move forward even without complete certainty. Deferring a decision and action is actually a decision – usually a poor one.

As Samuel Clemens (aka Mark Twain) wrote: *"when all you have is a hammer, every problem starts to look like a nail."* We want to be better than the hack golfer with a small selection of clubs (a sport in decline for many causal trends). We want to be the professional who chooses the right clubs for the particular course and conditions.

Your first efforts at strategic analysis and strategy formulation may be cumbersome and rather formula driven.

With practice comes fluency. Practice often. Not just on your own business or organisation but wherever you can find an opportunity. In teaching strategy, we often use case studies to practice and try out different scenarios. This is a direct evolution from military strategy where they still review historical battles, even back to the Punic wars of Rome.

Look at case examples. Every time you see a business or organisation example, consider whether the strategy was appropriate and did they undertake good analysis. You will be amazed at how many fundamental mistakes are made. Just do better in your own work. Even watching the strategic manoeuvres of politicians or work colleagues can be illuminating. So can family politicking but you may be on dangerous emotional ground here.

"Experience keeps a dear school, yet fools will learn in no other"
~ Benjamin Franklin

Strategy surrounds us every day. We seek here to gain more skills at playing the game.

1. STRATEGY AT LIGHT SPEED

1.1 Strategy Relevance

Strategy is the most eclectic and holistic of the management subjects and tasks. You need to have enough understanding of marketing, operations, finance, organisational design, people, culture and economics to be able to put together a grand strategy. Strategy is the defining task of the CEO. This much has not changed. So what is different and new?

You need to be good in boom times but you need to be even better in down times. Today we are seeing strategies and CEO's being tested more than they have been tested in previous generations. It is an exciting and good time to be in management!

The strategies and strategic learning of the 1980's and 1990's have been overtaken and even the strategies of this century are being reappraised. We need to have evolved and adjusted. The basic framework is still there but the pace of change and dynamics of competition have quickened.

1.2 Changes to Strategy This Century

1. The World is More Competitive

Probably every generation claims that times are tougher than for the previous generation. This time, it is true.

Typically, most industries face much more competition today. Researchers such as Kathleen Eisenhardt argue that this increased competition is more due to globalisation than the popular view of the Internet. But it is all interrelated.

There are certainly many examples to support the view on globalisation. It has been enhanced by Governments opening markets around the world (except perhaps in the USA!).

Even into the 1990's in Australia, you only had to be better than your (generally) incompetent domestic competitors. With globalisation, you now need to be able to compete against the best in the world.

Lower tariffs, free trade agreements, rapid dissemination of information, easier movement of capital and people and the internet, have opened up the world.

Look at the rapid spread of the US sub-prime credit crisis in 2007 to global markets. We have never seen such a rapid conflagration (although a Reserve Bank report in 2005 warned this could happen: Andrews and Kohler, RBA Research Paper, 2005).

Even industries that were once considered "natural monopolies" have been opened to competition. So large scale infrastructure owners such as pipelines, telecommunications assets and similar are either forced to give access to competitors or are restricted in their pricing power.

2. Power to the People

Customers have more power and knowledge than ever before.

This is due to a combination of education (and cynicism), globalisation and other increased competitive factors and the availability of information.

McKinsey & Co have stated that in the new millennium, the old economics tenet of consumer sovereignty is dead. It has been replaced by **the consumer as tyrant**!

Consumers want more, they want it better and faster and they want it cheaper. Gerry Harvey and other traditional retailers can moan about unfair competition from the internet but that is evolution just as their discount stores replaced department stores in the 1960's and 1970's. In the USA, the regional shopping mall is now 60 years old. There were 1,500 large shopping malls in the USA 15 years ago. Today there are less than 900. There are predicted to be less than 700 by 2020. Sales are plummeting per square metre. Receiverships of shopping centres in Australia have risen but quality managed centres are still doing well, albeit much evolved. What is the difference between performers and failures?

By reading the trends too late, Westfield only sold off 7 of its USA shopping centres in 2012. The price was less than a quarter of their cost!

Interestingly, small shopping centres are still increasing in America, up from 66,000 in 1986 to over 100,000 today.

This strengthening of customer power is causing major shifts in competitive analysis and strategic formulation.

3. Pace of Change

Again, every generation claims that this era is faster paced than before. Again, this time it is true! Technology is moving faster. A connected world is disseminating knowledge faster than ever. We are also seeing more radical shifts in technology. We are seeing connections between technologies driving and creating new markets unlike ever before.

Product life cycles are shortening and even truncating. The supremacy of the iPod lasted 8 months. Nokia is virtually dead, taking Finland with it.

There used to be a rule of thumb that the amount of information in the world doubled every 14 years. Today, it is growing exponentially and is doubling faster than every 2 years.

Strategies that would last 10 years now last less than 3 years
.

4. Other Trends

Other changes are also having a profound effect on how we develop strategy.

Socioenvironmental issues are real and fundamental. From global warming and carbon taxes to pollution and waste to community and social responsibility and aging populations, there are enormous additional pressures not just on governments but also on organisations and their goals.

Aging and declining workforces being replaced by cynical and mobile Generations Y and X means that finding the right staff is now a critical factor for many businesses, especially service industries that now dominate the economy. Indeed, gaining the right staff forms part of the resource based views of the strategic resources available to a firm. Recessionary times are perhaps just a blip on this overall trend.

By 2050, only half of Australia's population will be of working age. That is unless the Government raises the retirement age to 75 plus.

Average job tenure in the 1980's was 15 years. Today it is less than 4 years.

By the way, Gen X overtook the Baby Boomers in numbers in 2010. We have been used to the baby boomers dominating markets but even that is passing (away).

1.3 Impacts on Strategy

1.3.1. Relevance of Michael Porter's Analysis?

In the 1980's and into the 1990's, Porter's Analysis was the staple of MBA courses on strategy, comprising some 80% of the conceptual framework.

Today, Porter would be less than 10% of a good program. Porter Analysis is viewed as just one of the many tools available, albeit still a very useful one.

The main "aging" problems of Porter's analysis are:

Lack of attention to technology and government

Focus on internal rivalry, whereas the power of the customer now dominates the focus.

Technology

The pace of change in technology was important but rarely critical in the late 1970's and even in the early 1980's when Porter was developing his framework. Today, to ignore or even sideline technology is a serious deficiency. *"If you can't pay attention to, and assimilate technological information beyond your borders, you're playing with one hand tied behind your back."* Richard J Samuels, MIT.

Some Porter advocates tried dismissing the Internet as just another distribution channel. But the information explosion it has caused is pervasive. New technologies and the costs of developing those technologies are leading to alliances on a scale not previously seen. Former rivals now need to work together to share the costs of developing the technologies.

Consumers have more faith in social media than advertising. By the way, the internet is the largest avenue for advertising in Australia now: exceeding print, radio and television.

Government

When it was pointed out to Michael Porter when he published his framework, that he had neglected government as a force, Porter took a typical American view of the time (Ronald Reagan was President) that government was not important, or if it was, its effects could be handled through its impacts on the other 5 forces. The dinosaurs of the Tea Party in America still cling to this illusion.

Apart from the inanity of dismissing the impact of government in places such as Singapore and China, this premise does not hold true in the Western capitalist world either. Aging populations, environmental and social concerns have made the influence of government more pervasive. In Australia, like the UK, the government is directly responsible for over 20% of the economy in terms of output and income. If we include transfer payments such as pensions and other welfare, the government is responsible for over 40% of the national income. How can strategic analysis ignore such forces?

Government policy on spending, the economy, the environment and other issues are major factors in industry analysis.

Focus on the Customer

Porter has a bias to internal rivalry or competition as the focus of his analysis. This reflects his training in microeconomics.

Indeed, his model downplayed the entire demand side with the force entitled "buyers". Most strategists found this too broad and usually split the category into customers (or channels) and consumers.

With the rising power of channels and end consumers, the focus of analysis has shifted to the right of Porter's model: to the consumer. Many recent models have the customer in the centre

of the analysis, acknowledging the primacy of the customer (for example Kenichi Ohmae's 3C model).

The shift has been so fundamental, that many players who would otherwise be treated as "internal rivals" now seek co-operation or "***co-opetition***" with each other to combat the greater foe of the customer e.g. suppliers to Woolworths and Coles.

1.3.2. Change and Sustainable Competitive Advantage

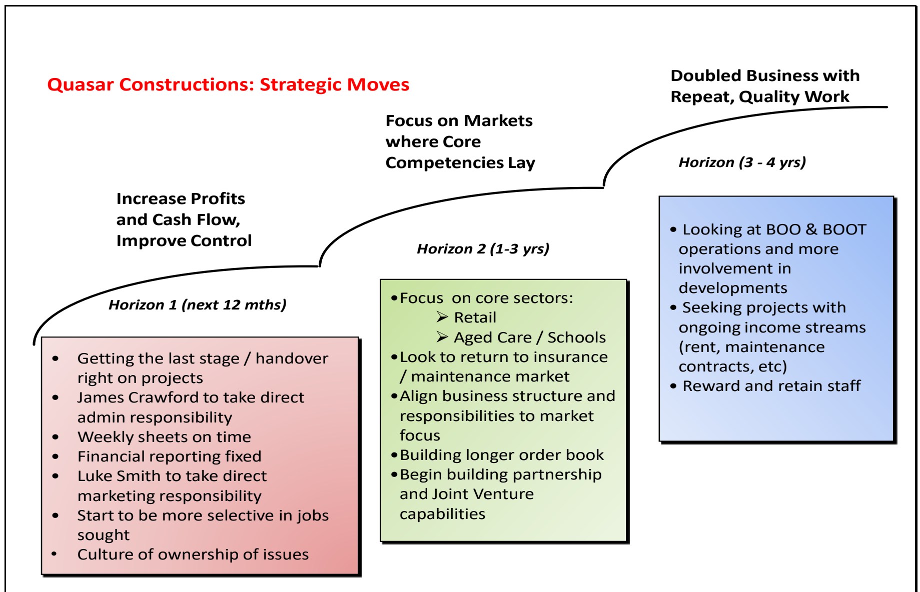
Porter also discussed the concept of sustainable competitive advantage. In the 1980's this began as an indicative 10 years or so. It was a strong selling point for strategy. You do some analysis and set your strategy and then sit back and watch the results roll in for the next 10 years or so.

In the early 1980's Mazda even had a 100 year plan. The fact that they struggled to survive to the mid 1980's (and had to call on Ford to bail them out), dampened the enthusiasm for such long term views.

It is now difficult to build sustainable advantage on a narrow basis. Competitors and customers seek to either emulate or counter narrow and simple advantages. Flexibility and willingness to learn are seen as more realistic attributes. Scale and cost advantages can be strong until a disruptive technology destroys the basis of such an advantage.

Today, most companies have a strategic plan outlook of maybe 4 – 5 years, with more detail added to the immediate years. See the example below for a construction company.

However, the horizon probably needs to be longer and you do need to consider what is over the horizon if you are responsible for the long term health of your business or organisation.



1.3.3. Time Horizon Schizophrenia

This shortened strategic horizon is not always adequate or appropriate though. Many industries require a long term horizon for significant investment: companies with long R&D gestations; major infrastructure investors and similar.

Qantas for example, buys aircraft which have a 20 year operational life, so they need to have a view about demand and needs 20 years away! Property companies need a similar view. Many companies need to think both long and short term.

They need to consider the long term first. The long term view will not be detailed but we need to consider where we want to be in the long term and how we will get there before setting the short term direction. Otherwise we may make short term decisions that are contrary to our longer term goals.

1.3.4. Strategic Flexibility

One response to the above conundrum of long and short horizons has been to seek strategic flexibility, even at the expense of accepting **sub-optimal profitability in the short term**.

We now seek strategies that allow ease of adjustment. One aspect is to weight preference towards strategies with **low regret**. If the strategy is not working or has been made obsolete, does it have a low cost to change? Hence, we may choose a sub-optimal strategy in terms of profitability but value it more because it has less fixed investment commitment or can be more readily modified.

1.3. 5. Strategy as Directional, Not Prescriptive

Allied to the pace of change and desire for flexibility, we now see strategy as more directional than detailed prescriptions. This is especially so for the "**Grand Strategy**" of the big picture: positional strategy.

We now use strategy to position ourselves; what are the general goals we seek to attain; and what is the direction in which to move? The strategy is a rough road map to give us direction. However, there may need to be detours as competitors, customers and others throw up road blocks or as opportunistic short cuts come into view.

At the short time frame, detail will increase and be more prescriptive.

1.3.6. Confusion About Strategy and Strategic Planning

Strategy is now more directional than prescriptive or detailed, but there is a counter movement led by the accountants. Here, as part of the annual budget cycle, many companies now incorporate a strategic review and strategic planning session as part of the annual plan.

Strategic planning was meant to be killed off in 1983 when Jack Welch took charge of General Electric and closed down its strategic planning department along with the 200 jobs there. By 1994, Henry Mintzberg

wrote of the fall of strategic planning, calling it an oxymoron. He saw strategy as too evolutionary for panelled walls and budget committees.

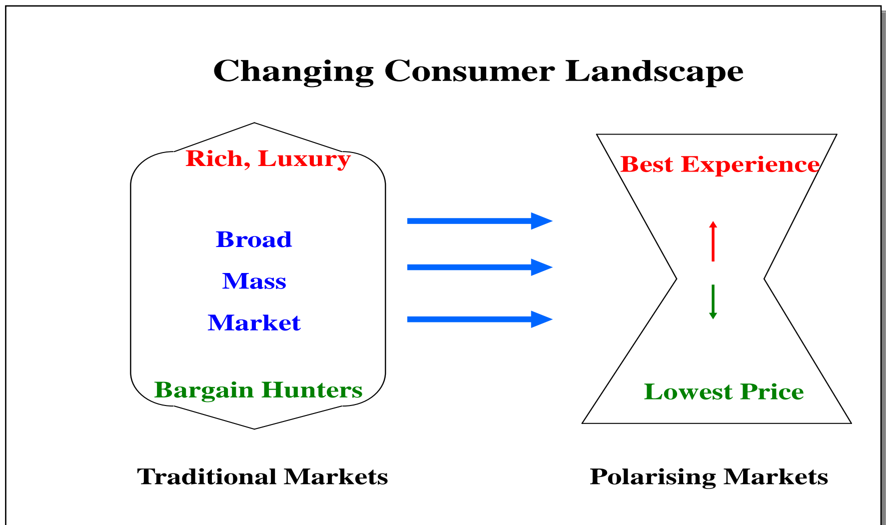
However, accountants and others have revitalised strategic planning to the point that it overlaps and has the danger of overarching strategy in some organisations.

Such stylised and perfunctory budget audits produce stunted "strategies" that are only operationally marginal. They miss the rich opportunities in-depth analysis and big picture views show us when you have your head up. The marginal or incremental "strategic planning" efforts risk being blind-sided by disruptive forces coming from left field and they miss exciting new opportunities.

1.3.7. Even More About the Consumer

While we now focus more attention on the customer, consumers are changing too.

The mass middle market in most industries is shrinking. We are seeing a polarisation away from the middle market. Although each end of the



spectrum still demands value, the value is defined differently. We are seeing consumers who are financially well off but time poor where value is the best experience for their time and money. At the other end, we are seeing cynical consumers who want a reasonable good or service at the lowest price.

Where does this leave firms supplying the mass middle markets like free to air television or mid-market restaurants or mass media magazines or ……? They too are shrinking.

Marketing has traditionally spoken of the 4 P’s: price; product; promotion and place. Today, there is much more emphasis on segmentation. We should change the acronym to 4PS.

Services marketing is even more complex and talks of 7 P’s. We add Process (delivery systems, etc), Physical evidence (that we really exist or to give credence to our service promise) and People (integral to providing service). We still need the S for Segmentation: a key strategic view of marketing.

1.4 Big Picture Changes

We have noted the pace of change and the increased competition from globalisation and the rise of consumer power. Strategy today is certainly richer, more complex and faster paced.

It is also more honest. Strategy no longer claims to find the single right answer that will be sustainable for years to come.

Other major changes include:

> Good strategy no longer (falsely) guarantees success. Rather, it improves chances or luck or probabilities, whichever term you prefer. Indeed, circumstances may mean that a good strategy fails in practice because of circumstances at the time but this is unlikely.

Overall or grand strategy is more directional rather than detailed prescriptions.

Flexibility is a key factor now in choosing the most appropriate strategy. Can we easily adjust? How much does it cost to change?

Micro strategies and tactics which are moves towards the strategic direction tend to be shorter lived and require constant attention and modification.

Generic strategies are too simple to be useful. Real strategies are richly complex and unique. We have different strategies for each set of circumstances and they need to adapt and change.

There is no single correct strategy. We should ideally have a number of strategic choices which need to be assessed for fit, flexibility, congruence and other parameters.

We then do considerable testing of strategies: break-even analysis; modelling and sensitivity analysis; scenario testing; trials; games theory. Effort is spent assessing risk and reactions from competitors, consumers and regulators.

We now look more at the sociological approach: human interactions; assumptions; bounded rationality; satisfying behaviour; profit sub-optimality; culture; shared goals; game playing.

The sociological approach is supplementing the previous dominance of the industrial organisation approach of Porter and colleagues.

We are finally moving (slowly) away from the linearity trap. Life does not progress smoothly. We can have discontinuities, leaps and paradigm shifts.

> Joseph Schumpeter's writings of the 1940's are back in vogue: capitalism is as much about **creative destruction** (of old structures and strategies) as it is about creating new structures and strategies. Alas, too many companies are wedded (even welded) to old habits and are too reluctant to let the past go, to destroy the old and release resources for a new future.

In the new millennium, researchers such as Brown and Eisenhardt are talking of "dynamic strategy". It is certainly no longer "set and forget".

Interestingly, as far back as 1997, Arie de Geus wrote of the "Living Company", one that could perpetuate itself. He saw 4 key characteristics of the surviving or living companies:

Sensitivity to the business environment (learn and adjust)

Cohesion and identity (leaders can tell a story and shared goals)

Tolerance and decentralization

Conservative financing (low debt)

1.5 Summary of Changes

For numerous reasons, competition is tougher – not so much from traditional local internal rivalry but from other factors.

Consumers are far more knowledgeable and cynical and powerful. Globalisation has added new competitors and given consumers even more choice.

The pace of technology is shortening product life cycles and creating even more change. Businesses often need to be schizophrenic and work simultaneously within several time frames, adjusting the detail of their strategies accordingly.

Meanwhile, business is facing greater scrutiny for its impact on society, the community and environment. Triple bottom line reporting and community social responsibility score cards have supplemented the goal of shareholder value. Consider the impacts on BP for its burst well in the Texas Gulf or on BHP and Vale for their burst dam in Brazil.

As well, we may still face global economic recession.

But we need to keep a perspective. Most businesses do not go bust in a recession. Most of the business failures in the past “global crisis” were not due to recession or financial crisis but to their own weaknesses.

Certainly, some were distressed by the credit squeeze but these were largely highly geared and badly run businesses that were exposed by the credit crunch. As such, clearing out these businesses and managers was probably a good thing. Even in recession, there are far more people employed than unemployed (by about 10 to 1). People still eat and move and live.

Meanwhile, there are much greater forces rolling towards us.
The cartoon from the Sydney Morning Herald cartoonist Alan Moir is apt. We are moving into different times. What are your goals, strategies and plans?

2. SHAREHOLDER VALUE

(our objective in successful strategy development)

2.1. What is Shareholder Value?

To complete our setting of the scene, we need to consider the purpose for our strategic analysis and strategy formulation: what are the goals we are seeking to achieve.

For a company, this is a major issue for the owners and the managers they employ. What is shareholder value, how do you measure it and how do you achieve it? The answers are neither obvious nor universal.

Indeed, many organisations do not even recognise shareholder value as the prime goal of the organisation. Public utilities, for example, recognise many stakeholders including customers (voters), employees, the environment, local inhabitants and the government. Large companies have thousands of employees and usually even more shareholders.

Today, there is a push towards triple bottom line reporting: financial results (the bottom line of the income statement, which is the profit); impact on the environment; and impact on the community.

Even so, shareholders think they own the company and do indeed determine who are the directors and thence the CEO. They generally want the company to deliver them value on their investment in the company: shareholder value.

For our purposes of competitive strategy, we shall largely concentrate on shareholder value as our dominant criterion of success. We will judge the worth of our analysis and strategies on whether they deliver superior results, in particular, superior long term shareholder value.

2.2 Determinants of Shareholder Value

Shareholder value is fundamentally determined by two factors:

Returns (profitability)

Risk

In addition, we credit value to a company that has growth prospects for its profitability. The market has a preference for growth stocks if they are performing and not too risky. So we add a third factor:

Growth

The usual proxy for measuring profitability (at least for publicly listed companies) is **E**arnings **P**er **S**hare (EPS). This is profit (normally after tax) divided by the number of shares. Even this simple calculation can become complex after allowing for preference shares and new share issues during the year.

Growth can be measured mathematically although forecasting is required.

Risk is the major difficulty. There is not a satisfactorily complete definition for risk let alone an agreed measurement.

Finally, what shareholders are interested in is NOT the historic profitability and risk. It is the **FUTURE**.

2.3 The Measurement of Shareholder Value

This all becomes very difficult to measure and define. So we have a convenient "cop-out" at least for publicly listed companies.

The proxy normally used to define and measure shareholder value is:

the share price

The share market is taken as the forecaster of future earnings and risk assessment.

For the purists, we should also include dividends. Shareholders not only receive growth in the share price (capital gains) but also receive dividends. The **total return to shareholders** is measured as the growth in the share price plus dividends.

For private companies or business units that do not have a share price, we need to use other proxies including return on investment and price to earnings estimates.

2.4 Putting It Together: Long Term and Short Term

We also have troubles about the time frame investors consider. The equity markets have both short term and long term views. The astute manager must consider the requirements of both ends of the time frame or else adjust the type of investors.

Warren Buffett quotes his mentor of the 1940's, Ben Graham: *"In the short run, the markets are a voting machine* [voting on fear and greed]*, but in the long run, they are a weighing machine"* [weighing up risk and return].

Certainly in strategy, we are working on the long term value. In terms of long term shareholder value, the prime ingredients are having the right strategies, and the capability platform to implement the strategies.

The main (but not sole) determinant of the long term capability platform is the management.

2.5 Link with Strategy

Our goal of shareholder value means that a strategy has value if it delivers long term profitability.

Just as importantly, a strategy is valuable if it reduces risks. The International Standards definition of risk is appropriate here. This defines risk as anything that may prevent us from achieving our objectives.

In reality, we cannot avoid all risks. Good strategies **balance** risk and return. We may accept certain risks but we should seek to obtain commensurate returns for those risks we undertake. A great strategy will deliver superior returns or profitability while helping to manage and mitigate risks.

Finally, if we can also gain some growth then that is the cream on top. Superior returns commensurate with the risks and strong growth prospects would be our ultimate strategy attainment. This would deliver superior shareholder value.

The benefits and returns from good long term strategy will be revisited when we look at Du Pont analysis later. It reminds us that the short term managerial actions of reducing costs and tighter asset control do help to improve short term returns. These are relatively simple actions as they are internal to the organisation and largely controllable.

However, it is the external, complex actions of raising prices and increasing sales that yield the highest returns. These are external factors and more difficult to manage. But they yield the best returns. To achieve these goals in a competitive market you need good strategy and implementation.

Good strategy and its implementation deliver the best long term results.

3. USE OF STRATEGIC MODELS

Models or frameworks are used extensively in the strategy activities of environmental analysis, capability assessment and strategy formulation. Several leading consultancies have been built on the development and promotion of a model.

For example, Boston Consulting Group (BCG) was formed in 1963 by Harvard Business School alumnus, Bruce Henderson. In the 1970's, BCG promoted its business portfolio matrix of cash cows, dogs, stars and problem children (or question marks in these more politically correct times). It is still promoted today although its heyday was in the 1980's. The fact that the matrix does not work, is based on flawed logic and is now largely discredited does not seem to matter to its promotion.

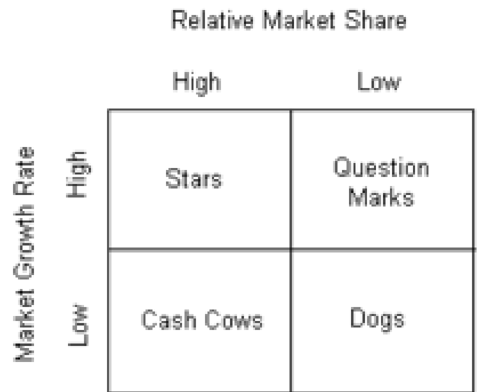


Figure 3.1 BCG Portfolio Matrix

In another example, Stern Stewart & Co took some old fundamental economics and finance and repackaged it to be Economic Value Added. This model still has proponents.

3.1 Benefits of Strategic Models and Frameworks

Strategic analysis and strategic management are complex tasks. Some of the complexity is due to the vast arrays of variables that come from many and diverse sources. We need to know about sociological trends, markets, our staff, competitors, stakeholders, technology, legislation,

the economy and much more. The analyst needs to scan both the external and internal environment to know what is happening.

Even more complex, these variables are not separate or discrete but interact with each other. The mathematical combinations and permutations are enormous.

Similarly, multi-disciplinary skills and knowledge are required to understand and assess these variables. The required skills include psychology, finance, accounting, organizational design, operations, statistics, marketing, technology and more. While not needing to be an expert, the strategic analyst needs to have sufficient understanding of all disciplines to take them into appropriate consideration.

An added dimension of complexity is that strategy is not played in a single point of time but runs over time series. Thus there are reactions by other parties to your strategy and you need to adjust and hone strategic plans in response.

The analysis cannot be entirely formula driven though. We seek some creativity and innovation in our strategies – otherwise they are too predictable and able to be nullified or countered too easily.

The process is not purely linear, even though it is usually taught in that manner. We do not simply proceed from

Step 1: analysis of the environment; to
Step 2: assessment of internal capabilities; to
Step 3: formulation of strategic choices; to
Step 4: evaluation of strategies based on risk, return and fit.

Rather, the process is iterative with feedback. We may get to Step 3 of formulating strategic choices and find no desirable choice is apparent. We can then either plough on and fail or go back and build the necessary capabilities in Step 2 or maybe even fundamentally change our goals to something more achievable.

Similarly, our choice of strategy may nullify some capability or better

still, nullify some perceived weakness, thus changing our results from Step 2 in assessing our internal capabilities.

Furthermore, these steps must be seen in the context of missions and goals as guiding principles.

Nor do we act with complete certainty. We work always with incomplete data which is changing all the time anyway.

Exogenous or external factors of "chance" can often overwhelm our analyses and strategies. Imagine how New Zealand would fare if suddenly mad cow disease ran rampant and devastated its dairy industry. We will later look at disruptive technologies which can suddenly and unexpectedly change the whole game.

Numerous variables and disciplines needed to be considered in strategic analysis over extended time periods. Together with the rapid pace of change, the analysis can become bewildering.

Finally, the analyst needs to take a holistic approach to all these factors. The factors cannot be appreciated in isolation but in their context of how they interact with all the other factors. We work in a system whether it is a socioeconomic system, business system, ecosystem or whatever. Indeed, the world now needs to be considered in terms of how each of these systems interacts with each other.

The complexities threaten to overwhelm us and prevent decisions. Hence the value we derive from models and frameworks to organise our thinking.

Models are essentially **tools to simplify** the analysis and to act as **checklists** to ensure the important points and issues are considered. This is their benefit. But they are not perfect and they are not all-encompassing. They are just tools to be used or discarded depending on the circumstances at the time.

3.2 The Basic Analysis

To avoid becoming lost in complexity too quickly, let us outline the basic steps or requirements for strategic analysis. We provide an overview of the full process in this chapter now and later return to look at each step in detail.

We start at least one step before the actual strategic analysis – with the goals or mission of the organisation. This is needed for guidance and focus and as a benchmark to determine success. We “end” with the implementation of the strategy. Strategy is generally wasted unless implemented.

A. Mission and Goals

It is desirable to have some mission or purpose as a guiding principle to action. This usually needs to be detailed into constituent goals and then perhaps measurable objectives. For example, companies have traditionally had shareholder value as a guiding mission (agency theory notwithstanding). This has often been detailed as set targets for return on equity, growth targets for earnings per share and so on. Even this simplistic world is now under pressure with triple bottom line reporting and the like.

This forms the purpose of our strategy: what we are trying to achieve. The success of our strategies can be measured against achievement of this mission or goals.

Stretch Goals are useful in strategy. They not only give us an inspirational goal but they can force us to be strategic.

Figure 3.2
Not a peanut on a string. It is an elephant lure – a stretch goal.

A small, incremental goal such as a 5% lift in sales or profits can likely be achieved by some operational tweaking.

But a stretch goal like a 50% increase in profits within 3 years or entering two new markets or having 40% of sales from new products in the next 4 years will not be achieved by some productivity or operational improvements. We will need to be strategic in order to achieve these stretch goals. We will need to organise resources, probably develop new capabilities and implement well.

Jim Collins in his book, Good to Great [Random House 2001] uses the term **BHAG** – Big Hairy Audacious Goal. He links the term to capabilities. He also distinguishes between good and bad BHAG's. Bad BHAG's are set with bravado and will most likely lead to disastrous shortfalls. Good BHAG's are set with understanding of the competitive environment and our capabilities. They are a stretch but attainable.

B. External or Environmental Analysis

Here we are trying to understand what is happening in the environment in which we operate, and more importantly, to **forecast** where the environment is heading.

We try to understand major socioeconomic trends. Then we become more detailed as to what is occurring in our local environment – either geographically local and/or local to our area of operations and expertise.

What does all this mean for the environment in which we operate now and will operate in the future?

C. Internal Analysis

We need to understand our capabilities (and the comparative capabilities of others if we are in a competitive environment). We need to know what we can do (and do well) and what we cannot. If we need more capabilities, what will it cost us in terms of resources and time?

D. Develop Strategic Choices

From the synthesis of the environment and where it is going and given our capabilities, what are the strategies we could pursue to achieve our mission? Generally, the sooner we do the analysis and act, the more strategic choices that are open to us. As we delay, our **degrees of freedom** narrow.

E. Select Appropriate Strategies

From our strategic choices, which ones best fit our capability, have the most chance to succeed and cost the least in terms of resources (i.e. efficient) or risk?

If a suitable strategy is not available, do we need to invest more resources on building capabilities or perhaps our mission is unattainable and needs to be revised (the iterative process described above)?

F. Plan and Implement

We now need detailed plans even to budget level and operational tactics.

Strategy is useless unless implemented. We need to act. Then we collect feedback and monitor and adjust the plans accordingly.

Plans not only detail the actions to be undertaken but set timetables and allocate who is responsible for each action.

The plans are not about devising strategic options – that has now already been done. They are the actions required and timetable to implement the strategy.

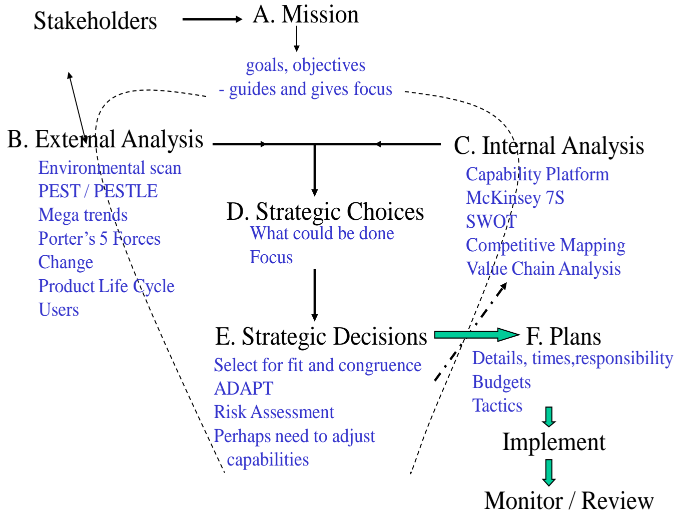


Figure 3.3 Contextual Framework for Analysis and Strategy Formulation

3.3 A Note on Reality

Reality is really complex! It is multidimensional, including the dimension of change over time.

The value of analytic and strategic models is that they allow us to synthesise reality into a framework (or at least a checklist) that is usable and understandable and in a timely manner.

To conduct complete and detailed analysis of our environment and capabilities would be self-defeating. By the time the analysis had been completed, so much time would have passed as to make much of the analysis obsolete. We will return to this decision-making with incomplete analysis shortly.

But a **warning**!

> Our models and frameworks are not reality. We need to keep in mind the limitations of our models and constructs.

Karl Weick, a professor at the University of Michigan, writes about how organisations try making sense of their surroundings and how they make decisions.

He shows how our models colour our view of reality. "Managers construct, rearrange, single out, and demolish many "objective" features of their surroundings. When people act, they unrandomize variables, insert vestiges of orderliness, and literally create their own constraints." [Social Psychology of Organizing, p.243]. The concept of which lens we use to view the world is similar.

Theodore Levitt as far back as 1960 [Harvard Business Review Classic] warned of the power of our definitions. The US Railroad companies defined their industry as the railroad business and continued to do so until they were put out of business by the trucking companies – they were really in the transport industry!

Management has been dominated by focus on decision-making and the concept of strategic rationality. But the rational model downplays the complexity and ambiguity of the real world.

3.4 Incomplete Data

Related to the complexity of the real world, is that we will never have complete information. Weick [in Sensemaking in Organizations] looks at responses when we are faced by conflicting and voluminous information.

Most organisations respond by seeking more information. This can often lead to no decision being made at all: **paralysis by analysis**. No decision is in fact a decision: a decision to do nothing or to maintain the status quo. Unfortunately, as it is made by default, only by chance would it be the optimal decision.

Weick argues that ignorance is not the problem. Instead of gathering more data, refer back to principles (mission), values and preferences to help make a choice. Weick says we need to learn to live with ambiguity and uncertainty in trying to make sense of our environment – he calls it **equivoque**.

Weick argues there are adaptive advantages of operating in chaotic systems. Authority needs to be distributed rather than centralised and decisions need to be made faster and be more prone to revision. It may also require organisational discrediting: turning your back on what has worked in the past; to rid yourself of hubris and blind spots. (This is Joseph Schumpeter's "Creative Destruction" again). It may mean that we need new skills in managers!

As Weick espouses: *"stamp out utility; complicate yourself."*

Colin Powell, former chief of staff for the U.S. Army and former US Secretary of State advocates:

> *Part I: "Use the formula P = 40 to 70, in which P stands for the probability of success and the numbers indicate the percentage of information acquired."*
>
> *Part II: "Once the information is in the 40 to 70 range, go with your gut."*

However, in the same "Leadership Primer" Powell goes on to state:
"Never neglect details. When everyone's mind is dulled or distracted the leader must be doubly vigilant."

"Strategy equals execution. All the great ideas and visions in the world are worthless if they can't be implemented rapidly and efficiently. Good leaders delegate and empower others liberally, but they pay attention to details, every day."

Sun Tzu makes similar statements about the general making many calculations in his tent before the battle.

In support of the above statements, the field of **competitive intelligence** does not concentrate on searching the internet or other sources for more data. Rather, we normally find that most of the information we need for strategic analysis already resides in the heads of key personnel in the organisation. So we start there. We then use our market and other research to fill in specific gaps.

Furthermore, modern competitive intelligence spends less time on the actual data research: maybe less than 20% of the time allocated to the brief as opposed to 40% or more previously. Instead more time is now spent on defining the brief and looking for insight through analysis, than on seeking the data.

3.5 Final Note – The Three Questions

Complexity is part of life. It does not mean we should retreat from reality but rather focus on what is significant for us.

In the end, the guidance of missions or goals helps set our area of focus. Yes, we should raise our heads and look around at times to avoid excessive myopia, but we still need to act within our sphere.

In the end, we seek to answer three basic questions:

What is happening and where is it going?

What do we have going for us (our capabilities)?

What can and should we then do to achieve our mission?

We use whatever models or frameworks that help **guide** us or act as **tools** in answering these questions.

But they are only guides or tools and we need to bring our own intellect and analysis to the specific issue. Then, we design our unique strategy and plans.

Some understanding of models and their background and formation is useful in appreciating their role and limitations.

There is no single perfect model. Attempts at achieving a unified model of everything in strategy have proved to be very confusing and rather “clunky”.

We should use what suits the circumstances and be prepared to modify or augment as conditions warrant.

An overview of many of the various models together with a critique of their benefits and weaknesses is included in the Appendices if you wish more depth in your theoretic evaluation of strategic models. As well, there is an appendix on the historical development of business strategy from its origins in military action to present day views.

For those eager to become practitioners, the next few chapters move on to show the models, tools and techniques we use to answer our 3 basic questions to devise good strategies.

4. WHAT IS STRATEGY?

Strategy is the marshalling of resources and activities to achieve a goal.

Strategy is winning when you do NOT have all the resources or the big guns.

Strategy applies across a broad spectrum between mission and action. It is the analysis of the situation and forecasting of direction. It is then the formulation of those actions that will best achieve the mission or goals.

4.1 Levels of Strategy

Strategy can be played at different levels. Whether you are running a function such as a production line of human resources or marketing or running a business unit or you are the CEO of a multi-national organisation, there is strategy.

Happily, the same basic analysis and steps apply at any of these levels. The main difference is that time frames tend to be longer the further up the hierarchy we go.

So strategy for an IT project will last as long as it takes to implement and start running the project. Marketing strategies may be run over several years with product positioning but only a few months for a particular campaign. Taking a business unit into a new market or product may require planning over several years.

Figure 4.1 Levels of Strategy

When looking at the hierarchy of strategies there is one key rule: our purpose and loyalty lies to the goals and strategies of the level above us. The strategies we play at our level need to be tested to see if they are **congruent** with the goals of the level above. It is dysfunctional to have strategies for goals that are not helping the higher order goals above us.

In a similar vein, when looking at our time frames for strategies, the most detail is in the short term phase. The longer term phase is more directional than prescriptive. But, you are required to consider the long term frame and needs first! It is counter-productive to go haring off with short term strategies and tactics only to find that they stymie your longer term efforts and goals. Short term strategies need to be congruent with your longer term goals and strategies.

Therefore, if you are operating at lower levels of the strategy pyramid, it is essential that the goals of the higher levels above have been clearly articulated and that the long term goals are known. Otherwise you risk operating in a vacuum and implementing actions that do not support the higher level goals.

4.2 Strategy and Tactics

Strategy is essentially long term. For a business, it is at least a few years and preferably longer.

Businesses today need both the short and long term views. This is mirrored in financial performance measures such as Net Present Value (NPV) for long term investments and earnings per share (EPS) or Return on Investment (ROI) for short term results.

Tactics are more the short term actions and plans to achieve a short term or intermediate goal towards the longer term strategy.

Businesses will vary and innovate tactics as they are countered or lose their potency. Changing core strategy too frequently though is expensive and just leaves everybody lost.

4.3 Marshalling Resources and Activities

The use of strategy implies that there are limited resources and activities with which to achieve the goal. This is a truism. Very few organisations have an open cheque book to achieve the goal.

Strategy then, is the formulation and activation of a plan to best use the resources and activities to achieve the goal.

This applies to all organisations. It is even more applicable when there is competition. In such cases, there are other parties actively seeking their goals which may be in conflict with our organisation. In business,

this may be rivals seeking to gain market share against us. It may be customers or suppliers seeking to derive more value for themselves at our cost.

4.4 The Need for Creativity in Strategy

Strategy is the means of making the best use of available resources to achieve our goals. It is crucial to have effective strategies if there are competitors who act counter to achieving our goal or when the resources are very limited.

Strategy is the way to win when you do not have an overwhelming advantage. It is choosing when, where and how to fight so that the odds move to your advantage.

Strategy improves the success rate of achieving the goal. It also allows the goal to be achieved at less cost to the organisation.

The master strategist Sun Tzu wrote:

> *In warfare, one generally uses the direct force to engage the enemy, but uses the indirect force to win. (The indirect force "qi" is something surprising, indirect, extraordinary or deceptive).*
>
> *In all fighting, the direct method may be used for joining battle, but indirect methods will be needed to secure victory.*
>
> *Do not repeat the tactics that won you a victory, but vary them according to the circumstances.*
>
> *He who can modify his tactics in relation to his opponent and thereby succeed in winning, may be called a heaven-born captain.*

While strategy is critical, it is not everything. The best strategy in the world is useless unless it can be implemented. An organisation (and its leadership) also needs the resources, staff, systems, structure, drive, etc to win.

4.5 McKinsey 7S Framework

The McKinsey 7S system reminds us of this need for a holistic approach to business.

Note you do <u>not</u> need to have all these factors perfect. That would cost too much and no organisation is perfect. What you do need to ensure is that all the factors are at least to a <u>minimum</u> standard in order to succeed. Having a great strategy while the staff members are disengaged or the systems to deliver or bill are woeful, means that the strategy will fail no matter how good it is.

We have often seen organisations demanding to have the perfect organisational structure before working on staff or strategy. This no doubt, is the preference of organisational consultants who want to sell a new structure every few years to the same client. There is no perfect structure – it is always a compromise. All you want is a structure that will not impede the performance of the other factors such as staff, style, strategy or systems.

The McKinsey 7S framework evaluates a company or any organisation in a consistent and integrated manner. It is more comprehensive than just listing the strengths and weaknesses as done in a SWOT analysis.

Studies have shown that to succeed, organisations need more than just good strategy or plentiful resources. They need a coherent patterning of a number of factors: the various categories in the mnemonic 7-S.

The seven S's are:

Strategy Plan or course of action leading to the allocation of a firm's scarce resources, over time, to reach identified goals against competition.

Structure Characterisation of the organisation chart (i.e. functional, decentralised, etc).

Systems	Proceduralised reports and routine processes.
Staff	"Demographic" description of important personnel categories within the firm (e.g. engineers, marketers).
Style	Characterisation of how key managers behave in achieving the organisation's goals; also the cultural style of the organisation.
Skills	Distinctive capabilities of key personnel or the firm as a whole.
Superordinate Goals	The significant meanings or guiding concepts that an organisation imbues in its members.

(Superordinate goals are also called "**shared values**").

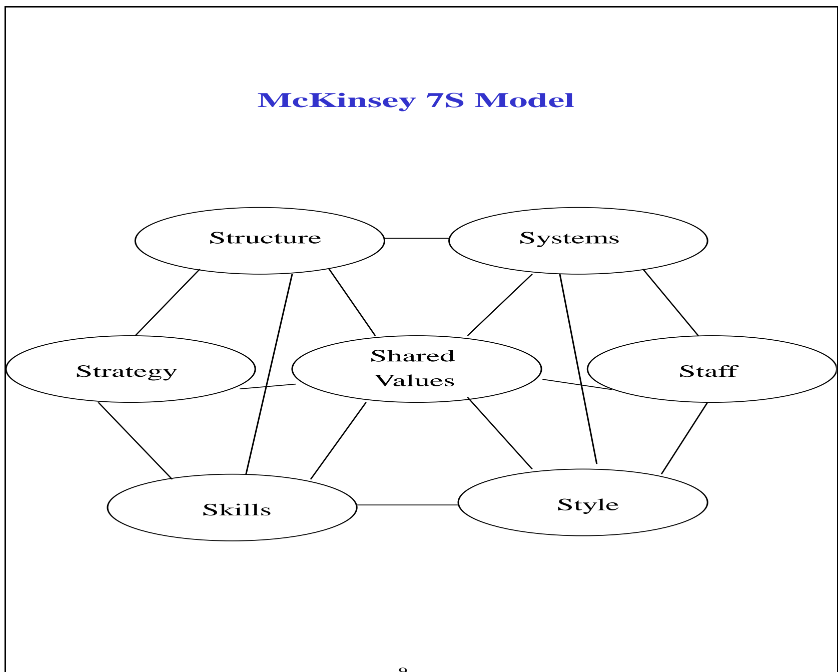


Figure 4.2 Interaction of factors in the McKinsey 7S Model

The soft S factors (staff, style, skills, shared values) are as equally important as the hard S factors (strategy, structure and systems). They need to work together for success.

4.6 Strategy Formulation

Strategy formulation is an imprecise science / art. Of our 3 Questions, this last question has the least tools or formulae to answer. There is often some creative leap to the best strategy.

You require some ability to think holistically - to see the big picture. It also helps to have some flair or creativity.

Even so, there are certain analytic techniques or steps that are useful guidelines. Strategy is taught in military and business colleges. Both use case studies to help develop analytic skills and experience. In the end though, there is scope for individual brilliance.

5. THE STRATEGY QUESTIONS

5.1 The Key Questions Reviewed

No matter what the issue or what techniques we employ, strategy is involved in answering the three key questions:

What is happening and where is it going?

What do we have going for us (our capabilities)?

What should we then do to achieve our mission?

5.2 The Basic Steps

There is no single formula for strategic development. The whole process tends to be iterative: we go back and forth and sometimes round and round. Much of strategy should come from an assessment of our competitive capabilities. But then, a good strategy can adjust how we view our capabilities or strengths and weaknesses.

To make matters more complex, there is an enormous volume of data to assimilate to understand our operating environment. Next, we cannot determine our strategy in isolation. There are competitors (and customers and suppliers and more) who are also running strategies to achieve their goals and perhaps to counter us.

Indeed, a major limitation of using military or sports strategy analogies is that they are very simple compared to business strategy. In the battlefield or on the sports field, there are usually only two sides or teams. But in business, there can be multiple competitors plus diverse customers and so on. The complexity grows exponentially as more players are added.

Finally, in business, we are normally looking at strategy over a longer period of time than a war or sports competition. This introduces more cause and effect events, the effect of learning and the impact of more change over time.

In order to proceed in a timely manner, we need to simplify matters.

There are a number of frameworks or guides that help us distil the complexities into a format we can understand and manipulate. We look at several of these tools like Porter's Industry Framework, SWOT analysis and Competitive Mapping.

Please remember that they are just tools and guides. They are there to help but they are not rigid rules or formats.

The three basic steps (mirroring our 3 key questions) of Strategic Development are:

> **Analyse the environment regards our industry:** is it attractive; what are the major forces, in which direction is the industry moving?
>
> **Analyse your business' competitive position:** Do we have what it takes; how do we compare to our competitors; do we have a strong value proposition?
>
> **Devise appropriate strategies:** What are the strategic choices that utilize our capabilities to pick up opportunities and defend against major threats, which are the most appropriate strategies?

Then remember, a strategy is not static and will change over time as our competitors and customers evolve and technology changes and products near the end of their life.

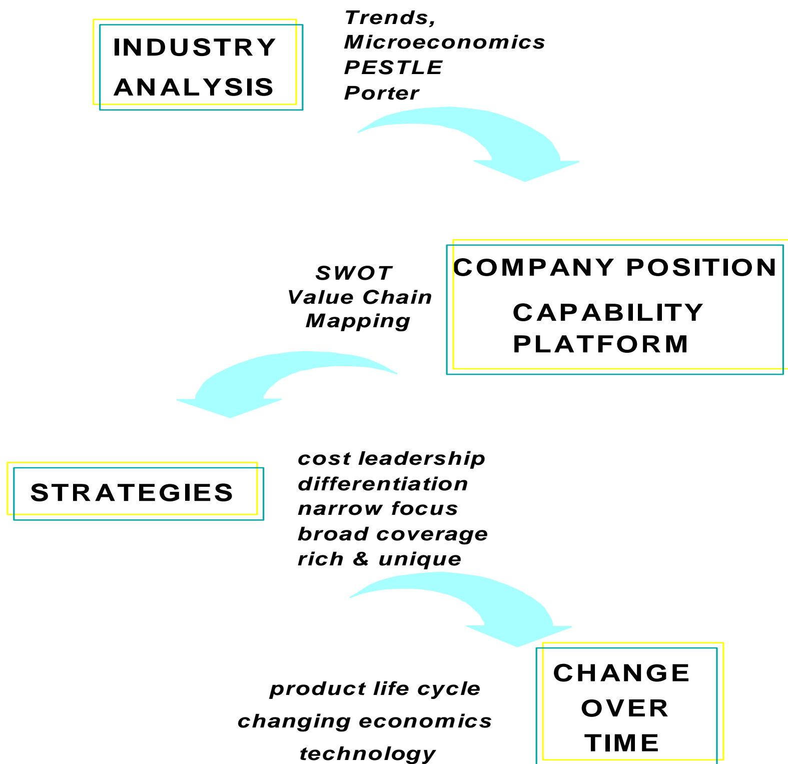


Figure 5.1 Overview of Strategy Processes

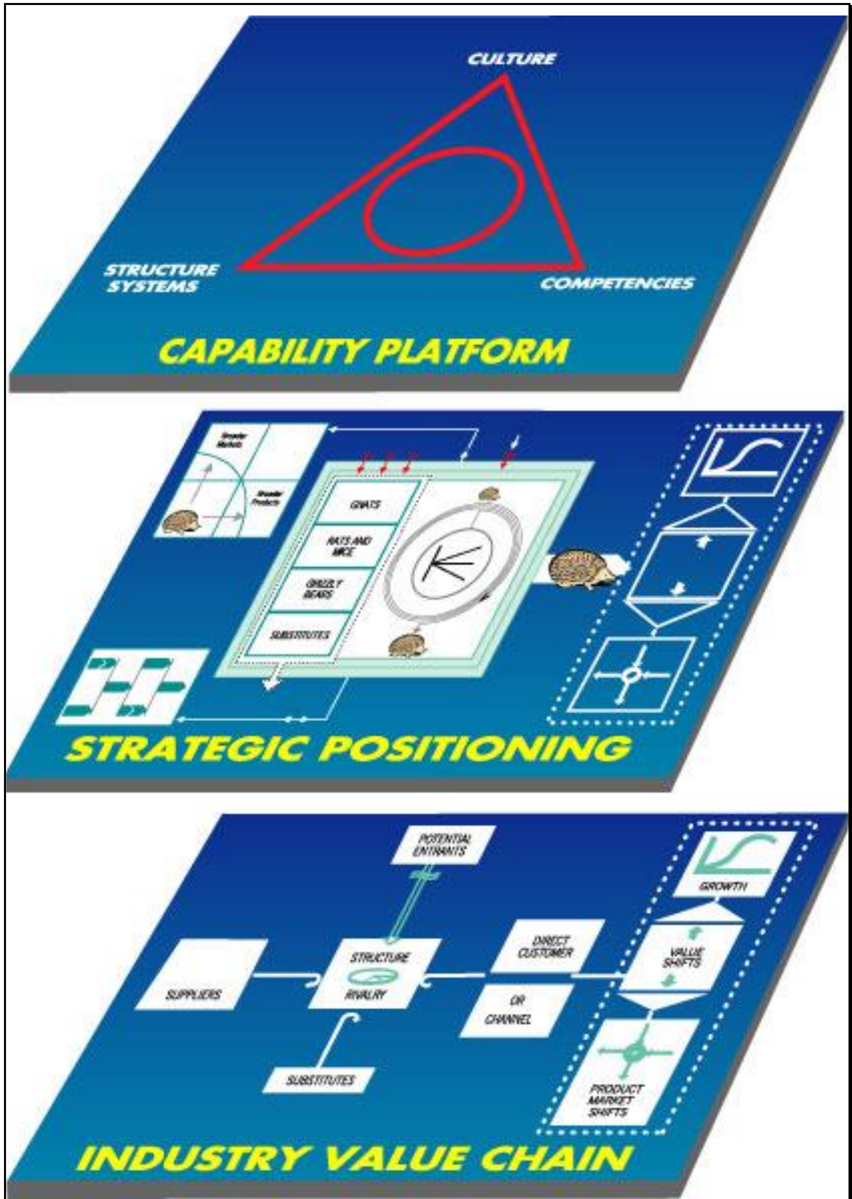


Figure 5.2 Another View of the Processes (from Robert Bruce)

5.3 Basic Issues to be Assessed

Environmental and industry analysis and strategy formulation are long term considerations. They will not provide answers for next week. They are concerned with basic forces that take time to develop and to change.

In some industries, no matter how good the management, there will be forces that compete away any super profits and so the industry is not attractive for investment. Industry analysis provides an analytic framework for deciding upon this attractiveness now.

As mega investor Warren Buffett has said:
"When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact."

Industry analysis seeks to determine:

is the industry attractive?

Attractiveness describes whether the industry is desirable because its characteristics are likely to allow sustained above average profits.

Interestingly, in a 2007 paper looking at major corporations, McKinsey & Co found that most growth came not from picking up market share or even from acquisitions. It came from picking the right industries to be in. This is especially so for large companies that already have considerable market share in an industry.

Strategy formulation next seeks to determine:

how best to compete?

Given the industry's characteristics and the firm's competitive position, what are the best tactics to adopt to tackle the competition it faces? The competitive position is partly determined by the industry analysis and

partly by the more firm-specific tools such as **SWOT** analysis, **value chain, competitive mapping** or other analytic technique.
The aim is to build on the strengths and minimise the weaknesses to take advantage of the opportunities and offset the threats.

A point to note: despite being long term, industry analysis and strategy formulation are not static. They are dynamic and changes do occur. No industry always remains attractive, nor is any strategy forever safe.

6. What Is Happening? Where Is It Going?

Our first fundamental question is: **What is Happening, and Where is it Going?**

In answering the first part of this question, we are well on the way to forecasting the answer to the second part of the question.

6.1 Tips on Scanning the Environment

Keep in mind why you are doing environmental scanning. You want to find out what is happening that will affect your strategy formulation. You are not trying to understand the world or gain the meaning of life.

So employ **filters** in your scanning. Look for what is relevant.

Discard **noise**. When you first cast your net over the wider environment, you are going to catch a great deal more than is useful to you. Most of what you pick up is likely to be rubbish or just background noise. Discard it. It will only confuse and clutter your thinking.

Perhaps only 10% of the data you collect will be of interest. You will want to sieve this still further to pick up the few key points that are critical. Focus on these few points and keep the remainder of the 10% aside for only brief analysis.

When you use checklists like PESTLE, you are NOT required to fill in all the fields of the form. If some items are not relevant, leave them blank.

On the other hand (sounds like an economist!) do not have blinkers on so tight that you are blindsided by something big coming out of left field. Levitt called this marketing myopia. Remember, you do not define your industry, market or competitors. It is your customers who define what is relevant. You need to look at the world through their eyes not yours. Whenever you have doubts if some information is relevant, test it through the perspective of a customer.

6.2 Environmental Scanning

We begin with our heads up and looking at the wider environment. What is happening in the world that affects us?

Later we will focus on our particular market and industry.

So we raise our head and cast our eyes around all that is happening, seeking those factors that are affecting us.

PESTLE Checklist

One method is to use a checklist to catch everything that might be of interest.

In the 1980's the common mnemonic used was PEST.

PEST stood for Political, Economic, Social and Technology. It is a sign of the greater complexity that today the mnemonic is usually PESTLE.

PESTLE or PESTEL stands for Political, Economic, Social, Technology, Legal and Environment. Even this expanded mnemonic of a checklist is facing further expansion. STEEPLE adds Ethics and STEEPLED adds Demographics as a heading separate from Social.

A checklist is just that: a checklist. It does not analyse or synthesise. That follows after scanning the environment for what is affecting us or will affect us in the future.

Under each heading we can have further descriptors to give greater detail to our scanning.

Some of the items to be considered under PESTLE include:

Political:

Environmental regulations and protection
Taxation policy (progressive, regressive, etc)
International agreements and treaties
Government system
Political stability
Election cycle
Government organisation and attitudes
Community attitudes and power
Lobby groups, especially special interest groups in the area of interest (for example, see the effectiveness of community lobbying against coal seam fracking or consumer backlash against Google, Apple and co on global tax avoidance).)

Economic:

Economic growth
Inflation
Interest rates
Balance of trade
Unemployment levels
Taxation
Exchange rates
Stage of the business cycle
Consumer confidence
Degree of competition and industry structures
Availability of key resources
Lifecycles of products and services
Industries in growth or decline
Regions in growth or decline
Savings and investment levels
Degree of indebtedness
Level of economic development

	Infrastructure levels
Social:	Population demographics (who, where, how many, age) Cultural beliefs and attitudes Income levels and distribution Labour mobility Occupations Social classes and mobility Education levels and availability Lifestyle movements Health levels and conditions Living conditions Leisure and lifestyle activities Religions Outlooks, confidence levels Attitudes Welfare levels Consumer behaviours
Technical:	Degree and level of technological sophistication Government and industry spending on research and development Government support (taxation incentives, legislation, etc) Infrastructure support: people; training; capital Rate of new inventions and technological development Rate of patent applications, value of patents, etc Net importer or exporter of technology Rate of technology development and technology obsolescence Rate of technology transfer and take up Degree of innovation
Legal:	Legislation – current and pending

	Independence of judiciary Safety regulations Consumer laws Company and business laws Labour and work place laws Tax laws Enforcement levels Support of laws in the community
Environment:	Legislation and regulations Enforcement Degree of environment degradation Sustainability Community attitudes Critical issues and limitations imposed Global warming (seen by some reinsurers as the biggest threat they face in the insurance industry)

Clients / Customers

Naturally you need to know about clients or customers in the market – both present and potential. You may even want to know about past as to why they are no longer clients (like an exit interview with departing employees).

Some of this information will be quantitative: who are they, where are they, market shares; demand at various price points, demographics and so on.

Qualitative data is also valuable. It can be most interesting, especially when it comes to forecasting. How do customers perceive you and your products versus competitors? Why do they buy or not buy when they do? What triggers their buying decision? Is your product or service bought in isolation or does it have connections to other products and services? How is their buying influenced by income levels and what is the income elasticity? Plus more.

How do you obtain this data? Well surveys have been the traditional method and more lately, focus groups.

These are time consuming and usually expensive techniques. Despite the costs and time they are often not statistically valid. Samples and questions are often biased and survey design can be poor. But if you have the money to spare, go for it. Shopping centre surveys are notorious for interviewing non-shoppers. Those who want to shop are too busy shopping to stop and be surveyed. Only the browsers filling in time are keen to stop for an interview.

There are several other methods to learn about your clients or customers. You should already have data of who buys from you, when they do it, what are the triggers, are they responding to advertisements and promotions and much more. If not, you need to become more sophisticated in your market intelligence. Do not just sell, learn during the selling process.

Many years ago, the first companies signed up to Coles Fly Buys loyalty program were Coles (of course), Shell and Dunlop. Later, Shell was keen to know more about the customers who were using their convenience stores in the petrol service stations.

When asked what information they had from the Fly Buys scheme Shell executives answered they had none! They thought it was just a promotional scheme rather than a data scheme. Coles knew more about the Shell customers than Shell. They knew what they bought, when and where and how far they travelled. Little wonder then that Coles later took over the retailing arm of Shell.

As an aside, it is interesting watch Woolworths and Coles now revamp their loyalty schemes in the face of competition from new supermarket player, Aldi. It was costing Woolworths about $80 million per year to buy fly buy points from Qantas while Aldi just offered lower prices.

A little observation goes a long way. Watch how customers purchase or why they turn away. Interview a few clients in depth. Once you hear a

theme consistently raised, you can be confident you have reliable qualitative information. Also look at who is buying your competitors' products and services and why. Again, a little digging will bring gold. Some companies regularly buy from their competitors to test service levels and other aspects.

You can also try theorising why some clients buy certain services. For example, the up market Gold Class cinemas tend to do better in lower socioeconomic areas than richer ones. Part of the hypothesis is that there are fewer classy opportunities for a night out in the poorer areas so competition from substitutes is less. Another part of the hypothesis is that you are not just selling an up market movie experience. You are selling a relatively cheap gold class experience to impress your date.

So for clients or customers, you have a number of techniques to get an approximate handle on what is happening, including:

polls
\ surveys
focus groups
mining your own sales data
interviews (only a few)
observation
theorise

Product Life Cycle

The product life cycle concept has benefits and shortcomings.

On the shortcomings, not all products or services fit neatly to a unique spot on the cycle. Customer and market segmentation can give differing positions. Nor do products and services necessarily proceed smoothly through the cycle. Finally, the time scale (on the horizontal axis) is rarely given much precision.

The benefits though can be highly useful. The diagram summarises visually the position and the likely trajectory for our products or services. If we can establish a time scale, we learn something of the rate

of acceptance and likely decay. If we plot our portfolio of products or services, we can readily see whether our spread of products is adequate or whether we should have been more active in developing new products as old products age.

Note that when plotting your products or services on the life cycle line, you are normally plotting the position of the product or service **in the market**, not for your particular company or organisation. Your sales may be falling because you are losing market share rather than the product maturing and beginning decline.

This is a critical distinction since the rectifying strategies would be very different. If the product in the market is declining, then you need to consider whether it can be revitalised or whether you should be considering exiting this product. If the product is still in a growth phase but your sales are falling, then you need to consider how to improve your offer to the market.

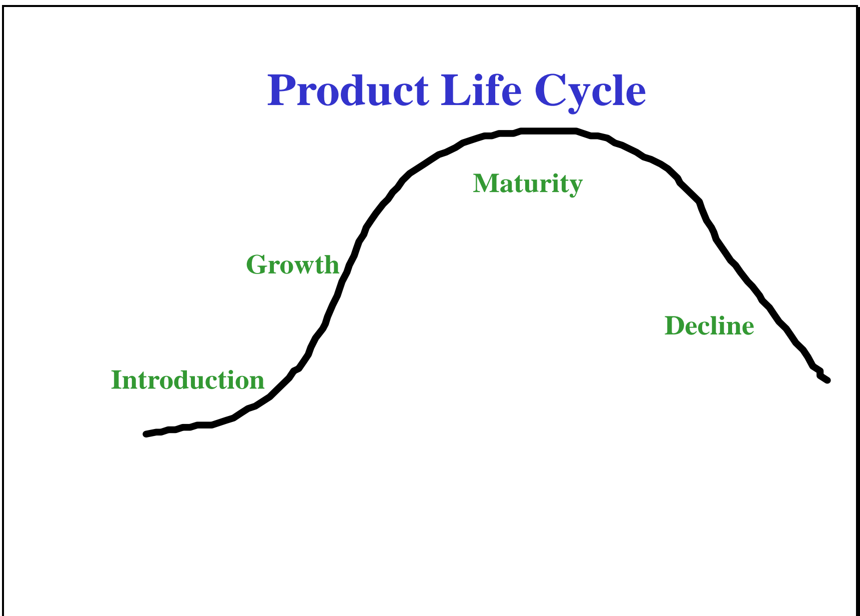


Figure 6.1 Basic Product Life Cycle Diagram

Some generalisations about the Product Life Cycle include:

- Products or services do not need to progress smoothly through the stages. Indeed, one of the tasks of marketing is to revitalise or find new uses for a product. A classic case is bicarbonate soda which has been through several “lives” in the past 100 years from baking to bird food to underarm deodorant to tooth whitener.

- The Introduction phase can have several sub-stages especially around early adopters. This is an expensive and high risk stage for the providers of the good or service until sales reach a break-even level. Hence the efforts to have influential early adopters and hasten through this phase (such as rumours that Apple hires students to wait in line outside Apple stores for a new product release and using “push marketing”).

- Generally the best profits are made in the growth phase when competitors can maintain margins while still all achieving their growth goals.

- Cash flow though is usually best in the Maturity phase when high sales are being made but little new investment in capacity is required.

- The Decline phase can be messy with fights over dwindling sales. However, if most suppliers leave in an orderly fashion (for example if there are few fixed costs or low strategic stakes) the last supplier can achieve good margins by charging high prices to the last few customers who demand the product.

A danger sign is a preponderance of your products in the mature or decline phase. It does not require a crystal ball to forecast future sales and profits. You can be confident of decline.

For example, in 2001, the drug company Pfizer was briefly the most valued company in the world, partly rising on the success of Viagra. But then analysts realised that most of Pfizer's products were coming to the end of their patent protection and end of high margins. The focus of stock analysts was turned to what was in the development pipeline. The development cupboard was found to be quite bare and the market reduced the value of Pfizer dramatically. Pfizer had to go on an acquisition strategy paying hefty premiums for companies with drugs in earlier phases on the product life cycle.

Then in 2015 came the 2nd biggest acquisition / merger in history with the $US160 billion bid for Allergan. To dodge the higher US corporate tax rates of 35%, the acquisition has been styled as a takeover of Pfizer by the Irish based Allergan.

6.3. Analyse the Data

So now you have scanned your environment and you have a considerable amount of data.

Data is NOT information.

You must **analyse** the data to gain information.

As mentioned previously, sift the data. Be prepared to set aside perhaps 80%. It may be interesting but it is not significant to your analysis. Of the remaining 20% that is important or significant, sift further for the key items. There are maybe 4 or 5 pieces of information that do, or will, have a profound impact on your business and must be accounted for in your strategies.

6.3.1 Interrelations

A major step in analysis is to look for interrelationships in your data: especially cause and effect.

You may be able to simplify some of your data (remove some observations) if you find several observations correlate to each other: they all move in the same direction at the same time. In which case, you <u>may</u> be able to partly ignore some of your observations. Also, the observations may be moving together because they are all being affected by some underlying, causal agent.

Is your data or observation a result or outcome of some other factor or is it a causal agent? Dig until you find the causal agents. These are the real determinants of what is happening.

Consider whether there are triggers or blocks. We will return to these factors when we forecast the future.

6.3.2 Trends

Look for trends. Again, this will be important when we are forecasting. A trite but true quip in financial markets is "*the trend is your friend*". You still need to know the causal factors of these trends. It is the causal factors that will determine the strength and pace of the trends.

Megatrends

Megatrends are the big, rolling forces that are like a glacier: inexorable rather than slow. Such trends are often socioeconomic and should normally be obvious.

Demographic trends are an obvious example. Even governments have picked the aging populations in first world societies. Better yet, they have analysed what this means in terms of work forces, tax bases and spending on aged care and health. The Australian Government introduced compulsory superannuation guarantees in the 19080's to meet a crisis in pension funding 30 or 40 years in the then future.

Other trends are more subtle but just as compelling. Greater environmental awareness, growth of information networks, transacting via the internet, increasing health consciousness about foods, attitudes to road safety and the like are trends that keep going.

Such trends are there to see if we are not myopic. It took McKinsey and Co until 2005 to recognise that China was rivalling the USA as an economic power. Homer Simpson knew it several years earlier. When he was bemoaning his fate, daughter Lisa reminded him he was a member of the world's greatest economic superpower, to which Homer replied: *I'm Chinese?*

Microtrends

Moving from the overarching megatrends that may be across the entire society, we may find it useful to consider microtrends. These are not just small movements but rather large movements localised in either geography or by market segment that is of particular interest to us.

It may be that a new transport interchange has redirected consumer traffic either towards or away from us. Perhaps changes to food laws have required fast food outlets to state the calorie content of their burgers and shocked consumers are now turning to healthier eating choices in droves!

A different aspect of microtrends is to look at emerging trends. Mark Penn and E Kinney Zalesne published their book <u>Just 1%: The Power of Microtrends</u> in 2015. They argue that "society is being pushed and pulled by microtrends that involve as little as 1% of the population". The book argues to consider megatrends emerging from today's microtrends. However, there is little evidence that most of such microtrends will grow to full blown megatrends or how to pick which ones might.

6.3.3 Direction and Pace

Obviously, if you have detected a trend, it is moving somewhere. Clarify the direction and the pace.

6.3.4 Synthesise

Having scanned the environment and analysed the data for what is important and key, you have then looked for correlations, patterns and trends. You know and understand the driving forces affecting you and your operations.

Now you add value to your analysis by synthesising all your information to draw meaning. You want to answer: **So What**?

So what does this information mean for your customers, your market, your operations, and your position in the market? Do you have the right products and services for the future? Should you be getting out of some products or markets? If you can see this before the general market, you can buy in without paying a premium or you can leave without having a fire sale.

Be logical and not attached to the old ways because you have always done it that way. The market does not care about your history other than it might show you have some credence.

Try to state what is happening in a simple and logical statement that catches the key points. This will also help you communicate your view to those you need to influence and co-opt to your side.

Example: How GPT lost $100 million by not understanding the environment

GPT is a publicly listed property trust on the Australian stock market. They focus on shopping centres.

In 2004, it began quietly acquiring the properties on two blocks of land in the Newcastle CBD. The intention was to build a mega shopping centre as part of the revitalization of the Newcastle CBD.

The heyday of CBD shopping centres was in the 1950's and 1960's and Newcastle was no exception as seen from the photo of the 1950's below.

HUNTER STREET, NEWCASTLE. N.S.W.

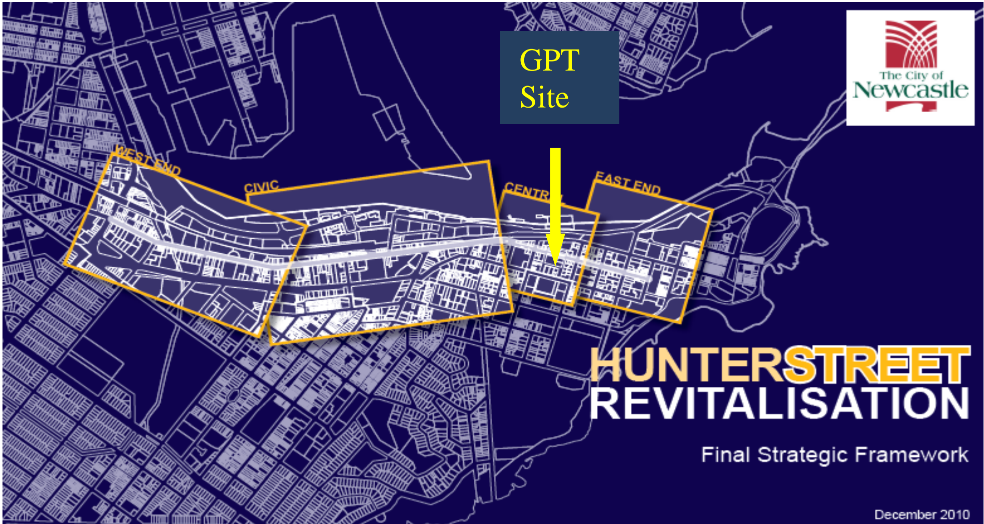
But then family cars became more ubiquitous, mothers were driving and refrigerators and freezers grew in size. During the early 1960's, Coles pioneered large regional supermarkets and in 1965 the first large regional shopping centre opened at Roselands in Sydney.

Now, instead of travelling by public transport to the CBD, family shopping was done at regional centres: supermarkets, department stores and specialty stores all at one location with parking.

Somehow, GPT thought that it could reverse all these forces and return shoppers to the centre of Newcastle's CBD.

Strangely, GPT even owns and operates the nearby large regional shopping centre at Charlestown. Westfield has a centre nearby at Kotara. These centres would be in competition to the proposed Newcastle development.

Between 2004 and 2012, GPT spent some $120 million on acquisitions, studies and plans. But it was never going to fly.



Below is Hunter Street in 2012.

The final nail in the coffin involved poor mundane environmental scanning. It was realised that parking was needed to be provided if the

centre was to have any chance of succeeding. When GPT began excavating for a car park, they realised they should have checked on Newcastle's history: the site was riddled with old underground coal mines! This was the last straw but it was not the killer. If the concept was viable, they could have considered rooftop parking or an adjacent site for parking.

The real issue was there would never be enough customers. Even the last anchor tenant of the site, David Jones, gave up its lease – it was already at Kotara anyway.

So GPT blamed the nearby railway line for the failure rather than their poor understanding of forces. This has ended with the rail line into the centre of Newcastle being torn up when there were several alternatives other than wanton destruction.

In 2012, GPT sold an 80% interest in the land to the State Government property agency, Landcom, for just $20 million.

Amazingly, having botched the analysis of the environment, GPT was unable to raise its head and think of anything other than a shopping centre. Landcom changed strategy and instead planned mixed use more suited to the local environment with professional offices, residential apartments and some specialised retailing. GPT lost $100 million by not understanding quite obvious trends.

6.4 Where Is It Going?

This is the big question. After all, we are devising strategy for tomorrow, not for today.

Many budding strategists baulk at this point, saying the future is unpredictable.

Perhaps they are channelling St Augustine (354 – 430 AD)

"The good Christian should beware of numerologists [sometimes translated as mathematicians] *and all those who make empty prophecies. The danger already exists that mathematicians have made a covenant with the devil to darken the spirit and confine man in the bonds of Hell."*

Certainly, it is easy to look very stupid when making specific forecasts. Leading economists in Australia are asked each year where they think the economy will be in one year's time: forecasting economic activity; interest rates; exchange rate, etc. The results are published in a national newspaper. For the past 13 years, the majority have not even had the direction of movement correct in 10 of those 13 years. That is, if they thought the exchange rate would rise, it fell and so on.

Renowned economist Paul Samuelson's joke that some economists have predicted 9 out of the last 5 recessions is wry.

The comment by US financial journalist Jane Bryant Quinn is apt*: "The rule on staying alive as a forecaster is to give 'em a number or give 'em a date, but never give 'em both at once."*

As strategists, we need to have a view of at least which direction we are moving. Market forecasters, stock and bond traders and horse punters need to do the same. But then the wise forecaster appreciates the probabilities and scope for error and may hedge the bets: either laying off some of the risk or having contingency plans. We will return to this point later when devising strategies and considering the attribute of flexibility.

We need to take some view of the future in order to act decisively.

"Strategy is visioning what the future will look like and then stretching the firm's skills in order to position it to take advantage of that future." (Gary Hamel)

6.5 Art and Science of Forecasting

This topic can be a tome in itself. Contrary to the philosophy of David Hume, we can rationally predict the future – at least the direction - some way ahead with a reasonable degree of probability. Some techniques and some common sense go a long way.

6.5.1 Forces of Change

Newton's first law of motion states that a body remains at rest or continues in a straight line unless acted upon by a net force.

The same applies in strategy. Albeit it is more complicated than determining the arc or trajectory of a cannon ball as gravity pulls it towards the Earth' surface. In strategy, we are looking at many factors and need to determine the overall net force for change.

Some forces are quite inexorable. They are obvious and large and unlikely to alter in the short term. Often these forces are referred to as megatrends. Aging populations in most developed countries are a megatrend unlikely to alter direction in a hurry. Even China's final relaxation of the "one child policy" in 2015 is expected to have little impact for 20 years or so.

Some social trends are similar, Kenichi Ohmae says that as populations became more educated and information more accessible that the people lose faith in governments and religion. What does this mean to our social structures?

Megatrends and forces should be readily apparent. You now need to determine what such trends mean to you, your market and your industry.

Localised trends can also have major impacts in their immediate location. Changes in transport infrastructure or employment opportunities can have major flow on effects. The large property developer Australand considered local employment levels to be the best

predictor of the success of a major property development over the coming few years.

6.5.2 Inertia

Newton's second law of motion can be stated as implying that the force needed to move an object is in proportion to the mass of the object. Massive objects require a great deal of force to have them move: the public service; political self-interest.

To any movement, there is likely to be some resistance (not equal and opposite as in Newton's third and final law of motion). So it is unlikely that movement and change will proceed smoothly. There may be revolution and counter revolution.

History does matter and has some impact on most futures. Change is typically more evolutionary than revolutionary.

For example, there is a notion in finance called the **Random Walk Hypothesis**. It states that in an efficient market, all the known information about a security (share, stock, bond, interest rates, currency, etc) is already embodied in the current price of that security. If you accept this concept, you see that all the finance pundits are blowing hot air. Saying that iron ore prices are falling and therefore the Australian dollar will fall over the next 12 months is non-sensical. All the information about future iron prices and their effect on the exchange rate should already be factored into the exchange rate now. We even find this in interest rates: not the short rates that hit the news headlines but the 10 year bond rate.

The Random Walk Hypothesis also suggests that if new information comes that say calculates BHP share prices should fall from a current $40 to $20, then that will happen virtually immediately.

The problem is that the prices rarely fall that dramatically instantly. It seems that markets have a "memory" and in most cases cannot bring themselves to make the full adjustment straight away.

Even the dam disaster at BHP and Vale's mine in Brazil took about a month for the BHP share price to fall from $40 to $20 (and then even lower).

The market "remembers" the $40 share price and that is factored into the new appraised value even though the newly known fundamentals calculate a value of $20 per share. Over several weeks or months, the share price will drift towards the $20 unless new information arrives which causes another reappraisal.

Memory by markets and people forms an inertia that slows down radical change.

6.5.3 Underlying Causes

Remember that underlying causal factors are much more interesting than casual factors. Causal factors are leading to the change rather than just being symptoms of the change. Understand the causal factors and you are well down the path to more accurate forecasting.

Many years ago, your author was involved in the production and marketing or particleboard. Particleboard commenced operation in Australia in the 1960's with the CSR company as the first producer.

By 1980, CSR was no longer the major producer and needed to solve quality issues from its older plants. The company had a penchant for engineering solutions to every problem. The overall particleboard market demand in Australia had been growing at an annualised rate of over 7%. This is quite high and extrapolates that the industry is doubling in size every 10 years. So CSR embarked on a strategy of building new plants every few years at huge capital cost.

A product manager tried to point out that such growth rates were not sustainable long term. A little investigation found that more than half the annual growth rate was NOT demand for furniture products where particleboard was used. Rather, it was mainly a **substitution effect** as

particleboard replaced timber and plywood in wardrobes, cupboards and the like.

Now we know the underlying causal factor for the historical high growth rate: substitution of timber and plywood. So the key piece of information in forecasting was how much more substitution was possible. By 1980, the product manager reckoned that the substitution was just about complete. The only pockets where particleboard was not used were in high end furniture and in tropical Australia where the high humidity destroyed the particleboard. This meant that future demand for particleboard would fall back to overall demand for furniture.

CSR did not accept this and went ahead building the new capacity the engineers enjoyed. The capacity came on stream as Australia hit its worst recession since the Great Depression, in 1983. Demand fell 30% in that one year. The substitution was over and CSR had massive over capacity by not understanding or accepting the underlying cause.

6.5.4 Pace of Change

Not only the direction of change but some feel for the pace of change is helpful.

Western thought tends to be linear in projections. Such simplistic projections are really little more than extrapolations – extending the trend line.

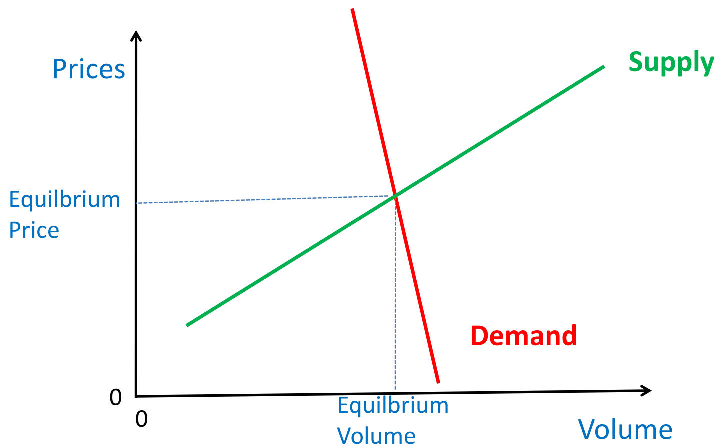
Real life is much richer and more complex. History and understanding underlying causes will help us to determine acceleration and deceleration of change.

Is the market cyclical? Is the demand for the product or service derived demand? Mining company Pasminco did not really understand that demand for its main product, zinc, was totally dependent on the demand for galavanised steel products (zinc coating is the galvanising). Worse, they did not understand the dynamics of the market where China was the biggest producer of zinc but also the biggest user. So Chinese

demand was critical to prices and Chinese stockpiles and galavanised steel output were the two key factors to understand.

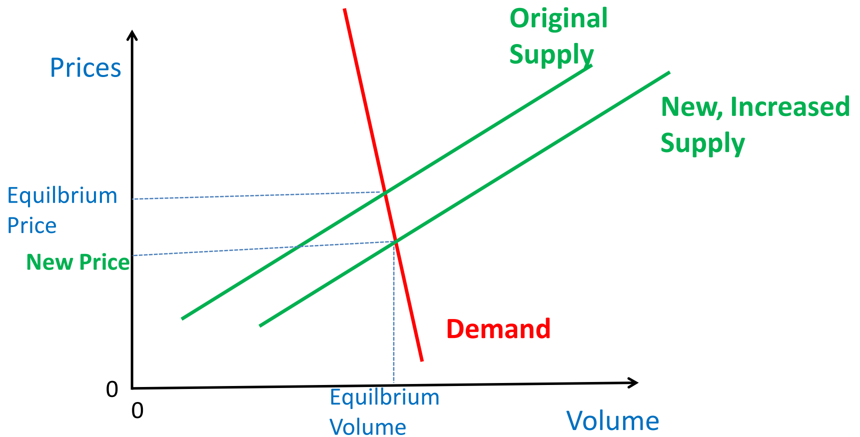
Curiously, Pasminco unwound its entire zinc price hedging just before it increased world supply by 20% with its huge Century mine. Some basic economics can forecast what would almost certainly be the result.

Zinc Supply and Demand



The demand curve is steep to show that demand is relatively price inelastic. That is, a change in price has little impact on the quantity demanded. Lowering price does not stimulate much demand since it is the demand for galvanised steel (to go to cars and the like) that is the prime determinant of the demand for zinc.

To show the effect on the equilibrium price of an increase in supply we shift the supply line to the right.



Since the new Pasminco mine was a 20% increase in world supply, we shift the supply line or curve 20% to the right. Where the new supply curve intersects the demand curve will be our new equilibrium price as shown above. The result has to be a drop in equilibrium price by much more than 20%. In fact, the result was a drop in world zinc prices of nearly 50%.

It is amazing that Pasminco wound out its zinc price hedging just before announcing the massive expansion in world supply. They did however, keep currency hedging but they speculated rather than hedged – again because they did not know what they were doing. They lost over $1.5 billion on their currency hedging in the hope that the Australian dollar would rise to over 70 cents against the US dollar, Instead it fell to under 50 cents in the 2000 – 2001 global recession. So much for forecasting and analysis!

6.5.5 Triggers and Blocks

A further technique to advance your forecasting beyond simple extrapolation is the concept of triggers and blocks.

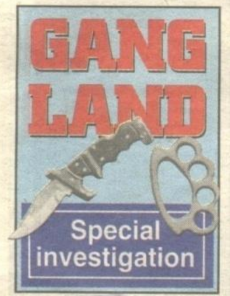
The concept was popularised by Malcolm Gladwell's book, *The Tipping Point: How Little Things Can Make a Big Difference* (2000). However, the concept and technique is much older.

Forces for change may be building but there is no movement because of some block in the way. Alternatively, there will be little movement until some trigger is pulled and then there will be an explosion of activity.

To give an example, in the 1980's the NSW Police Force was trying to think beyond reactive police enforcement. The then Deputy Commissioner, Jeff Jarratt, had just completed his MBA and asked two of his Strategy lecturers for assistance. Among various topics, they were trying to understand youth gangs and what to do about them.

The first move by the strategist was to define the mission and bring focus to a complex issue. What did the Police Force mean by "youth gangs"? There is a spectrum ranging from the Boy Scouts (probably not much problem) through to the then notorious 5T gang involved in drug distribution, extortion and murder.

What the study found and recommended was that most youth gangs were <u>not</u> a major problem. Most complaints came from shopping centres that did not want them loitering. The Cat Stevens' (now Yusuf Islam) song *Father and Son* has the apt lines of



City street gangs crisis

EXCLUSIVE

By BRUCE McDOUGALL

FIFTY street gangs with an estimated 1500 members are committing a range of crimes throughout NSW.

And a secret report to police warns that a major crackdown is needed.

The report detailing gang crimes from graffiti and theft to extortion, intimidation, drug dealing and murder, accuses police of failing to keep adequate data on gang members and having a "very poor image" with Australian youth.

It says there is potential for street gangs in NSW to expand their activities into more serious crime and strong action is needed to stop them.

The report, a copy of which has been obtained by *The Daily Telegraph Mirror*, claims some of the groups now rival feared and organised motorcycle gangs in their methods and criminal activities.

It is believed about 50 street gangs, 40 of them in metropolitan Sydney, are operating around the State with member-

Continued Page 4

"find a girl, settle down, if you want you can marry".

In effect, most youth gangs "age out". Eventually gang members find a girl, a family, a mortgage, a job and they settle down. So the report recommended little action than watching for most youth gangs.

Typical of strategic analysis, this then released resources which could be focused for maximum effect. Now take your policing resources and concentrate on the most dangerous of the gangs. You gather evidence and target the leaders. Once the leaders are jailed for several years, these worst gangs are generally mortally wounded.

But…….. The strategic report also warned of triggers that would take a gang from benign to dangerous.

The two triggers to watch for were:

1. Girls now associated with the gang
2. Defending a territory

Now the gang would not age out. They had the girls within the gang environment. If a gang was defending a territory, this was almost certainly because the gang was a major drug distributor in the territory and might perhaps have a side line in extortion / protection rackets. You will note that the same characteristics apply to motor cycle gangs and similar groups. Once these triggers were observed, resources should be devoted to the gang to destroy it.

How was the analysis for these triggers derived? By observation, theory and logic! Partly in observing other examples such as the motor cycle gangs and development of youth gangs in America and elsewhere. Some common sense analysis gives us early warning triggers.

In terms of strategy with youth gangs, we have considered the future and focused scarce resources for maximum impact.

As an aside, the popular press managed to distort the analysis. The article on the right of the previous page is from the front page of the

Daily Telegraph in NSW. It talks about a secret report on youth gangs. It was not secret – it was sitting in the library of the Police Academy for study by the thousands of new recruits.

The article quotes from the Executive Summary (did they even read the rest of the report?) saying the report to police *“warns that a major crackdown is needed”*. Unfortunately it was a slight misquote in that it left the word *“not”* out of the statement.

It is appreciated that the main purpose of newspaper stories is to sell newspapers. Why spoil a simple and dramatic front page story with facts and complicated analysis?

6.6 Disruptive Technologies

We have seen that forecasting is not impossible. It will not be exact but we should at least aim to have the direction correct and some estimate of the pace of change.

A warning though that sometimes we can go very wrong!

Typically this is because something comes out of left field where we had little or no warning. The “in” phrase today is **disruptive technologies**.

Economists have referred to this concept for decades as exogenous shocks. “Exogenous shocks” is probably a better term but not as marketable. Not all shocks to our forecasting are from technology innovations. They might be a social attitude change. Drink driving is one where social attitudes changed from *“bad luck about getting caught, mate”* to *“you irresponsible and dangerous idiot”*. In a similar vein, it has been fascinating to watch police culture in NSW change from a hard drinking culture to abstinence and responsibility on the job. Not by coincidence did this happen under a teetotal Commissioner, Andrew Scipione. This change in internal police culture then extended to Police lobbying against alcohol as a social and order problem leading

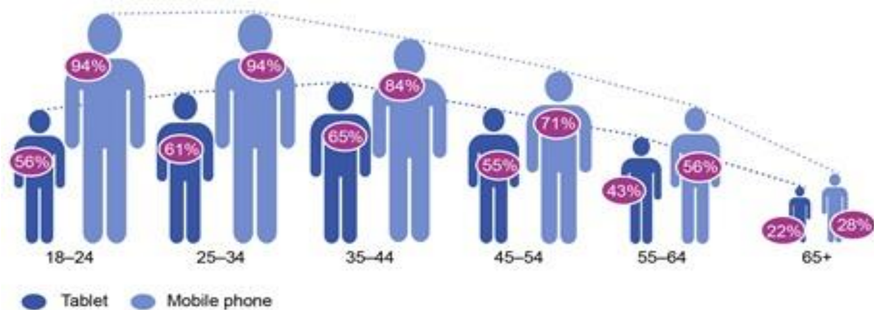
to pub lockouts. Hospital emergency departments stepped forward as vociferous allies of the Police actions.

Likewise the change may be political such as China banning Google or stopping visas for Chinese gamblers going to Macau.

Admittedly though, it is frequently some unexpected technology that sweeps away our assumptions and projections of the future. Finland blames Apple for the demise of Nokia and hence the Finnish economy because of the success of the iPhone.

One Australian economist with a good predictive track record projected home ownership of a personal computer to reach 90% of households by 2015 only to find the penetration was much lower. Residents took up iPhone and Android internet capability as more flexible than using a personal computer.

Mobile phone success has even curtailed the rise of tablets which grew rapidly from their main introduction in 2010 but are now mainly used as readers. By 2014, phones had beaten tablets across all age groups for access to the internet as shown below.



Use of tablets versus phones to access the internet.
Source: ACMA Commissioned Research, May 2014

What can you do about disruptive technologies? You can try to monitor and catch them, perhaps have contingency plans. But the term

“**exogenous shocks”** reminds us they are unexpected: often catching us by surprise. As such shocks become more the norm, we need to give greater consideration to how rigid we make our strategies or how dependent our market offering is on just a few product or service features.

Covid19 or the Coronavirus has been a massive global exogenous shock with profound and long term effects. But in today’s very connected and mobile world, such swiftly developing shocks may become the new norm.

Allowing for some flexibility in our strategies and agility in our responses becomes more critical. As well, we need to have more hooks or benefits to our customers rather than just one or two product features that may be in for a shock.

6.7 Summary of Environmental Analysis

We have been concerned in this chapter with answering the first of our 3 strategic questions: **What is Happening and Where is it Going?**

We have used our Mission and objectives to give us some focus in a wide and bewildering world.

We have used checklists like PESTLE to scan our environment and perhaps detect trends. We may use the Product Life Cycle to see how our products and services are aging.

Importantly, we have not just been descriptive. We have synthesised the data into what is critical, what is important, what is interesting but not important, and what is just “noise”.

We have added value by analysing the information for what it means to us and our markets. In particular, we have looked for causal factors. We may try to strip it down to the few critical or **key success factors** we must account for in our strategy formulation later.

We then need to determine the direction and pace of change which leads us to forecasting. Forecasting is not precise but some technique, logic and common sense will improve the reasonableness of our prognoses and boost the probability of our "accuracy".
We realise that change is not necessarily linear or a simple extrapolation of the past. There may be triggers or blocks that mean little change until a sudden release of force and movement.

A final complication is the growing frequency of exogenous shocks or disruptive technologies. In an interconnected world, such shocks may come from outside your immediate location. You now need to scan the world, not just your backyard.

In the end, we need some view of what is happening and what will happen since our strategy formulation is for tomorrow.

In the next chapter, we will consider one further refinement in our analysis of our environment and its future direction. Now that we have a view about our general environment, we will look specifically at what is happening in our particular industry.

7. INDUSTRY ANALYSIS: PORTER'S MODEL

7.1 Position of Porter's Model

We are still answering our first question of **what is happening and where it is going**: our external or environmental analysis. We now go from the broad environment to bring our focus more directly on what is happening in our industry.

Porter's five competitive forces model is outlined here. In the 1980's and 1990's Porter Analysis, as it is known, was the backbone of most MBA strategy courses.

It is symbolic of the greater complexity of strategic analysis today that Michael Porter's model is just one of many tools we now use in assessing the environment. We need our techniques from the previous chapter to analyse the broader environment in which our industry operates before focusing on our industry.

Central to Porter's model is competition. Michael Porter was a microeconomist who translated microeconomics into a strategic model that could be understood by business managers! At the heart of microeconomics are the firm and the degree of competition. So it was almost a foregone conclusion that competition and industry structure would take centre stage in Porter's model. Porter called this force Internal Rivalry.

Internal rivalry or competition remains a powerful force in most industries. Microeconomics also had the concept of **consumer sovereignty**. This did not give regal status to the consumer but was a technical point that many consumers would be willing to pay above the market price for the good or service but need not do so. (Customer

segmentation is a tactic where companies try to extract some of this "free" value to consumers).

Today however, for many reasons including market knowledge (internet and social media) and government trade practices legislation and global competition, consumers have more power than ever. The global consulting company McKinsey & Co has stated that in this century consumer sovereignty has been replaced by the concept of consumer tyranny. Consumers are able to demand and get better quality, service and more and at lower prices.

Porter's model is enhanced if more attention is devoted to customers. Certainly today, much more attention is given to analysing consumer power in understanding industry forces.

Porter initially labelled this market force "Buyers" and it was a general catch all for the market. Separating buyers into the direct buyers of the product or service (customers or distribution channels) and into the users or end consumers of the product or service normally provides more useful detail. Considering changes in consumer preferences gives further insight e.g. through use of the product life cycle concept. Then we may consider particular market segments and their characteristics.

7.2 Outline of Porter's Model

Porter's Model is usually referred to by its "5 Forces" or simply Porter Analysis.

His 5 forces are:

- Suppliers
- Buyers
- Threat of New Entrants
- Substitutes
- Internal Rivalry (or Competition) as the central force

It is sometimes argued that because of its pervasive impact, government should be recognised as a 6th force. Porter argues that it is simpler to limit the framework to the 5 forces and treat government by how it influences each of those forces.

Under a brief description of each force below, a list is given of the major factors determining the impact of the force. In the analysis of any particular industry, some of these factors will be relevant and others will not. As well, research will probably be needed to calculate the effect of each factor.

In practical terms, the first difficulty is how to **define the industry** i.e. where to draw the boundary within which the industry lies. For example, should we look at the "wine industry" or is it wider to be the "alcoholic beverage industry" or wider still to be the "legal recreational drug industry" or whatever. Furthermore, do we look at the industry within just one country or do we consider it regionally or even globally? Or should we segment between fine table wines, casks and mixers? What about by varieties of wine?

Don Taylor and Jeanne Archer in their books *Up Against the Wal-Marts* define a competitor as anyone after your customer's dollar or time. It is a good definition to guard against market myopia but it is very broad and would make your analysis impossibly exhaustive.

There is no perfect answer. We need to remember that when we define an industry, we are applying our own simplifying constructs or definitions. It will never be a completely true representation of the industry. We should also guard against defining our industry by the products, services or technology we use. Customers define an industry not suppliers.

In part, we partly overcome the industry definition problem by how we use the category of "Substitutes". If we define the industry very tightly (e.g. bottled wine in one country) then the wider industry will be analysed by considering alternatives (flagon or cask wine, beer, spirits, etc and imports) as close substitutes. Such substitutes would be given

considerable attention but not as much as internal rivals. Further away as substitutes may be soft drinks, coffee or narcotics and these would receive more cursory attention.

In the end, remember that the model is only a guide and a tool. It is there to put some order and framework to what is really a very complex situation. The analysis aims to help you identify major forces and their interrelationships. Just be aware that it is always a simplification and is always subject to change.

To simplify your analysis so that it can be done in a timely manner, a practical tip is to define the industry tightly where possible. Then use gradations of substitutes for further analysis.

7.3 Porter's 5 Competitive Forces

Michael Porter developed a reasonably straightforward framework out of microeconomics to help understand what drives an industry and whether it will be attractive (long term profitable).

The great benefit of Porter's framework is that it stops us from being ego centric and just concentrating on our company and close rivals. It reminds us that there are many other players that make up an industry: suppliers; buyers; new entrants; and substitutes.

The internal rivalry or competition may be gentle but still little profit accrues to the competitors because one or more of the other forces is able to draw most of the value in the industry to itself. For example, customers may have most power and can demand quality product at low prices, to the detriment of the competitors' profits.

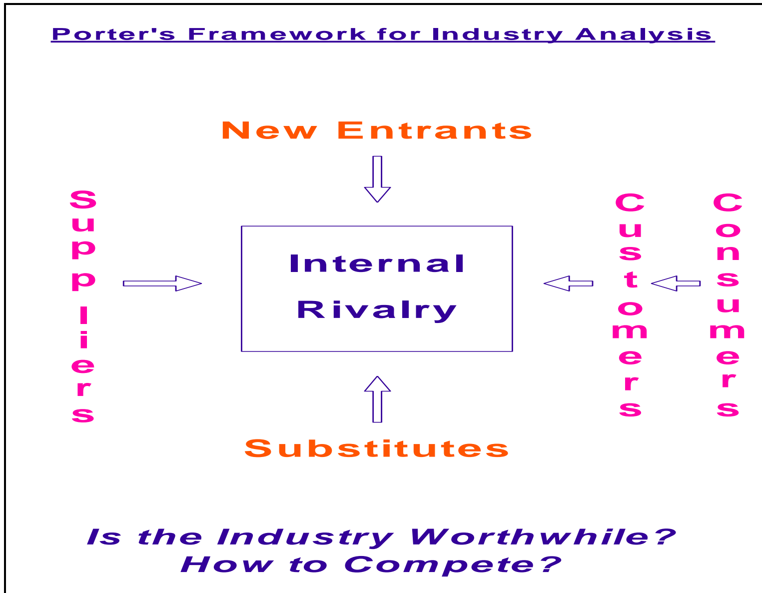


Figure 7.1 Porter's 5 Forces Model (modified with customers and consumers)

Internal Rivalry

Internal rivalry is competition that operates between producers in the same industry. Rivals are mutually dependent (especially in an oligopoly). The greater the intensity of the rivalry the less profitability is likely to accrue to producers. An attractive industry in terms of profitability has low rivalry.

How intense the rivalry will be depends upon:

Number of Competitors

Relative Size of Competitors to Each Other

Diverse Competitors

High Fixed Costs

Lack of Differentiation

Lack of Switching Costs

Capacity Increased in Large Lumps

High Strategic Stakes

High Exit Barriers

Slow Market Growth

Note: no single factor is definitive in itself. For example, having many competitors is normally considered to be a negative influence on obtaining and maintaining above normal profits. However, if the industry has some large competitors able to enforce competitive discipline or if there is considerable differentiation in the offerings, and high switching costs for customers, then competition may be quite low.

Consider the example of Microsoft and its ability to maintain reasonably high margins and profits in the software markets where it operates despite the myriad of competitors.

Alternatively, just a few competitors may lead to intense rivalry if there is little differentiation, high fixed costs (which makes the rivals very volume sensitive) and slow or declining market growth. Consider the examples of the domestic airline industry when it moves from 2 to 3 major airlines or the building materials industry when there is a cyclical downturn.

You need to consider all the factors holistically to determine the overall intensity of competitive rivalry.

Threat of New Entrants

An attractive entry will attract players to enter the industry. If new firms can easily enter the industry, it will be competitive and profits

will decline. (Ease of entry is one of the assumptions of perfect competition in microeconomics). Such an industry will not be able to sustain above normal profits for the rivals.

How easily new firms can enter the industry depends upon the barriers to entry:

Economies of Scale

Product Differentiation

Capital Requirements

Plant Increased in Large Amounts

Switching Costs

Access to resources (materials, people)

Access to Distribution Channels

Cost Disadvantages Independent of Scale

Expected Retaliation

Government Policy

Substitutes

The effect of substitutes on the profitability of the industry will be dependent upon how close the degree of substitution is (cross elasticity of demand) and the relative pricing between the substitute and the industry product.

This sounds good in theory but is very difficult to quantify in practice. For example, what is the cross elasticity of demand between wine and beer? As traditional markets break down, substitutes now come from further afield.

Suppliers

If suppliers to the industry are in a strong bargaining position they can force costs up and profits down in the industry being analysed.

Suppliers include labour, providers of raw materials and other inputs, capital and even management. Factors that influence the bargaining power of suppliers include:

Concentration of Suppliers

No Close Substitutes

Industry is Not an Important Customer of the Suppliers

Suppliers' Product is an Important Input to the Buyer's Business

Suppliers' Products are Differentiated

There are Switching Costs

Supplier Group Can Threaten Forward Integration

Buyers

Strong bargaining power by buyers limits prices and profits. Most strategists today find this group to be too important and influential to be just lumped as buyers. It is preferable to split buyers into two distinct groups: customers (or channels) and consumers. For a manufacturer, the customers would be the retailers while the consumers would be the actual end users. These groups have differing needs and power.

The strength of buyers is determined by:

Purchases are a Large Proportion of Seller's Total Sales

Products Purchased are a Large Fraction of Buyer's Costs

Products are Standardised or Undifferentiated

Low Switching Costs

Buyer Has Low Profits

Buyers Can Threaten Backward Integration

Product is Unimportant to Buyer's Products or Services

Buyer Has Full Information

If we break this category into customers (or distribution channels) and consumers, we can find more competitive determinants.

For example, some distribution channels have managed to use information as a major competitive force. They keep their suppliers ignorant of the final consumers and their needs while providing great service to their end users. In the end, such distribution channels come to “own the customer” and have considerable strength over the providers of the goods or services. An example would be the major insurance agencies or the mortgage brokers.

7.4 Quantifying the Forces

You may have realised another weakness in the Porter analysis. It does not readily quantify the strength of each force on the industry attractiveness. It is more of a checklist that requires some judgments to be made on the overall impact.

Some analysts seek to provide a score for each of the major forces or provide ticks and crosses to see which forces are favourable and which are negative to the overall industry attractiveness.

Even such rudimentary quantification is limited. It does not provide a weighting of the importance of each factor. In some cases, the internal rivalry may dominate all the other factors. In other cases, it may be the customers who dominate.

When Fosters (already a large wine producer) acquired the largest wine producer in Australia – Southcorp for $3.8 billion – there were

statements about controlling or dominating the market due to the combined market share of around 40%. However, this ignores the dominance of the two large supermarket groups – Woolworths and Coles – who channel some 60% of all wine in the market. Even if Fosters held 100% market share, it would be unlikely to "control" the market against such powerful buyers who could threaten backward integration, encourage new entrants or simply import.

7.5 Forces and Movement

A major benefit of Porter Analysis is that it is analysing **forces**. Forces move an industry. So the analysis is partly to understand the industry today but more importantly to understand in which direction is the industry heading and at what pace.

An industry may be attractive today but our analysis may show the attractiveness waning in coming years. So we cannot sit idle. We need to make decisions and take actions to strengthen our position or maybe exit the industry before there is a general awakening to its decline.

7.6 Change

A word of warning: The analysis is not static. It changes over time. Change can happen just due to the passage of time. For example, the market becomes saturated or it declines due to demographic reasons.

External to the industry, new substitutes may be devised. New technology or government decrees may take effect and so on.

As well, participants in the industry attempt to constantly alter the forces to improve their own bargaining position in the industry. Since the play for profits in an industry is a zero sum game, to squeeze more profit for one group means taking profit from other groups.

This is what strategy is about!

8. ASSESSING YOUR POSITION

Our second fundamental question is: **What do we have going for us (our capabilities)?**

Once the **external analysis** has been completed, an individual firm in that industry needs to make an assessment of its **own competitive position** within the industry – for both now and for the future.

A related concept is the firm's capability platform: what does the business have going for it; what is it good at; are there serious shortcomings (gap analysis)?

There are several methods or techniques available. Some are as simple as considering market share (similar to the BCG matrix). Others become complex, looking at the firm's position in the value chain and what can be done to increase the value added.

8.1 SWOT Analysis

An old but potentially effective method is **SWOT** analysis. The basic idea is to determine the significant:

Strengths

Weaknesses

Opportunities

Threats

Most companies have carried out a SWOT analysis. Most companies find it unsatisfying. They return the next year to repeat the same fruitless exercise.

Below are some tips to improve your next SWOT analysis.

SWOT analysis is **relative**. A factor is only strength if you have it more than most of your competitors. It is only a weakness if you have it worse than most of your competitors.

So really, you cannot do a proper SWOT analysis without knowing and understanding your competitors' strengths and weaknesses too! If still in doubt about whether or not some factor is a strength or weakness, view it from your customers' perspective, not your internal viewpoint.

Try to concentrate on the **key** or major strengths and weaknesses. List the 5 or so critical issues. There is too often a tendency to try and list as many strengths or weaknesses as possible. Keep focused.

Be **objective**. Some optimists want to list all possible strengths and believe there can be no weaknesses in their organisation. Alternatively, we have pessimists who indulge in self-flagellation and dredge up every problem in their organisation. In truth, most organisations have some major strengths and weaknesses. Where a strength or weakness is claimed, is it supported by facts?

Avoid vague discussions. Most SWOT analysis sessions are spent with groups tossing around views and voting on issues. Research beforehand and bring numbers and data to the analysis. So if you claim cost advantages, give evidence on why your costs are lower than your competitors (or about product quality or market position, etc).

Finally, you will often find that the same factor can be listed under both Strength and Weakness (or Threat and Opportunity). That can be logical but you cannot just leave the listing under both headings. You need to clarify under what circumstances is the factor a Strength and under what circumstances it is a Weakness.

Strengths and Weaknesses

Strengths and weaknesses are due to factors **internal** to the company. They may be factors such as:

Low cost operations

Profit levels

Product or service quality

Financial resources

Management ability

Reputation in the market

Established distribution channels

Economies of scale

Patents held

Opportunities and Threats

Opportunities and threats are due to factors **external** to the firm. They may be factors such as:

Competitor increasing capacity

Tariff protection changes

Changing market demographics

Government actions (many)

New technology discovered

Changing consumer tastes

Change by major buyer

Transport costs change
Interest rates change

Economic cycle

Caution

Remember to avoid the temptation to list <u>all</u> the strengths, weaknesses, opportunities and threats that can be considered. This merely confuses the analysis. Choose those factors that are significant, that are likely and/or will have a major impact.

Sustainable Competitive Advantage

When the significant SWOT factors have been determined, the next step can be taken.

The idea is to build on the strengths and negate (or minimise) the weaknesses. This should be directed by a strategy to place the firm in a strong position to take advantage of the few chosen opportunities while avoiding the major threats (if possible).

It is not possible to remove all threats - there is no safe place in the competitive world. Nor is it possible to pursue all opportunities - you spread your resources and abilities too thin. Sometimes, the strategy will not negate all the weaknesses. You can then either: minimise these weaknesses; work on them; or hope that no-one takes advantage of them.

Sustainable competitive advantage is a concept that encourages us to remember that strategy is a <u>long term</u> function. Rather than try to pursue short term opportunities with transient strengths, you need to consider what advantage your firm has that it can maintain for some period of time. It must be maintainable in the face of actions by competitors, new entrants, substitutes, buyers and suppliers.
A sustainable advantage may be that the firm has very low cost operations (perhaps from unique access to cheap raw materials, or from

economies of scale, or integrated operations, or .....). The firm could then work to pursue this low cost advantage in all that it does. It will need to continually work on it.

Alternatively, the firm may have an ability to design and produce better quality goods or services than its competitors. This would encourage a differentiation strategy based on quality or design flexibility.

However, if this advantage can be quickly imitated by competitors or they can cheaply copy the designs then the advantage is not sustainable. It is then unlikely to allow long term superior profits.

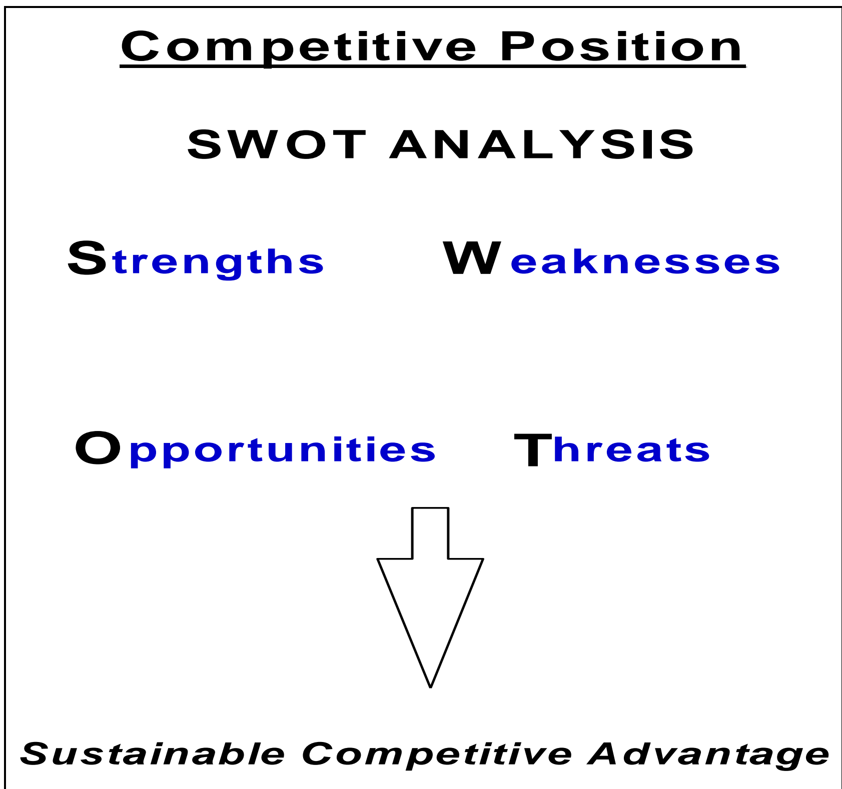


Figure 8.1 SWOT and Competitive Advantage

8.2 Value Chain

An alternative (or complementary) analysis method to SWOT is the Value Chain. The idea is to see where the firm adds value in its offering to its customers or other stakeholders. If a particular activity does not add value then what is the use of it?

Note we broadened our "market" from customers to stakeholders. The Government or employees or the community may be stakeholders we need to consider. So for example, we will do regulatory compliance activities as required.

With our customers, the firm seeks to charge more to the customer than what it costs to provide the value. The entire operations of the firm are analysed for what value they add, what they cost and what extra margin is received by adding this value.

One of the benefits of a value chain is that we can see if the firm is following a consistent strategy throughout its operations e.g. low cost or differentiated.

A value chain is also useful when looking at process re-engineering. Are the activities undertaken by the organisation adding value to the customer? If not, why are we doing these activities? Note that if we add value, we should aim to charge the customer more for the value added than what it cost us.

We can also take a more macro approach and look at an industry value chain. The processes to satisfy customers are still the same but we now look along the entire value chain including suppliers, production, distribution channels and so on. This can be a useful technique to help determine where along the chain is the most desirable place to be. Also, are there opportunities or threats for extension along the value chain: backward or forward integration by some players?

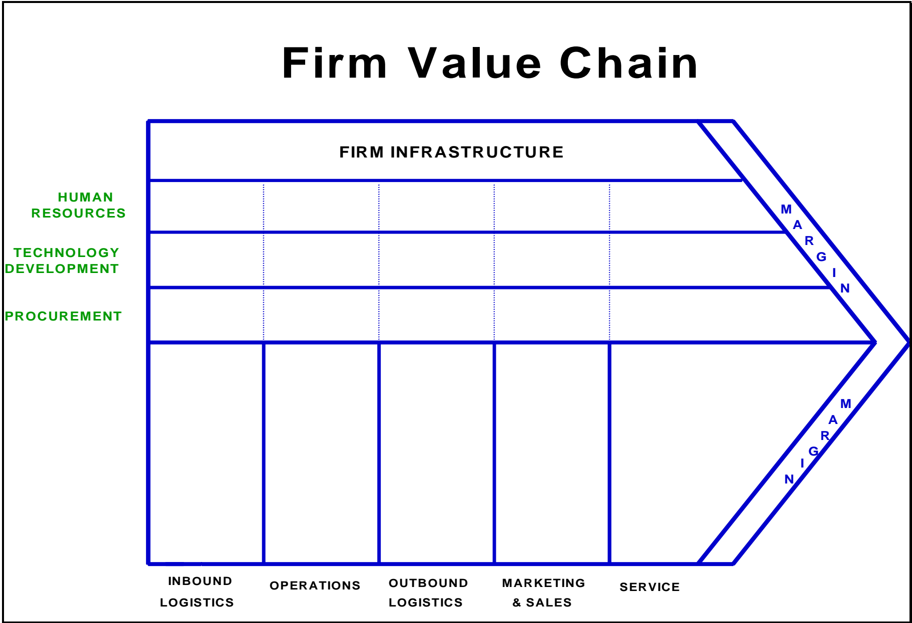


Figure 8.2 Value Chain Analysis

8.3 McKinsey 7S

We considered the McKinsey 7S model earlier in Chapter 4 as a reminder to have a holistic approach to management and that strategy cannot be successfully implemented if the structure, systems, staff, skills, style of management and shared values are wrong or unsupportive. The diagram is repeated below.

The McKinsey 7S framework is a good checklist on the health of your firm or organisation. Under each **S** heading, you diagnose the state of your organisation, noting in particular shortcomings that hinder the achievement of your objectives.

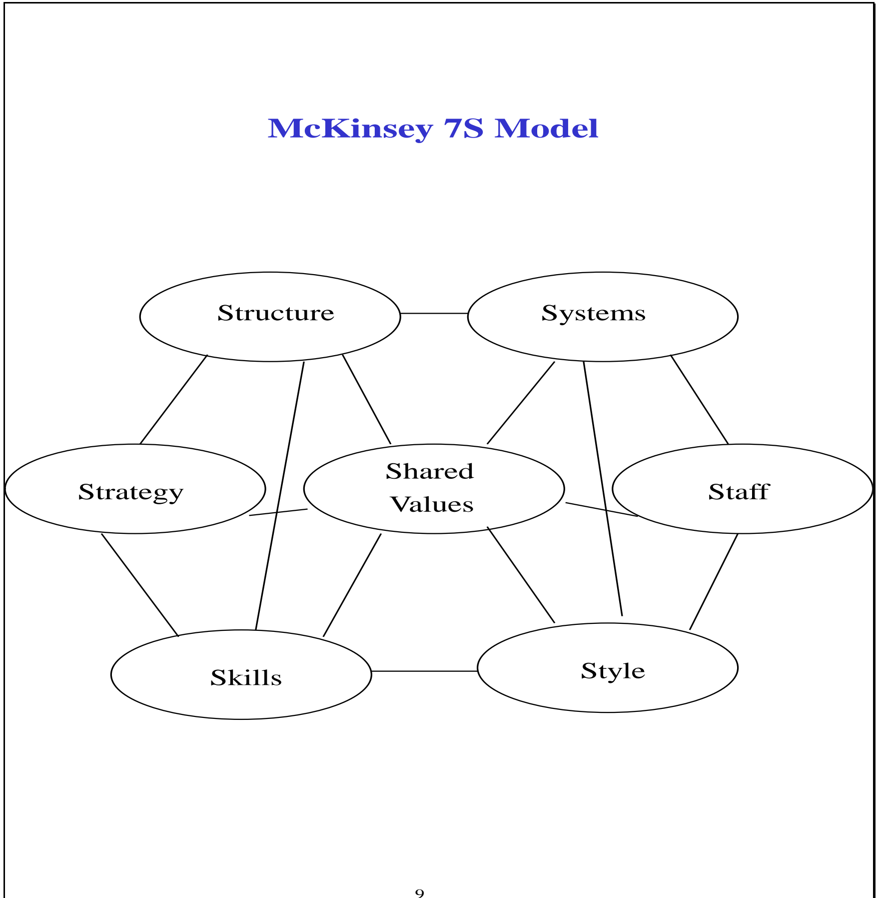


Figure 8.3 McKinsey 7S Framework

After assessing the capabilities of your organisation, you then need to decide what to do about such shortcomings: either invest in fixing these shortcomings; devise strategies which minimise their impacts; or set different but more achievable objectives.

You do **not** need the 7 S factors to all be perfect. It would cost far too much to achieve such a luxurious state. What you must ensure is every

factor is to at least a **minimum standard** in order not to hinder the implementation of your strategies and achievement of your objectives.

Often we see companies with poor strategies and other deficiencies in their seven S factors say that the problem is the Organisational Structure. This is usually an easy excuse not to fix up more fundamental problems in the organisation.

In any case, there is no such thing as the perfect organisational design – they all have compromises. Generally having the right people and management style gives more chance for success than having the perfect structure. Good people and management will make most structures work. What we do not want is an organisational structure that is completely at odds with what we are trying to achieve.

8.4 Competitor Mapping

A conceptually simple but very effective technique for understanding the competitive position of your business against competitors is competitor mapping.

It is usually just a two axis diagram (those into 3D imaging can try 3 axes). Each axis has a significant competitive factor such as price, speed of delivery, service, quality, guarantees, innovation, distribution points, etc.

Which factors are chosen depends on what is significant in the industry to customers. This means you must still have detailed and quantified knowledge of your industry (about you, your competitors and your customers). Otherwise, you will end up with a vague and debatable map. So research and knowledge are still required.

Your firm and your competitors are mapped on the diagram depending on how they score on the factors chosen. Size of competitors can be indicated by the size of the circles drawn on the map to depict each firm.

Some degree of time and change can be indicated by placing an arrow on each firm to show the direction in which it is heading. Some mappers even have a dotted outline of where the firm used to be to show how far it has moved.

It sounds simplistic but it often provides great insight into what should have been obvious but cannot be seen due to too much detail or verbage.

This is one of the few internal analysis tools that places you and your competitors on the one page. We obtain a visual depiction that often leads to "ah hah!" insight moments. We gain fundamental insight into the competitive nature of the industry and our positioning in it.

If you and your competitors are all at the same location on the map, how can your customers pick you apart? You are undifferentiated and left to compete on price. If you are far apart, it will help explain who must offer the lowest prices in order to remain competitive. It also says who are likely to be the "natural" customers of a particular firm and why some customer segments will struggle to find value in your offering and so perhaps should be removed from your focus.

Lower prices are used to compensate customers when you do not score as high as competitors. Your "natural customer" would be one who is willing to accept your competitive factors in exchange for higher prices.

Difficulties arise from customers who want (and can demand) the highest scoring factors but still at the lowest price.

The strongest position is in the top right hand corner, where you are providing the most of both attributes to the customer or have the greatest degree of competitive features. That is providing it does not cost too much to provide such levels or else you can charge a premium price (as argued by the value chain technique).

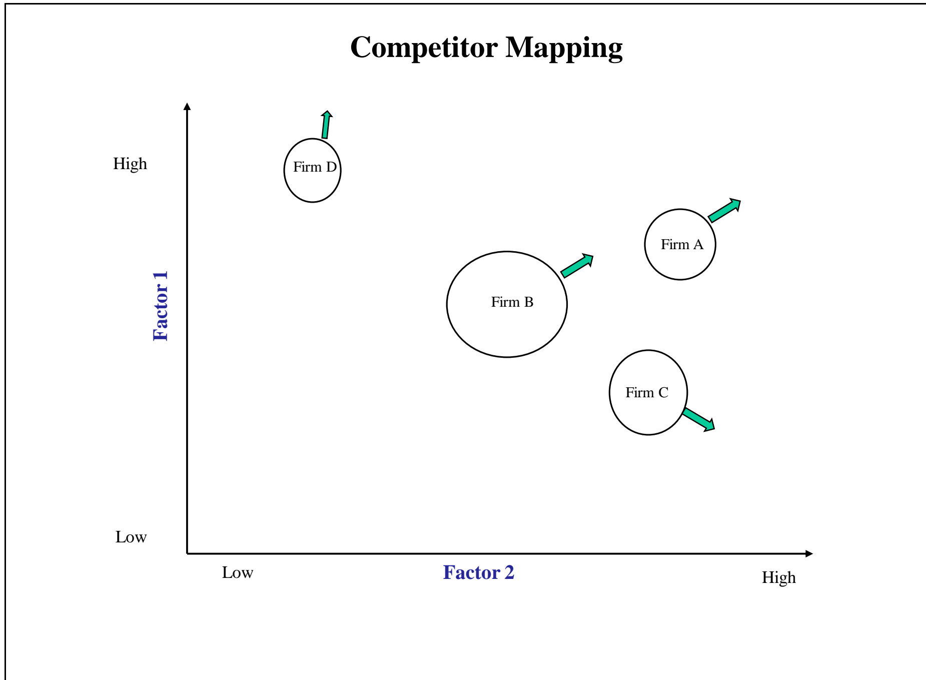


Figure 8.4 Competitor Mapping

The diagram above shows an industry where the producers are quite differentiated from each other. They are not clustered and so have different appeals to different segments of customers.

As shown by the size of the circle, Firm B is the largest business. Typically it seems to be supplying to a mass middle market. However, the arrow indicates it is attempting to move up market by offering higher levels of both Factors or Features 1 and 2. Firm A, probably sensibly is therefore moving itself to even higher levels of these features in order to maintain its premium position. The issue now is whether there is a market segment large enough to support (price and volume) both firms in this premium segment.

Firm C has taken a divergent strategy. It is reducing its offering in Factor 1 but increasing its offering in Factor 2. This may allow the firm to have lower costs while increasing its attractiveness with Factor 2. It is already unattractive in Factor 1 compared to its competitors and may have decided to no longer compete on this factor or feature.

Firm D is rather the opposite. It has the strongest offering of Factor 1 but is basically out of the market for customers who value Factor 2. So it is moving to offer the greatest amount to those customers who value Factor 1 but are not greatly interested in Factor 2. As long as Firm D remains small enough, it may find enough such customers to be viable.

As stated, the top right hand corner has the strongest offering to customers, at least on the map of these two factors. However, it is usually expensive in terms of resources and costs to be in such a position.

It is a strong competitor who can operate in the top right hand corner at low cost. In the car industry, Toyota used to manage to be in the top right hand corner on just about every feature bar one (style). It managed this feat at low cost. Not surprisingly, Toyota was the most profitable car company in the world. Indeed, by 2008 it could buy all of General Motors on the stock exchange with less than one year's profits! But times change and Toyota lost some focus on quality. Previous "losers" like Hyundai have resurged and new low cost entrants from China, India and elsewhere are emerging.

Indeed, relying just on low cost as your competitive advantage always runs the danger of a new entrant with lower costs. The more advantages you can build, the more robust your strategy.

You will probably need to draw up several maps to derive all the insight you seek. The drawback of mapping is that we are basically limited to just two factors, one for each axis. Change one or both factors and you are likely to obtain a different map.

8.5 Gap Analysis

Gap analysis is determining where you have serious deficiencies in your capabilities. Such gaps will significantly compromise your ability to achieve your objectives.

If you decide to plug the gaps, you need to determine the cost, time and effort to do so. Even if the cost is reasonable, the time required may be too long for you to survive competitively.

You also need to consider alternative methods of closing gaps or overcoming deficiencies in your capabilities.

There are many instances of companies seeking to close a capability gap via an expensive acquisition. This may be to close a gap in product range, geographic reach, technology levels or even staff skills. Frequently, such a move ignores all the integration problems that occur with an acquisition or the premium paid that can never be recovered in the market place.

Occasionally you may be able to create a brilliant strategy that negates the weakness, perhaps even turn it to an advantage. Congratulations if you do.

The final fall back is to acknowledge that your objectives may be unrealistic given your capabilities. You need to adjust your goals and objectives to what is reasonably attainable.

8.6 Summary of Internal Analysis

After conducting environmental analysis, including detailed analysis of our industry, we turn to diagnosing our internal capabilities to be competitive in our offering to customers.

There are several techniques or tools available to assess our internal capabilities. Most require us to be skilled and objective (and to have

data). For most tools, the analysis is relative: how do you compare to competitors. Unless you are acting in a pure monopoly, it is difficult to see how good analysis of internal capabilities could be undertaken without knowledge of the capabilities of competitors.

You also need to understand your customers. Strengths and weaknesses are defined by how they position you in the eyes of your customers.

9. FORMULATING STRATEGIES

Our third and final fundamental question is **What can and should we do?**

In this Chapter, we consider the first part of this question: what can we do? If we begin our analysis earlier enough, we should hopefully find several alternative paths or strategies to our goals.

If we defer analysis and decisions as we approach a cusp, the number of choices narrows quickly. We may be left with a Hobson's choice of the "least bad" decision. We talk about **degrees of freedom** in the amount of choice we have. The earlier you begin, the more you preserve your degrees of freedom for action.

9.1 Story and Vision

You need to synthesise all the analysis from the external and internal assessments. If you can embody this information and analysis into a simple statement it will be of great benefit when you come to sell this vision to stakeholders.

Evidence is growing to support the perception that the prime characteristic of good leaders is that they are good story tellers. They can cut through myriads of detail and give a concise analysis of the situation and a clear map forward.

This does not mean the analysis or the story teller are simple. It takes great skill and considerable effort to make a complex situation comprehensible to a wide audience. It takes brilliance and background detail to ensure that it is correct! Behind a simple message will be much data and analysis. If questioned on the message, the story teller can explain, argue and support the conclusions presented.

"An ideal strategy tells the story of how a company will offer substantial and unique value to customers in a way that is difficult for competitors to imitate." (Joel Shapiro)

9.2 What is a Strategy?

A strategy is NOT some statement of where we want to be or to go. Too often we see strategies presented along the lines of:

> "we will offer superior service to our customers"
>
> "we seek to dominate the market in left handed potato peelers"
>
> "we will be market leader and yield returns of 20% on equity"

These may be visions or maybe goals but they are not strategies.
The strategy is **how** you will achieve these goals. It is what you will do to reach your destination taking into account the actions of other parties like suppliers, competitors, customers, changing technology and so on.

Strategy is a set of integrated choices:

> A strategy is an **integrated** set of **choices** which **positions** a firm in its industry to generate superior financial long run returns.

So a strategy is a suite of cohesive choices and decisions to use our resources to achieve the long term goals.

A strategy is more than mere analysis. *"The product of an arithmetical computation is the answer to an equation. It is not the solution to a problem."* Colonel G. O. Ashley, A Declaration of Independence from the Statistical Method, Air University Review, March / April 1964.

A strategy is a solution.

9.3 Formulating Strategies

Of our 3 questions, this is the sparsest in terms of structured steps and tools. For both our environmental and external analyses there were several tools or techniques and some clear processes. Strategy formulation almost requires some intuitive leap.

There is no strict formula for formulating strategies. There is scope for creativity and divergence. More inductive reasoning is required.

From the environmental and firm analysis, a logical strategy might become evident. The logical deduction is to develop a strategy that:

Builds on your major strengths

Offsets major weaknesses

Takes advantage of some key opportunities

Wards against significant threats

The strategy should build on your capabilities platform (or else adjust your capabilities) to position your company where it has the most ability to earn and defend high profits.

Easy! At least in theory!

This is a start. But such a formulaic approach may miss the radical game changer or the divergent ideas.

Consequently, the main gambit is to build experience in formulating strategies, and practice consideration of alternatives. This is the prime way to gain fluency in strategy formulation.

It is said that the main difference between a good chess player and the grand master when looking at a play on the chess board is that the grand master considers fewer possible moves than the good player! But the options considered are much higher quality. That is why chess nerds

spend so much time reading books of chess games and why they fastidiously study the moves of great players in tournaments. They are building up experience so that when they see a certain situation or play, they can consider what successful strategies were employed in the past. They may still innovate but their thoughts are already directed to the better possibilities.

So it is with strategy formulation. You are unlikely to devise many strategies in your normal activities for your own business but you can still build experience through other means. Management (and military) schools utilise quality case studies to give practice. As well, look around at all the strategies being played in the business world and assess whether those strategies are successful or not and why.

Skills and fluency at devising and assessing strategies will rise quickly.

9.4 Generic Strategies

There have been attempts to provide generic strategies. Michael Porter's second effort at generic strategies is shown below.

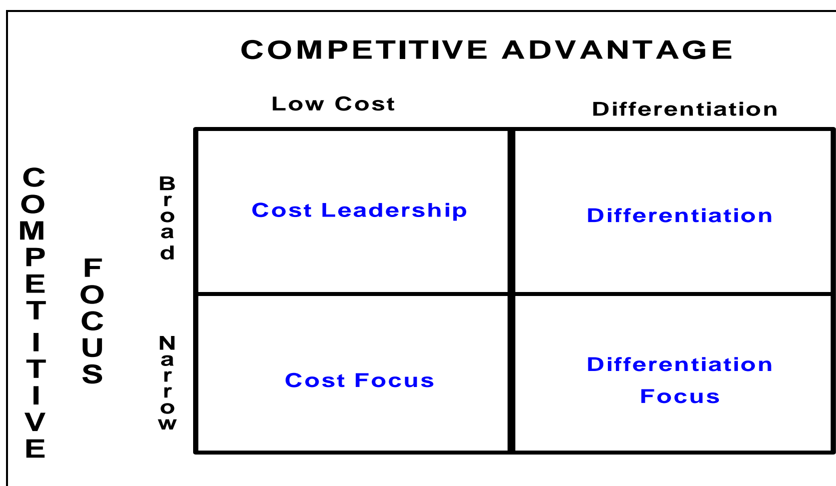


Figure 9.1 Michael Porter's Generic Strategies

In Porter's model, there are only two broad bases for competitive advantage: low cost or differentiation. There can only be one low cost winner: whoever has the lowest cost. There can be several players in the differentiation category depending on their chosen method of differentiation e.g. quality or points of service or warranty or performance or whatever. The desirability of each position would depend on the size and profitability and growth prospects for the market segment that wanted that particular differentiating feature.

The second dimension is on focus: either across the broad market or a tightly defined segment such as a geographic or demographic segment. So a producer in a tightly defined segment could possibly be even lower cost in that segment than the broadly based low cost producer.

Unfortunately the model is too simplistic to be practical.

9.5 Designing Unique Strategies

In real life, we find companies develop and implement rich and complex strategies. Indeed for the same company, some products or markets may pursue a low cost strategy with plain vanilla offerings while for other products or markets there may be differentiation by several aspects. Indeed, as seen with the competitive mapping tool, it is a powerful strategy that delivers superior qualities to the customers and does so at low cost.

The real issue is what **value** is offered to customers. Customers define value in different ways. Thus a business is unlikely to be able to best meet the wants of all customers in a market. Some customers will be satisfied with a standard product and just want the lowest price. Other customers may want certain features or other attributes and will hopefully be prepared to pay for such benefits.

But all customers seek value however they define it. Even the "bargain hunters" do not want shoddy products or services and will demand a

minimum standard. Most high end consumers are not oblivious to exorbitant pricing.

Our consumer tyrants now often find they can command more features and lower prices to receive a double dose of value. A strategy and a capability that can add benefits and control or reduce costs are powerful.

Every company has its own unique set of strengths and weaknesses. The target market segments have their own characteristics. Not surprisingly then, each company can have its own unique strategy and positioning.

So how do you start to devise your unique strategy?

There is not a step-by-step instruction book but there are some sensible guidelines. The process can be iterative rather than a straight forward journey. This means that you may often need to circle back: perhaps you find a desirable strategy but you do not have the capability to implement – yet. So you may need to build some new capabilities. You may find your target market is shrinking so you need to step out into some diversification. Other roadblocks and diversions will arise.

A guideline:

1. Keep your mission or goals in mind. That is what you want to achieve and what your strategy is supposed to lead to. Your first test of a strategy is whether it is leading to your mission and goals.

2. Answer the first two questions:

   What is happening and where is it going?

   What are our internal capabilities?

3. Synthesise this analysis into **So What?** Articulate this answer into a clear and concise statement of the situation and the way forward.

4. Consider what could be done, how you could be positioned. If you do your analysis early, you will retain degrees of freedom and should develop several alternatives.

   Take into consideration the current and likely future actions of competitors. Never devise a strategy without considering the actions and responses of competitors and even customers.

   Build fluency and creativity in your thinking. Use some creativity techniques. Talk to people: staff, customers, suppliers, and children. Look at many examples: your own industry; your industry in other countries or markets; similar industries; different industries; dream.

5. Conduct your gap analysis. Do any of your strategic choices require new strengths or do they require some existing weaknesses to be removed? If so, at what cost in time, money and other resources?

6. Choose the best alternative in terms of reasoned chance to succeed with a desired risk / return profile. Test your decision before implementing. (This is covered in the following Chapter).

7. Be focused on implementation and do it!

Remember your strategies may need to **evolve**. The right strategy now may not be appropriate in the future. Markets and situations change. Competitors adapt and counter our strategy. Technology moves on. Our capabilities improve. All these developments may mean we need to change or at least adjust our strategy.

9.6 Summary of Strategy Options

If you do your analysis and make your decisions early you are likely to find several options to proceed.

A strategy is a **set of integrated decisions** that will position your business to defend against competition and to achieve its mission and goals.

Such decisions will take into account the environmental analysis and meet the needs of your environment and industry in the future. Your strategy will be related to your strengths and take into account your weaknesses which are relative to competitors.

You may find from your gap analysis, that you need additional strengths or must remove some weaknesses for your preferred strategy to proceed successfully.

There are no rules on formulating a strategy so there is scope for creativity and divergence. Some guidelines help to give some structure to the process but you need to leap to the conclusion.

Such an almost intuitive leap comes easier and better performed with practice. Take opportunities to practice beyond your own business. Talk to others look at many examples.

The master military strategist Sun Tzu warned against having a stable and sustained strategy, or at least tactics:

> *"Do not repeat the tactics that won you a victory, but vary them according to the circumstances.*
>
> *"He who can modify his tactics in relation to his opponent and thereby succeed in winning, may be called a heaven-born captain."*

10. CHOOSING: STRATEGY DECISIONS

Our third and final fundamental question is **What can and should we do?**

We conclude our questions by now considering the second part of this question: **what should we do?**

By early analysis, practice and creative thinking, we should have several options from which to choose our way ahead.

10.1 CRAFT

CRAFT is a mnemonic for the tests we apply to our strategic choices to determine the preferred path. You need to make a decision as some choices may be mutually exclusive and you need to focus resources.

Congruent: Do your strategies run with or against the other strategies of your business? This is especially important if your strategy is for a business unit within a larger organizational structure. Your strategy should preferably not run counter to, or spoil, the strategies of other business units. Even more importantly, your strategy should run with the strategies of business units further up the hierarchy or even the company as a whole.

Indeed, the strategy at lower business levels must be aligned to achieving the goals of the level above. (See page 31 for the hierarchies or levels of strategy.) So a product or market strategy must be in line with helping

the goals of the business unit to which the product belongs. Then the strategies of the business unit must be aligned and supporting the strategies of the company which owns it.

This is a prime test. We must keep our eyes on the bigger picture above. By the same token, it is nigh impossible to devise strategies at the bottom if the strategies and goals at the top have not been clearly articulated.

Risk: How do your strategies rate in terms of risk? What will they cost your business unit (or company) if they go wrong or do not achieve the goals? Do your strategies account for risks and manage and mitigate where they can? Do the returns or profitability of your strategies more than compensate for any residual risks?

Our value to shareholders is a risk / return trade-off. Reducing or managing risk is just as valuable as increasing profits. Is your strategy robust?

Apt: Are your strategies apt or appropriate for the environment as per your analysis? Do they address the issues? Do the strategies fit with your capabilities or can you readily acquire the necessary capabilities? Do you have what it takes to implement these strategies?

Flexible: Is the strategy flexible or at least easily **adaptable**? Given the rapid rate of change today, adaptability or flexibility are often desired traits in choosing a strategy. We may choose a strategic option that is not optimal in terms of returns but is less expensive to adjust if events turn out other than as predicted.

The term sometimes used is “low regret”. We may opt for a strategy that does not yield the best returns but it

costs less to change or abandon than the more profitable strategy.

Timely: Can the strategies be implemented in a timely fashion? In a fast changing world, waiting patiently for several years for your position to take shape may be too long. The world may have changed too much around you by the time your strategy is implemented.

Also, are your strategies robust over time? That is, can they last for a reasonable amount of time or will they require constant tinkering. It is very difficult to implement successful strategy if it chops and changes too quickly. In part this comes back to flexibility. Can you readily evolve and modify your core strategy without having to start again from scratch?

Testing your strategic choices against these criteria above will help to give an objective assessment of the strengths and weaknesses of your choices. All the criteria are important. Congruence and risk are critical.

10.2 Simulation and Scenario Analysis for Choices

The results of not choosing the best strategy is reduced outcomes in terms of the risk / return profile. But you should still do well and better than having no strategy.

The results of choosing a very wrong strategic path range from lost returns or great expense through to disaster putting the business at risk of failure.

Given the effort we put into devising strategies and the resultant effects on risk / return profiles and value to shareholders, it makes sense to invest some effort into testing our strategic choices. In addition to the

CRAFT checklist above, we can employ other tests, some of which are quantitative.

We may run simulation and scenario analysis to test the effects and outcomes of our chosen strategies. These are methods that can be employed to answer some of our CRAFT headings, especially risk.

With considerable computing power readily available today on any desk or laptop, it is possible to build algorithms to model a situation and play out **simulations** under differing rules or algorithms to observe the outcomes.

Such techniques are not new. Econometrics is about building large and complex models to mimic the economy or an industry and see what will happen as parameters are changed e.g. changes in interest rates or levels of economic activity.

While computing power has increased, so too has the level of complexity in most situations. Econometric models do not always have a good track record for predictions and generally are quite expensive and time consuming to build. Nor are they very good at the microeconomic level which is where we want to play business strategy. It is debatable whether an industry model could justify the expense and expertise that is required, especially if the industry is rapidly changing in fundamental ways.

On the other hand, some simple models can add to our understanding of systems and consequences. They could show major cause and effect events without being too precise.

For all business ventures we investigate, we can build a simple Excel spreadsheet. There are three main outcomes of developing a financial model:

1. Assumptions must be stated in mathematical terms (and so can be tested for reasonableness)
2. Ease of conducting sensitivity analysis
3. The “answer” or results

Probably the "answer" is the least important of the three model outcomes. The answer is highly dependent on the assumptions used.

For a model to work, the assumptions must be stated numerically. So instead of saying "we will achieve strong sales growth" the model requires you to input initial sales and to state the assumed growth rate. It is likewise for inputs of other parameters such as costs, working capital assumptions and escalation rates.

The old computing acronym of GIGO applies: garbage in, garbage out. Now that the assumptions are numerically stated we can test them for **reasonableness**. For example, is it reasonable to assume we will achieve 50% market share against 4 other established competitors? Can the market really grow at 10% per annum for the next 8 years? Are these prices realistic? Can we service that many customers with this number of staff?

Where you are vague about an assumption, you now know you have a gap in your knowledge of the business.

The second key outcome is sensitivity analysis. This is the key test for risk. Some business strategies are very sensitive so that only a small change in prices or volumes or whatever leads to a massive change in the bottom line results of profits and cash flow. These are highly risky ventures and your strategy needs to take into account such risks. Other projects are robust so that it requires massive changes in the parameters before disaster falls. Such a business would typically have low fixed costs or solid long term contracts.

For nearly every business or project, the two prime sensitivities to run are about price and volume. For example, what is the impact of a competitor reacting by cutting prices by 10%?

You can combine several sensitivity analyses into a model scenario. For example if there is a recession and a competitor reaction what will be the outcome. Prices and volumes are likely to fall together. Have the model recalculate the outcome.

Skill is required to build a flexible model that can readily handle many sensitivity analyses. The financial model is like a laboratory model of your business. You have the opportunity to try different strategies and tactics and see the outcomes in an experimental version rather than face the costs of real life.

Always remember though, that it is a model and that real life is more complex and not as rational. Psychology of customers, competitors and staff can be difficult to model!

Scenario Analysis has an older heritage. We are not talking of a model scenario here but rather playing out a situation with people taking active roles in a developing scene.

Scenario analysis is a fundamental technique used in military strategy training. Military strategists study past battles and consider what else might happen. They use these skills to then look at current of future battles and play out various scenarios: if……. then what could happen.

It is a useful risk identification technique but also is useful in considering competitor reactions and responses. Indeed, when used in a business setting, the technique is often referred to as "War Games."

The benefits of scenario analysis are largely dependent on the strategic skill sets of the "players" and their knowledge of the scenario, including key information about their own businesses, competitors and customers. The advantage of scenario analysis over more static external analysis is that it introduces the dynamics of actions and reactions and we see strategy as a "to-and-fro" process over several stages. It is along the lines of: "if we do this, our customers or competitors may do that, and then we should ….."

We have run scenario analysis and the outcomes are usually illuminating. A cherished strategy can suddenly be shown to have serious flaws when participants playing the role of competitors or

customers give their reactions and completely destroy our chosen strategy.

10.3 Break Even Analysis

Break even analysis is probably the simplest equation in finance. It is also one of the most useful. It is included in the Appendices.

It simply computes how many units at what price are needed to be sold in order to cover costs in a given period of time. You can calculate it in your head during a meeting.

It is a coarse sieve to weed out the worst ideas. We have seen too many projects proceed that need well over 100% market share just to break even. We have seen projects where simply enough units cannot be produced in the required time to break even.

You can add additional features to the calculation such as profit targets or work out the break even for a business selling multiple products or services. You may then need a calculator.

10.4 Du Pont Analysis

Du Pont Analysis is almost as simple as break even analysis and is similarly powerful. It can detail where the problems likely lie in our business and point to where we need to make improvements. Again, there is more detail about this technique in the Appendices.

10.5 Key Success Factors

Conducting all the external and internal analysis and then formulating strategic choices and now choosing the optimal strategy can leave us a little bewildered.

Pause for a moment to collect your breath and your thoughts.
Stop every so often and raise your head to check your mission and goals. These are what you are trying to achieve. Keep them in mind. Are you still on track, working towards them?

Also simplify when you can. While a strategy may eventually be rich in analysis and detailed plans, beware of too much complexity. A very complex plan will be difficult to communicate and difficult to implement. Do not dismiss a simple plan just because it seems simple and common sense. That probably indicates it is right and doable.

A useful simplifying technique promoted by Pulpin is to consider and list our key success factors.

These are the **few** factors that are critical to our success. For example, for a major mining company there are probably 3 factors that they must satisfy to achieve long term profitability. The other factors are good but not crucial.

First, they are largely selling commodity products on the global market so they need low unit costs. Certainly in times of recession, it is the low cost mining operations that survive. How you achieve low costs comes from a number of attributes: high grade ore, close to the surface, good logistics to get from mine to port to customer and economies of scale to spread fixed costs are all part of the jigsaw.

Second, we find that low gearing (low debt) allows flexibility in the downturn of commodity cycles and allows little hedging to be undertaken so that advantage can be taken of high spot prices in the upturn.

Third, you need a pipeline of resources. Mines have a finite life so you need a portfolio of deposits in various stages between prospecting, proving up, development and operation.

One of the big global miners, Anglo American had neglected this third key success factor. So by the turn of the century, it was facing a future where its mines in South Africa were approaching the end of their life but there was little in the larder for replacement. In the end, Anglo American had to go on an acquisition trail. In some cases, it was paying over 3 times as much as competitors rejected for mining prospects. This filled the gap in its key success factor but at premiums that hurt its future low cost position. By 2016 with depressed commodity prices, Anglo American had to shed 85,000 jobs globally to offset the recessionary commodity prices.

This restructuring to survive included fire sales of some of the assets bought at premium prices 15 years earlier.

The downturn and high debt has resulted in poor shareholder value.

Anglo American lay-offs, Wall Street Journal

Ensure you have your key success factors covered by your strategy. If you have those success factors right, you probably have 80% of your business strategy requirements.

In 2001, a well known Australian airline had a 6 page sheet in 8pt type of its more than 80 key success factors. These cannot all be key success factors and there had to be a loss of focus. Add capability deficiencies at the airline as shown by the McKinsey 7S analysis around structure, systems and shared goals and you will understand why it was nigh impossible to have any strategy successfully implemented over the next decade. This airline needed to work seriously on its deficiencies.

10.6 Summary of Strategy Decisions

More than one strategic option should be derived from our analysis. So we now need to choose which strategic option to pursue and implement,

The CRAFT mnemonic provides a check list against which to measure our strategic options. It is important to keep in mind the higher goals we are trying to achieve and to ensure our strategies at the level we are operating are congruent with the goals above. Risk level, Aptness of fit, Flexibility and Timeliness are further traits for judgement.

We can further test or quantify our assessment with computer modelling or role playing scenarios to judge the effects of changes in parameters, including reactions by customers and competitors.

Some simple techniques such as Break Even Analysis and Du Pont Analysis can provide quick and effective checks of the viability of our strategies.

It can become overly complicated very quickly. Remember to get your head up frequently and check the horizon and keep your purpose in mind. Ensuring you cover the key success factors is a means of not missing the forest because of all the trees.

What is the practice in real life? The answer is one of great choices, trials, and use of multiple strategies. Overlay this with a myriad of tactics or micro strategies that may last only a few months or even weeks as they are countered by competitors or lose efficacy with customers.

The end result is considerable complexity and richness in our strategies.

11. ADDED DIMENSIONS

The processes and skills to analyse the environment, assess capabilities formulate strategic options and decide on the strategies to implement have now been covered. We now add extra dimensions to our skills. Several have been alluded to earlier and are now treated in more detail.

11.1 Levels of Strategy

We have discussed levels of strategy particularly when considering congruence of strategies: lower level strategies must be consistent with achieving higher level aims. Let us now give some more consideration to the levels of strategy. We can review the diagram below.

Figure 11. 1 Levels of Strategy

It is imperative to start from the top. It is difficult to devise strategy for a business unit or product and marketing strategies when it is unclear what are the goals and priorities of the total organisation.

It is essential for the senior executive team to clearly articulate the vision, mission goals and so on of the overall organisation. Only then can lower level strategies be assessed for their congruence to higher level goals.

As well, the senior executive team of the organisation needs to devise the **grand strategy** for the organisation. This is like the war plan for an entire army. The subunits then know what they need to achieve to support the overall plan.

The role of the Board of Directors in the grand strategy is moot. Surveys of directors show shifting patterns over the years as to whether the Board should be directly involved in formulating the grand strategy or whether the strategy should be devised solely by the senior executives with the Board only giving approval or not.

There is no rigid answer. It would be expected that the full time executive team would have the most detailed knowledge and the time for analysis and should do at least most of the work on formulating the strategy. The executive is certainly responsible for implementation of the strategy.

However, directors have a stewardship responsibility and their approval of the plan cannot be assumed. At least, we would expect testing and questioning of the plan by the Directors. A good Board would probably demand further supporting evidence and analysis if it had misgivings about the strategy.

Note that the processes of devising strategies are the same for all levels: analyse the environment; assess internal capabilities; formulate strategic choices; decide on the best choice and course of action.

Obviously though, the amount and detail of analysis adjusts according to the level being played. At the grand strategy, it is essential to get the direction right and much analysis will be undertaken. Such analysis is likely to be quite broad and has a longer term outlook. Typically, businesses will look at 5 to 10 year grand strategic plans. The main determining factor on the time horizon is the pace of change such as from technology or social moves. Infrastructure and technology investment will also affect the time horizon.

At lower levels of play, the time frame shortens as does the time spent on analysis. Detail normally increases as specific information is sought on competitor capabilities, customer preferences, internal capabilities and so on.

By the time we drop to micro strategies or tactics, we may be looking at a plan that lasts for just a few months such as the launch of a new product. Here we have detailed plans about advertising schedules, launch activities, consumer feedback and competitor reactions.

11.2 Time Frames

We have seen how time frames are dependent on the level of strategy being played and the pace of change.

Remember that we are normally playing or competing over an extended period of time. We do not just play for today or this year. We expect our customers and competitors and our staff and resources to continue.

So we must keep in mind the longer position. We want to win the war, not just the immediate battle.

So while the most detail will be in the immediate period where we are currently acting, we also need to consider the intermediate and longer term periods. The detail will be less as we look further ahead. However, it is imperative to consider the longer term **before** the immediate term.

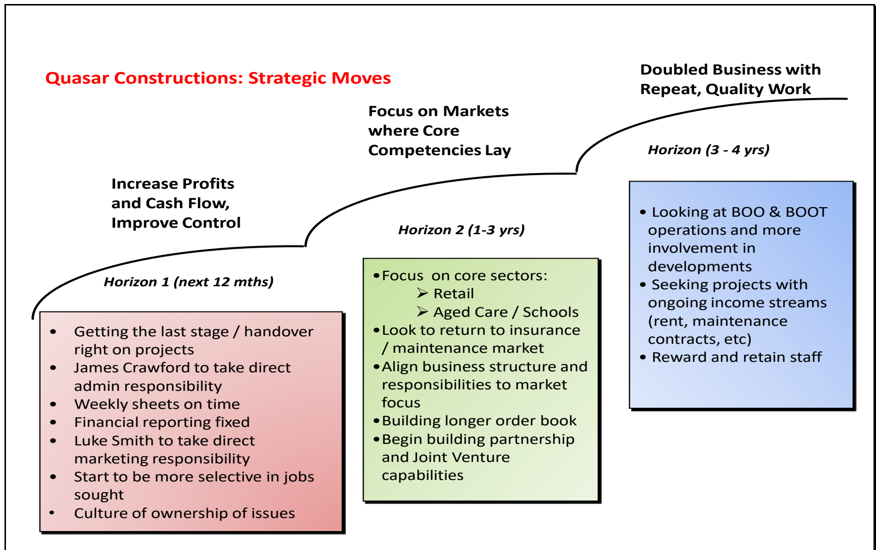


Figure 11.2 Time Periods for Strategy

As first raised in the overview to strategy, the congruence is to the longer time period. We do not want to implement strategies in the short or intermediate terms that counter and perhaps foil our achievement of goals in the longer term. So we must at least sketch out our goals and plans for the longer horizon first.

11.3 Portfolios

An added dimension to our strategies is when we have a portfolio: of business units; of products; of markets; even of customers.

How do we keep a coherent strategy and how do we handle the extra complexities?

Most companies are not a single product or single market supplier. Indeed, the share market values some diversification. Studies generally

show that over the long run, a reasonably diversified company will generally outperform a single focus company. The key term is *"reasonably diversified"*. Diversification well beyond your capabilities and thinly spread resources is a recipe for problems.

Reasonably diversified companies have several advantages. Apart from smoothing out market fluctuations (like a diversified investment portfolio) there is the advantage of using some cash rich products or business units to help finance start-ups or growth projects.

Not so obviously, we find that a diversified company can better survive times of strife. Much like a hot air balloon that is losing altitude, it may be possible to jettison some business units to gain vital funds without destroying the core businesses.

Thus it is useful to have a portfolio view. We can marshal resources between growing (and hence cash negative) businesses and stable but cash positive businesses. Resources can be apportioned according to need and according to the grand strategy of the whole business.

GE Matrix

One of the pioneering companies that looked at managing a portfolio of businesses was General Electric (of the USA). G.E. looked at all its different businesses in the 1980's and was overwhelmed.

G.E. coined the term "strategic business unit" or SBU (by Jack Welch and Peter Drucker). A strategic business unit is a business that basically stands alone although it may use shared corporate services and even have intra company transactions. Its defining characteristic is that it has external customers. Therefore it must compete strategically. G.E. found it had over 600 SBU's.

It was not possible for the senior executive team or the Board to adequately comprehend and analyse each business. Some simplifying methodology was required.

G.E. developed a matrix to manage its portfolio of businesses. Which businesses should it hold, which to build and which to divest. A diagram of the G.E. 3x3 matrix is shown below.

GE Business Screen

Market Attractiveness

Business Strength	*low*	*medium*	*high*
high	build selectively	invest to build	protect
medium	limited expansion or harvest	manage for earnings	build selectively
low	divest	manage for earnings	protect and refocus

Figure 11.3 GE Business Screen

Determining market attractiveness is on a checklist along the lines of the Porter analysis. Likewise, determining business strength is determined by a number of factors including cost competitiveness, differentiation, market position and so on. Some 20 or 30 factors go into determining the positioning of a business unit along each axis. The analysis is quite comprehensive.

Essentially the long term ability of the business to yield above average returns was assessed. In the words of Jack Welch, the now retired but

legendary CEO of General Electric: *"If you do not have a competitive advantage, then don't compete."*

If GE was not number one or two in its market segment, then it would look to exit if it could not improve the position.

Alas, GE lost focus in many of its businesses and was out competed by more agile newcomers, more open to technology changes.

The Shell and ADL matrices are similar.

Shell Directional Matrix

Prospect for Sector Profitability

Enterprises Competitive Capabilities	Unattractive	Average	Attractive
Weak	*Disinvest*	*Phased Withdrawal*	*Double or Quit*
Average	*Phased Withdrawal*	*Custodial Growth*	*Try Harder*
Strong	*Cash Generation*	*Growth Leader*	*Leader*

Marketing101.co.uk

Figure 11.4 Shell Matrix

The Shell Matrix is similar to the GE Matrix with just the direction of the axes reversed.

ADL Matrix

Competitive Position		Industry life cycle stage			
		Embryonic	Growth	Mature	Aging
	Dominant	All out push for share. Hold position	Hold position. Hold share.	Hold position. Grow with industry.	Hold position.
	Strong	Attempt to improve position. All out push for share	Attempt to improve position. Push for share.	Hold position. Grow with industry.	Hold position or harvest.
	Favourable	Selective or all out push for share. Selectively attempt to improve position.	Attempt to improve position. Selective push for share.	Custodial or maintenance. Find niche and attempt to protect it.	Harvest, or phased out withdrawal.
	Tenable	Selectively push for position	Find niche and protect it.	Find niche and hang on, or phased out Withdrawal.	Phased out withdrawal, or Abandon
	Weak	Up or out	Turnaround or abandon.	Turnaround, orphaned out withdrawal.	Abandon.
	Non-viable	Immediate or rapid exit.	Immediate or rapid exit.	Immediate or rapid exit.	Immediate or rapid exit.

Figure 11.5 ADL Matrix

The ADL matrix is more detailed with a 6x4 matrix. It is doubtful if the added detail gives better clarity of understanding.

BCG Matrix

A simpler (and poorer) matrix was developed by the Boston Consulting Group (BCG).

While the GE matrix uses many factors to determine the position on each axis of a business unit, the BCG matrix basically gives all priority to market share (as a proxy for low cost) and market growth (as the measure for industry attractiveness).

It is too simplistic to be of much use and it has many errors of prediction and analysis. Still, it has been widely used by senior managers, possibly because it is so simple. A sample diagram is attached. BCG has since revised the matrix.

It is very emotive with its terms and meets many of the criteria of Rosenzweig's fad tests. The idea is to have enough cash cows (highly profitable but not growing) businesses to financially support the fast growing stars.

The problem children are growing fast but do not dominate market share. Can we boost them to be stars or will they fall to be dogs when the product life cycle eventually drops the growth rate?

The dogs are doomed to disposal.

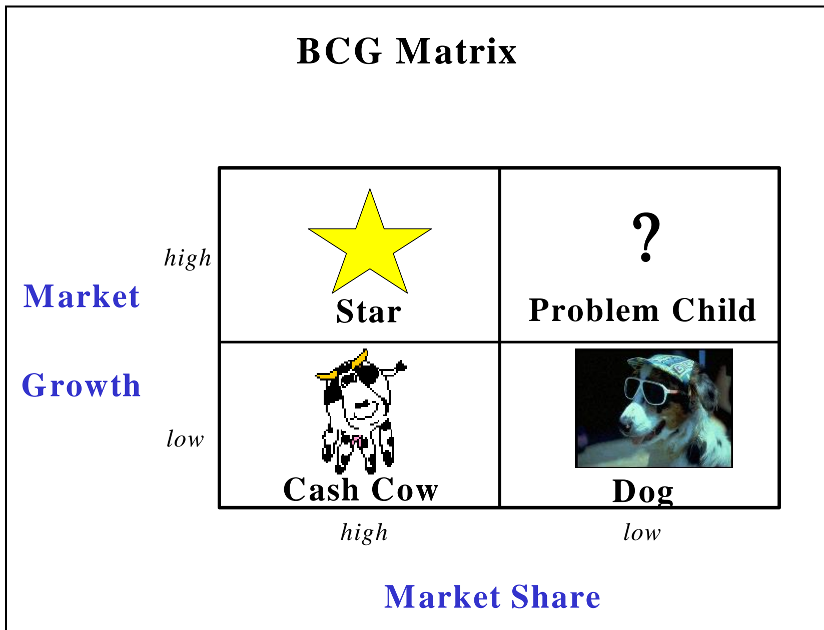


Figure 11.4 BCG Matrix

The cut off between high and low market growth is about 4% real growth per annum. The original model had it higher at around 8% but it meant there were too few stars. Also, many supposed cash cows growing at 4 or 5% per annum were actually cash negative as they needed to invest in capacity.

The cut off on the Market Share axis is relative. The cut-off point is 1.0 times. If you have the most market share (say 40% market share) and the second largest supplier has 20% market share than you would score 2.0 (twice the market size of the 2nd biggest player). The 2nd biggest player would score at 0.5 (half the market share of the biggest player). The scoring starts at zero at the right hand side of the market share axis. According to these parameters, only one player in an industry can be a cash cow.

The reason for the focus on market share was linked to the learning curve concept and the need for lowest cost in mature, commoditised industries. The didactic "logic" progression is shown below.

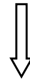
In the long run, all industries become commoditised.

Thus, in the long run, the most successful suppliers are those that have the lowest costs.

The supplier with the lowest cost is the one that has moved furthest down the learning curve on how to make and deliver the product cheapest. (BCG even gave estimates for the slope of the learning curve such as 6% for the motorcycle industry). Note the curve is logarithmic. To have a 6% reduction in unit costs, you need to double output. To gain a further 6% reduction in costs, requires doubling of the cumulative output to date, and so on.

The supplier who is furthest down the learning curve (and hence has lowest unit costs), is the one that has made the most product.

To make (and sell) more product than other players requires having the major market share.



Therefore, the supplier with the most market share will have the most production, be furthest down the learning curve and so have the lowest costs and will be the winner in a commoditised, mature market. Simple!

The logic is neat and straightforward. It is also severely flawed in many parts.

Not all products become commoditised. Indeed, a key task of marketers and strategists is to revitalise markets and products (or leave the market).

There are many other ways to lower cost than the learning curve including scale, new technologies, a cost culture, access to inputs and more.

Nor does the model test well in reality. There are many industries where the business with the major market share is performing badly (often by having an undifferentiated product selling at low prices). Hewlett Packard followed this strategy with its calculators in the 1970's based on the BCG learning curve hypothesis. Hewlett Packard cut the prices of its high performing calculators and met disaster with falling

profitability. Many industries have “dogs” that perform very well by segmenting on quality or other attributes or having a narrow cost focus.

Another analysis promoting market share as a dominant factor was the PIMS study, which worked on surveys to determine the attributes of successful firms. It has much the same problems as the *“In Search of Excellence”* texts: purely descriptive of companies at a single point of time. This is a common error and is termed the ***halo effect***. Just because these companies are performing well at a point of time could be just luck or circumstances. The real test is whether they perform well over the longer period.

11.4 Extend Your Skills

You have developed a suite of tools and processes for strategic thinking.

You are now able to extend yourself and devise your own tools or modify basic tools to specific needs.

For example, we can extend the GE Screen for businesses to manage our portfolio of products. You place your products in the matrix depending on their competitive position and market attractiveness to determine which products you will defend to the death and which you should probably exit and all the options in between.

You can do the same with customers or market segments. It is a simple and clear tool to help organise your thoughts when you have many data points and you want clarity to make decisions.

11.5 Dynamics

A final dimension to add is time. A trap for strategists is to do all the analytic work and devise a brilliant strategy and then “set and forget”.

Our world truly is changing faster than ever. Most industries are more competitive, partly due to government competition policies and a more global environment.

Distribution channels are not passive conduits to customers but combative participants and competitors for customer loyalties and value.

Technology is changing rapidly and combining in ways that are highly unpredictable.

Consumers are segmenting to more highly defined and tighter niches. At the same time, consumers are more highly educated, more cynical and more knowledgeable than ever before. As McKinsey & Co pronounced in 2006, the concept of "consumer sovereignty" is dead (the concept can be traced back to Adam Smith in 1776). Instead, the concept has been replaced by the "consumer as tyrant".

Some buyers are now so powerful that they are the major determinant of industry profitability as they pull profits to themselves. Consider the major supermarket chains in Australia. The power of Woolworths and Coles as dominant buyers in many industries has left suppliers to these chains struggling for profitability. Suppliers see these distributor customers as more of a threat to their profitability than their fellow competitors. They welcome the rise of Aldi and other chains as new customers and a change in the balance of power.

As a result, suppliers often seek to gain some help from each other while not falling to illegal collusion. In other cases, the cost of new technology or the requirements of scale find "competitors" now working together in order to be cost effective. This has coined the term **"co-opetition"**.

We are seeing major shifts in most industries from the middle ground of the mass market. Markets, consumers and industries are polarising. Rather than a broad mass market with some bargain hunters at the bottom and rich, luxury seekers at the top, markets are seeing new

categories of buyers. Many now cynically (rationally?) see little value in glib differentiation and merely want good product for the lowest price. Other buyers are income rich but time poor. They measure value on time saved or ensuring their time is spent enjoying the best possible.

The mass market in the middle is segmenting and shrinking. Companies that focused on servicing these markets are struggling such as free to air television, main stream magazines, Ford Falcon and Holden Commodore!

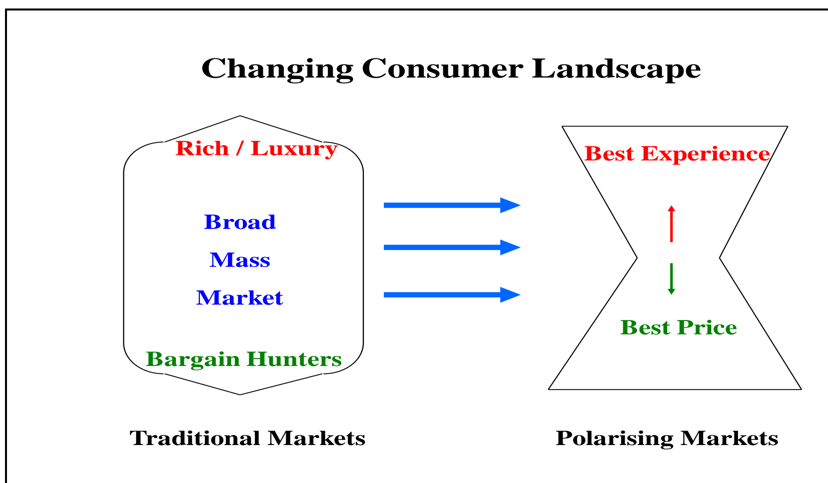


Figure 11.5 Polarising Markets

In a parallel movement, the middle ground of companies is being decimated as mergers lead to a few mega players that are harried by many small but nimble players who redefine niches and offerings.

We have considered the product life cycle concept earlier. Here we should note that product life cycles are dramatically shortening. Technology is causing more change, social media and other internet information dissemination is almost instantaneous and we have educated and informed consumers. All this leads to rapid introduction

of a new product or service but also its rapid replacement when a better substitute arrives. Does anyone still have a Blackberry?

Figure 11.6 Avoiding decline by finding new uses for the product.

11.6 Summary of Added Dimensions

With the basic strategic analysis and strategy decision making now completed, we look to refinements and added dimensions.

We can consider how strategy is played over the various levels from the grand strategy of the entire organisation down to micro strategies or tactics for a smaller, particular activity. The basic processes apply at all levels but the time horizon and the level of detail vary.

With time horizons, we need to consider the position and goals for the longer term before embarking on detailed strategies for the immediate period. This is so we do not compromise our strategies for the longer term by non-congruent short term actions.

Portfolio analysis is suitable to most businesses and activities. It gives us the bigger, overall picture of how we will allocate resources to our various activities. We can undertake portfolio analysis on the different business units in our organisation.

We can extend this analysis below the grand strategy by doing portfolio analysis on products, markets or customers. Indeed, we are not limited in our analysis to set tools. You should be able to modify existing tools or create your own to assist in analysing your unique circumstances.

Finally, there is always the dimension of time. Changes over time are happening faster than ever. We need to constantly monitor our environment and perhaps modify our strategies. This is why flexibility in strategies is now regarded as a worthwhile characteristic.

12. ENTERING, DEFENDING & LEAVING

The fundamental tools of analysis and strategy formulation have now been covered. In this chapter we will look at some extended points on three major strategic issues that most businesses face often.

As seen in the portfolio matrices in the previous chapter, we frequently need to make decisions about which businesses to defend robustly, which to harvest and which to let go. If we also seek growth beyond our existing sphere, then we also need to make decisions about which industries or markets to enter and how.

Practice makes perfect but the suggested recommendations here may save embarrassment not to mention time and money.

12.1 Entering

There are two categories of fields to enter: green fields and brown fields. Green field opportunities are white spaces of opportunities: there is a blank canvas for us to create the industry – for a while. Such spaces are rare and you need to fill them quickly before others see the opportunity.

Brown field opportunities are far more common. Here we are entering a space already occupied and we must have a strategy for entry and to compete.

White Spaces of Opportunity

Not often, we come across a white space of opportunity. Here is a space where you can be the first entrant and can create much of the scene.

The white space concept has been around for a long time but was rebadged as Blue Ocean Strategy when W Chan Kim and Renee Mauborgne, professors at INSEAD, launched their book of this name in 2005 – selling 3.5 million copies.

Their website highlights "Create an uncontested market space" and "Make the competition irrelevant".

One of the key concepts is "value creation" which is the simultaneous pursuit of low cost and differentiation. We covered such a proposition in Competitor Mapping when we discussed the power of being in the top right hand quadrant with low costs with the example of Toyota.

The fact that the authors went back as far as the nineteenth century to find 30 examples perhaps indicates the difficulty of finding totally uncontested blue oceans. Still, you must admire selling 3.5 million copies.

Though rare, blue oceans or white spaces do crop up. They often arise because of some paradigm shift in technology or social attitudes or legislation or a combination.

For example, until the 1960's around the world, most non grocery shopping was done in department stores. Then, about the time the baby boomers were entering the work force and building homes, there was a surge in demand for the same goods but at lower prices without the service of expensive department stores.

In Australia, we had a few discount stores starting up but the department stores dominated the retail channels. To encourage competition, the peak trade union body, the ACTU, began stirring up matters such as launching a petrol retail chain and a discount store, Bourkes-ACTU, just a block away from the main Myer department store in Melbourne.

Sporting goods company Slazenger refused to supply Bourkes-ACTU store, reportedly due to pressure from Myer, who did not want their profit margins eroded by the nearby discount store. The uproar, public and union response and finally Trade Practices legislation against retail price maintenance opened the door to discount stores.

A white space of opportunity arose but it was quickly filled with myriad discounters.

In New Zealand, import controls had delayed a retailing revolution until the early 1980's.

Stephen Tindall had been working in department stores when buoyant economic conditions in New Zealand combined with the removal of import restrictions released the pent up demand. There was an opportunity to sell a range of household goods at discount prices.

Tindall opened his first Warehouse shed in Takapuna, Auckland in1982.

Tindall filled the white space very quickly to leave little room for competitors. He focused on his few key success factors, especially having the products in demand and quick stock turnover. Competitors did try to follow but by then Tindall had more coverage and greater economies of scale.

The Warehouse Group floated on the New Zealand Stock Exchange in 1992 and the pressure was on from equity analysts to show where the future growth would come. Alas, in 2000 they invaded Australia by paying over $100 million for Clint's Crazy Bargains and Silly Sol's.

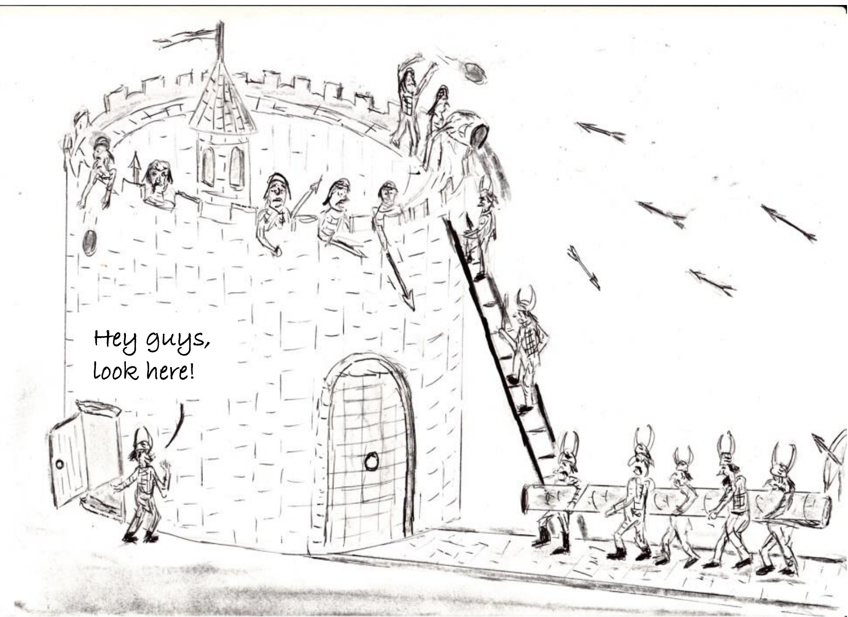
It was a disaster with operating losses and then further losses selling up during the retreat in 2005.

Unlike New Zealand in the 1980's, there was no white space of opportunity in Australia in 2000 for discount stores. The Warehouse and similar discount chains like Reject Shop and Chickenfeed have been serial failures over the years. Australia simply does not have enough concentration of poor people to make enough stores viable.

Catching one white space in a corporate lifetime is quite an achievement. It is most unlikely you will catch two. Steve Jobs was perhaps an exception with his revitalization of Apple.

Entering an Occupied Space

Entering an established space already occupied by potential competitors is the more common occurrence.



Low Price Entry

The default method of entry seems to be low prices, even without having low costs. It is astounding how often this appears to be the only thought for entry method.

In Australia in the domestic airline industry there were just two airlines for decades: Ansett and Australian Airlines (now Qantas). They were notoriously bland, flying the same schedules with the same plain service. The scope to do something different was wide. Yet all the entrants from Compass (Mark 1), Impulse, Compass (Mark 2), Virgin and even Ozjet entered on a low price proposition.

This author analysed the original Compass as soon as it launched and deemed it to be doomed and taught it as such in MBA classes. This analysis was later requested by the Board of NRMA which was being pressured to invest in the airline which was teetering by this stage. The company secretary of Compass was incensed by the analysis and rang your author to blast him about academic tripe and why did he not recognise that Compass had the lowest costs. Compass also took intimidatory legal action of placing caveats on our house.

Compass claimed lowest <u>operating</u> costs but even that was doubted. But operating or variable costs are only part of the cost story. What of all the fixed costs like safety systems, advertising, IT and booking systems, general management overheads, chief pilot, interest on loans and so on? Compass never had the scale to spread these costs as thinly as its two main rivals. The results show it ran at losses from day one and folded shortly after a year. It did not help that the airline also had poor systems, thin management and was undercapitalised.

Unless you truly have substantial costs advantages, entering on a low price basis is just begging to fail. Even if you do have a low cost advantage, still hesitate to enter on a low price basis. Nothing destroys the attractiveness of an industry like a price war. Rather, consider using the higher profit margins to build better service or features.

Judo Economics

If there is a dominant incumbent in the industry, it may be possible to enter using a technique called judo economics.

If the incumbent has major market share of say 60% or more, the entrant can use the size of this large competitor against it. If the incumbent retaliates, it risks harming the industry attractiveness and its 60% plus stake in the industry. Retaliation will hurt the incumbent more than the new entrant.

The key is for the new entrant not to be too greedy. The new entrant cannot target too large a market share or the incumbent will decide it is better to retaliate early rather than have a substantial long term problem.

The upper limit for entry is generally seen as about 10% market share. This goal needs to be clearly signalled to the incumbent (such as capacity levels) so that retaliation is deferred.

Later we will see how judo economics can be turned around as a defence strategy.

Competitive Advantage

Unless you want to join the list of failures and just enter on an offering of low prices without low costs, then you need to have some competitive advantage. You need to have a strategy and capabilities that will give you an attractive value proposition to customers and which is difficult for competitors to counter.

Move Decisively

Once your entry is out in the open, you must move decisively. Swift movement keeps your opponents off guard and you achieve objectives and scale. This requires good planning and capabilities before launching.

When ING launched its banking into Australia, they had a practiced entry strategy and executives experienced at market entry.

ING launched in Australia in 2005 with Vaughn Richter as CEO. The major banks at the time were at an all-time low in terms of customer satisfaction. They were shutting branches and reducing service while increasing fees to extortionate levels. Meanwhile they had just been exposed in the "cash for comments" scandal where certain radio talk jocks were paid secret commissions to make favourable comments about banks on their radio shows.

ING used a focused entry strategy. They targeted a select market: mainly young people who had few ties to the major banks and were tech savvy. So there were no branches.

There were few fees which also attracted the young audience. Then ING insisted that customers have a bank account with another bank. Just leave $2 in your other bank account then transfer the balance via the internet to your ING account. When you want a withdrawal, transfer the money back to your regular bank account.

It was a "parasitic" strategy but effective at reducing costs and complications for ING. Only 10 years later did ING really establish transactional banking facilities.

ING gradually raised their profile to show they were substantial and had been in finance for over 100 years in Europe. They used comedian Billy Connelly as their advertising front man. Such moves are typical of service marketing where you need to show your credibility and substantive nature when there are no bricks and mortar.

ING also considered competitor reactions to every move they made. They ran sessions on scenario sessions, calling them "War Games".

Vaughn Richter went off to open more ING banks in Asia but returned to Australia in 2012 with his family to head up the Australian operations again. He is also head of retail banking operations for Thailand, India and China!

To be balanced, it should be noted that ING was a successful entrant into a market dominated by four strong incumbents – the major banks.

ING Direct has done well but it remains a niche player. They are about the same size as the Bank of Queensland with some $33 billion in retail deposits. Profitability in 2015 was 8% return on equity which is about half of that achieved by the Commonwealth Bank. ING believes though that by treating their customers well, they will ultimately outperform.

Lessons for Entry

1. White spaces or blue oceans are rare. If you find an attractive opportunity, dive in quickly.

2. Whether a white space or a grey space muddied with competitors, move decisively and quickly. Time is not your friend. You cannot let potential entrants or incumbents get organised against you.

3. Entry on low price should be more of a last resort than first or only option.

4. If you do not have a competitive advantage, do not compete (Jack Welch).

5. Look for an indirect method to move around the incumbent and avoid head on confrontation.

6. A competent incumbent should not have left any space for entry. But be prepared for when they slip and open the door. Often this can be due to arrogance to customers.

12.2 Defending

Changing hats, what to do if you are the incumbent and you want to keep out the new entrants?

From Porter's Industry analysis framework, we have all the tactics available to raise barriers to entry such as blocking access to distribution channels, large capital requirements, minimum scale for efficient operations, legislative complexity, long term supply contracts with key customers, long term purchase contract with key suppliers, golden handcuffs for key people, patents and licenses and whatever you can add.

In addition to raising barriers to entry, a basic strategy is not to open the door to the market by leaving a substantial and attractive market

segment available. Be forever vigilant and scan the environment for potential entrants – either domestically or foreign. The biggest concern may be an entrant from left field, often due to a disruptive technology.

Never be arrogant to your customers. Once they leave, you need to overcome their inertia and distrust to lure them back. This means not gouging customers to boost short term profits. You need to take a long term approach about providing value.

Treating customers and channels well and closing substantial spaces of opportunity are key tactics to defending a market.

So we see Coca Cola launching as many product variants and sizes it can to take up shelf space in the supermarkets in order to limit shelf space available to rivals. (Alas for Coca-Cola Amatil, more fundamental shifts in consumer preferences have seen the space allocated to soft drinks shrink to make room for bottled waters!

Similarly, most of the brands of clothes washing detergents come from just two manufacturers. Cold Power, Fab, Spree, Dynamo and others were from Colgate Palmolive. These brands were acquired in Australia and New Zealand by Henkel in 2015 to join Henkel's Persil (under license from Unilever). OMO, Surf, Breeze, Sunlight, Viso and Drive are Unilever brands. Load the shelves with as many brands, variants (lemon scented, pine fresh and more) and pack sizes. The consumer believes there is already too much choice and the retailers do not need the complication of a third supplier.

In the domestic airline industry, Qantas left a door open for a business class airline, Ozjet to fly from Perth to Sydney and Melbourne by leaving unsatisfied demand for business class seats on these routes in 2005. Fortunately for Qantas, Ozjet did not see this opportunity but took the more obvious journey of scheduling routes along the east coast at discount prices. Ozjet barely lasted a month before crashing. The

scare though led Qantas to put Boeing 747 jumbo jets on the Perth – Sydney and Perth – Melbourne routes at the time just to provide enough business class seating in order to close the door on this opportunity.

In your defence strategies, there can be opportunities to be creative. In flour milling, the major player in Australia was Allied Mills. But they have been under attack from a very astute and nimble private competitor in Manildra. When Manildra would take a customer supplied by Allied Mills with a low price proposition, Allied Mills was loath to respond due to its larger market share at risk in a price war (judo economics) and its publicly listed owners who need to report earnings to the market.

So Manildra could attack in the flour market almost with impunity. Part of the solution was not to play this game in the flour market where Allied Mills had the most to lose. In the associated but smaller starch market, Manildra had the major market share with about 80%. It would be tactically better for Allied Mills to acquire a small starch manufacturer and retaliate in the starch market for actions by Manildra in the flour market. Allied Mills could apply the judo economics in a different market.

Also consider the **personalities** and **drives** of those you compete against. We do not fight companies but the people running them using the resources of that company.

You should know your enemy. This means knowing their goals, plans, rewards, personal attributes and motivations. Sun Tzu made much of his enemy general's characteristics and knew when to provoke and when to mollify and how to distract.

We often dismiss a competitor saying he or she is irrational because they do not follow our logic. Rather, consider that the competitor has different motivators to you and is logical in their own mind. You just need to know what the motivators are.

If all else fails, there is still the **price war** option: the last resort of the desperate. You need to ensure you have more financial resources than your opponent and that your actions are legal. It helps if you can offset the pain in the price war with profits made elsewhere.

The danger is controlling the outbreak of war when you have achieved your objectives. Customers are a party to price wars and they like them to continue.

The price war Fosters initiated against new brewery entrant Powers in Brisbane in 1980 lasted nationally for over 15 years even though Powers was killed off within the first year.

Pizza Hut decided to have a price war to remove Dominos from the pizza market in Australia. Pizza Hut has been decimated and sold several times but still cannot raise prices to levels of 30 years ago.

Saudi Arabia decided in 2015 that it needed to remove the sand and shale oil producers from North America in order to preserve long term high oil prices. While they drove the price to below what was thought to be the viable price for the sand and shale oil producers (about $US45 a barrel), the action was too late anyway.

The price war needed to be done before the North American producers had built their operations. Saudi Arabia needed to make entry into oil production unattractive. Once the operations have been built, they are a sunk cost. The relevant cost now becomes just the marginal operating costs, which are far less than $45 a barrel. Paradoxically, because the sand and shale operations are energy intensive, so the falling oil price also lowers their operating costs!

The price war has been ineffective at stopping the new entrants because it was enacted too late. The war has instead weakened Saudi Arabia.

Note that high debt levels weaken your defences. High levels of debt make a business more fragile and more volume sensitive. It reduces the degrees of freedom for action. When businesses believe they are secure

in their industry and there are no potential new entrants, there is the temptation to become complacent and to gear up returns on equity by taking on more debt. Beware!

Likewise, there is the temptation to save on innovation costs and stay with what you already have. The major cinema chains held on to their old film projectors rather than invest $200,000 per screen for new digital projectors. Small independent operators led the way and took market share until the major chains belatedly invested in digital.

Lessons for Defending

1. The best time to defend against a new entrant is before they enter. Discourage entry in the first place.

2. Always be considering ways and means of increasing barriers to entry. Deny resources and customers to new entrants.

3. Where feasible, avoid leaving substantial spaces of opportunity available to new entrants.

4. Avoid arrogance and gouging customers for short term profits. Long term profitability is at risk as customers seek alternatives.

5. As in any strategy, a defensive strategy is typically a number of cohesive decisions not just a single action. Consider the competitor's reaction to your reaction ....

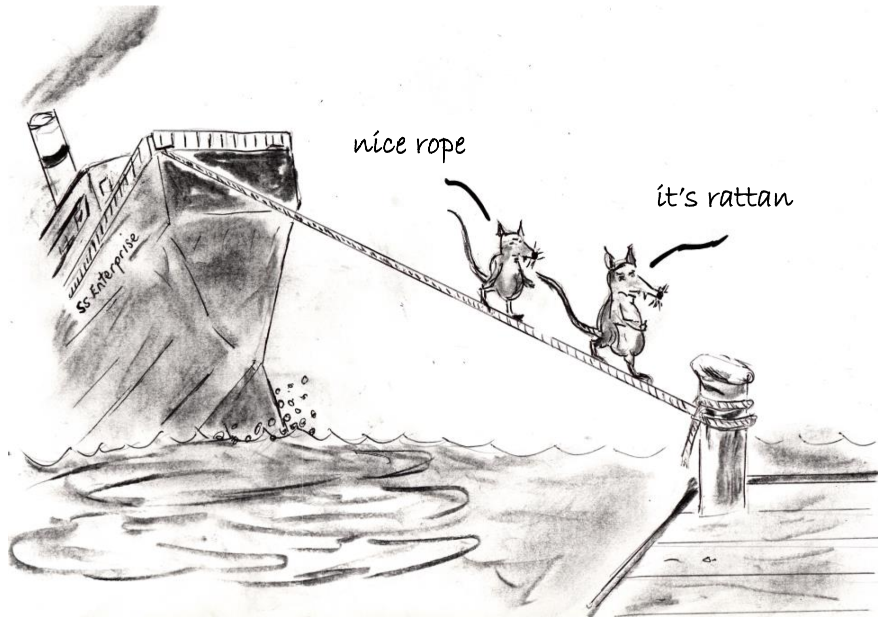
6. You compete against people not some nameless machine. Do you understand the people you are against and what drives them?

7. High levels of debt and high fixed costs or commitments reduce your flexibility to fight. Again, consider the long term when you make moves for short term gains.

8. If you must engage in warfare, can you do this on some foreign field and not your home turf?

9. Price wars are the last resort of the desperate. Ensure you have the resources to "win." Can you contain the price war in time and place?

12.3 Leaving



Know when to come, when to stay and when to leave.

If you have established yourself in an industry, should you ever leave?

Yes!

If you believe the industry will deteriorate significantly and you cannot change that situation or markedly improve your position, then certainly consider leaving.

Even in a good industry, if someone wants to offer you a ridiculous acquisition price that will exceed the returns you can foresee, why not accept the offer and go?

Far too often, managers hang on in industries, markets or projects when reality says leave. Hence the expression: "good money after bad." Studies show that most managers have difficulty in accepting sunk

costs and making their decision based on the investment and returns ahead. Instead, they keep trying to improve a bad or lost situation.

This is one reason why it is good to change CEO's every so often and that the retiring CEO should not move to the position of Chairman straight away. Have someone new who is not tied to defending failed positions.

A successful securities trader was once asked how come he never made a mistake in his investment decisions. He replied that he made many mistakes, "but rarely for more than 24 hours."

In strategy, we need a longer time frame than 24 hours but how long do you wait?

Having established yourself in an industry or market, the decision to leave is not made lightly. Use the skills of environmental and industry analysis and draw logical inferences. If the market is in decline, then you will see that reflected in the product life cycle. If the product cannot be rejuvenated, then the prognosis is not good.

The last supplier in a declining market may make good returns by charging premiums to the remaining customers who want the product. But if several players stay and they start bidding for the remaining customers, then the outcome is a price war on falling volumes.

Check the dynamics of the industry using Porter's 5 forces model and determine if profitability for rivals will increase or come under pressure in the coming years.

Logic will indicate whether returns will improve or deteriorate in the future. If returns seem likely to fall below the cost of capital, shareholder value will fall.

Discipline

Wesfarmers has been a very successful company growing from the small Westralian Farmers' Co-operative in 1914 to be Australia's

largest private employer. Wesfarmers has a discipline of businesses required to achieve long term returns above their cost of capital. At the turn of this century, the benchmark was a 17% return on funds employed (ROFE) which is defined as EBIT divided by (debt + equity). The original Wesfarmers Co-operative business was not meeting this mark and so was sold to AWB in 2003 without emotion.

Another example is the Australian Print Group which was the 4th largest book printer in Australia. But by 2000, the owners looked into the future and decided it was bleak. There was the thought that the internet would lead to a decline in printed media including newspapers and books. This has happened even faster than they predicted.

The internet was also the source of a disruptive technology. Until 2000, on demand book printing was largely done in Australia as physical copies of proofs (and the proof reading) needed to pass back and forth from the publisher to the printer. The internet removed this physical movement by allowing files to go anywhere. Suddenly, competition was no longer Australia based but could come from Singapore, Philippines, or anywhere.

Meanwhile, the second largest book printer, Diamond Press was winning orders with aggressive prices that competitors could not match. This continued until Diamond Press went into receivership for pricing below cost!

The final nail in the coffin was a change to the "rules" of book printing. For over a century, book publishers had filled book stores when they launched a new book. If copies did not sell in the first few months, the publishers would take them back, pulp the books and credit the book stores a refund. Such a rule was a bonanza for book printers who would receive printing orders up to 50% above real demand.

When GST was introduced into Australia in 2000, the book publishers unanimously changed this rule. They cited the complexities of refunding GST and GST BAS returns as an excuse to no longer take back unsold books. The bookstores halved their orders overnight!

The owners of Australian Print Group saw the writing on the wall and actively moved to leave the industry. They sold to the then 3rd largest book printer McPhersons for a price several times greater than they would have accepted. McPhersons was a publicly listed company keen to show the stock market it had some growth (albeit from acquisition) and possibly had a more rose coloured view of the future.

A third example is that of Woolworths entering the hardware retail market with its US partner, Lowes. They entered against a very strong incumbent, Bunnings, who is owned by Wesfarmers.

The brand used by Woolworths and Lowes is Masters. They have made just about every mistake there is on entering a market.

We are on record saying it would fail even before the first store was opened. Not only was there no competitive advantage, there were numerous competitive disadvantages

Bunnings is an able competitor. They have already tied most of the best brands to exclusivity deals, denying Masters pull through demand. They have filled most of the best sites and extensive market coverage.

There was no competitive advantage for Masters. The best locations for stores are already held by Bunnings so Masters went for large and cheap sites far from customers. In a scene reminiscent of the movie, *Field of Dreams*, Masters hoped if they built the stores the customers would come. The customers have not followed the script and the field is a nightmare.

Adding to the woes, Masters had no focus in its offering. The large stores try to be a bit of everything from homewares to hardware. Staff members are poorly trained and there is no credibility. The stores do not appeal to any particular market segment.

There remains insufficient scale. The first store was opened in 2010. By 2012, there were meant to be 100 Masters stores across the country but there were only 20. By 2015 there were 50 stores and in poor locations.

Sales were $930 million which was less than Bunnings made in operating profit that year. Analysts estimate that Masters needs to double its sales just to reach break-even, which is one of our tests for strategic decisions.

Meanwhile, the losses keep growing. In 2014, the losses were $170 million. In 2015, the losses were $250 million. There are estimates that Woolworths and Lowes have already sunk in $3 billion. Such losses should have been foreseen in a logical strategic assessment in the planning stage.

So, should they stay or leave?

CEO’s of Woolworths have been leaving but Masters has stayed. Money is being spent remodelling existing stores to look more like Bunnings. The number of stores needs to at least double. Is it worth it?

The Board and senior executives of Woolworths kept insisting they were in for the long haul. Lowes may have had different feelings. Finally, in early 2016, it was announced that Masters was dead. Woolworths and Lowes were looking for a buyer but the realists expected it to just close.

Meanwhile, Woolworths has been facing increased competition in the Supermarket arena with a revitalised Coles (again owned by Wesfarmers) and an expanding Aldi keen to block out its fellow German rival Lidl from entering the Australian market.

Possibly after much time, effort and funding, Woolworths can make Masters viable. The real question though is whether it is worth it. What else could be done with those scarce resources elsewhere?

This is the point by economist Joseph Schumpeter saying that capitalism is as much about destroying old structures as creating new ones. Unless we release resources from poor investments, we limit our ability to invest in new and better opportunities.

The $3 billion already invested in Masters will not be lost when Woolworths and Lowes quit. It is already lost. It is a sunk cost that has gone.

Lessons on Leaving

1. You can dream on or face reality.

2. Leaving should always be a strategic option.
3. Environmental analysis and industry analysis will provide logic on likely outcomes.

4. If you can see it is time to leave before it is generally accepted, you have the opportunity to maximise your return on leaving.

5. It may be possible to play games to have another layer to buy you out at a premium.

6. Sunk costs and history should be irrelevant to your decision. However, many managers find it psychologically difficult to let go. They throw good money after bad.

7. Staying on in a poor industry has an opportunity cost. What could you have done with the resources if you had left and released them?

13. GAMES THEORY

13.1 A Brief Overview

Games theory has evolved from a group of mathematical theories regarding competition. Games theory applies statistical logic to the choice of strategies.

A game consists of two or more players (individuals, companies, groups, teams) that choose strategies designed to maximise their own winnings or to minimise their opponents' winnings (called maximin solution). The game rules specify the possible actions for each player, the amount of information they have as play progresses, and the amounts won or lost in various situations.

Originally the games were zero-sum (what one player won, another had to lose) but now we can look at co-operative versus non co-operative games. Indeed, the term "co-opetition" is just an extension from games theory.

Cynics would argue that it is still a zero-sum game. Just that now one group of players is looking to do better for itself at the expense of other players.

13.2 History

Games and game theories have been practiced for millennia. Modern games theory adds considerable statistical power to the play. Modern games theory was devised and set out by John Von Neumann. He was a brilliant mathematician who was employed by Intelligence in WWII to develop mathematical models from the photographs of bomb blasts to understand and improve the efficiency of bombs and bombing. Despite his name, Von Neumann worked for the Allies.

He was described by his colleague, the physicist and later anthropologist, Jacob Bronowski, as one of the two most brilliant men Bronowski ever met. The other man was someone called Albert Einstein.

During the 1940's and 1950's, Von Neumann was trying to understand how the world of people really worked. He was joined by a neo classical economist, Oskar Morgenstern.

Initially, Von Neumann was looking at games with just two players. He then expanded it to three and showed how it became exponentially more complex.

Von Neumann and Morgenstern restricted their analysis to zero-sum games.

In the early 1950's, John Nash removed this restriction by mathematically distinguishing between co-operative and non co-operative games. He also recognised that there are sets of optimal strategies which lead to a stand-off (now called Nash equilibria). Nash and two others received the Nobel Prize in Economics in 1994 for their work on Games Theory.

13.3 Basis in Economics but Going Beyond

Economics was based on the assumption that people are absolutely rational in their economic choices ("rational man"). [More recently, "rational man" concept has been replaced by "psychologically complex person" concept]. Basically, we seek to maximise our welfare. It thus narrows the possible choices down to something that is more predictable than irrationality. We are not going to touch chaos theory here!

However, such an assumption really is applicable only to the individual in the economic circumstances or environment applying at the time. What about when there is less than an efficient perfect competition

situation (this is the economist's nirvana)? Or if ownership is not clearly defined (one player can grab something that perhaps rightly belongs to someone else)? Or if there are non-monetary goals like prestige or power?

Games Theory tries to overcome these problems. It looks at how people **interact directly** rather than through the mechanisms of the market through supply and demand and so on.

Despite the title, games theory is about serious interactions in our societies. Yes, it covers games like cricket, football, poker and so on. But it is applied to military strategy, market competition, pollution control and so on.

In these interactions, our choices are about strategy. The outcomes will depend on the strategies chosen by each of the participants. Games Theory will not guarantee a particular outcome. It is a statistical assessment of **probable** outcomes over time.

We need to consider such interactions in business, politics, social life and so on. Do we have the luxury of having several rolls of the dice or is it a sudden death game? Can we perhaps change the rules if we do not like the current set of rules?

Finally, we are usually playing in a complex real world with many players, not just two or three. Therefore, we are NOT going to get a neat mathematical formula for strategy and pay-off. Still, we can use the theory as a guide but we will need to apply considerable "art" to achieve a realistic strategy.

13.4 Playing Games

We can play games at all levels of strategy, from the grand strategy over several years to micro strategies and tactics over a few weeks.

We can look at the game playing of Singapore Airlines when it was blocked as being the foundation shareholder of Qantas at its IPO to its moves to shake out Newscorp from its half ownership of Ansett Airlines (including having Impulse Airlines and Virgin Blue enter the market to scare off Newscorp).

We might consider the games to legally promote a price rise.

Some of the issues to consider in game playing include:

Alliances
Signalling
Effects of Learning
Threats of Retaliation
Single or Multiple Period Games

Finally, if you do not like the way the game is being played, can you **change the rules**? If not, maybe you might need to leave the game. In any case, you have choices and there are usually opportunities even in the most dire of industries.

Figure 13.1 Making Money out of Lemming Suicides
[Note: Lemmings committing mass suicide over a cliff is a Disney myth]

13.5 Payoffs and Probabilities

At the heart of games theory are probability payoffs.

If you bet $10 on the toss of a coin you should have a 50:50 chance of winning $10 or losing your $10. A statistician would likely be indifferent to this outcome. The probable result is still the $10.

Interestingly, most people and nearly all accountants would choose not to bet and keep their $10 safe. Most people have a bias towards risk aversion.

But what happens if we change the payoff? Say it is still a coin toss and you bet $10 but now the payoff if you win is raised to $30. Most people, unless very risk averse or opposed to gambling, would now choose to gamble.

So payoffs and probabilities change behaviour.

We see this exemplified in the plea bargaining in criminal cases. Lazy prosecutors give the criminal the option of pleading guilty to dangerous driving with a $500 fine or taking the chance on prosecution for murder and a possible 20 year sentence. This example is perhaps a tad extreme but we do see exaggerated payoffs against their probabilities to reinforce the preferred behaviour.

Such exaggeration explains some regulatory behaviour. It is very difficult for the Trade Practices Commission to gain evidence for successful prosecution for price fixing between suppliers. So the legislation gives dire penalties: multiples of damages to be claimed by the affected parties, heavy financial penalties and criminal sentences for the executives involved. As well, there is considerable lenience given if one of the colluding parties confesses early and provides evidence.

We see much game playing in strategy, particularly at the tactical level. If we take this action, how will it make our competitor react? Can I signal that I would like to see a general price rise in the market? Watch

how the banks take turns to signal changes in interest rates and how the others soon follow.

13.6 Time and Learning

We sometimes see a competitor react in a manner that seems disproportionately aggressive to our actions. For example, we may pick up a competitor's customer only to find the competitor "buys back" the customer with much reduced pricing and then goes on to attack several of our customers. This is done, even to the detriment of lost profits by our competitor.

Although "unreasonable" in the short term, the competitor is probably thinking about long term profitability. We will eventually learn not to target this competitor's customers – it costs us too much. We have been taught a lesson for future plays.

When we play games in business, it is usually over a long time period and will involve several plays. So there is much scope for learning and changes to responses.

13.7 Complexities

Von Neumann, when first developing Games Theory, found that the complexities in a game increased exponentially as he increased the number of players from 2 to 3. Once we have 4 or more players, as we usually do in business, the exponential curve starts to rise up off the chart!

Now add plays over several time periods and the effects of learning and the complexity multiplies again.

Consequently, successful game playing is usually restricted when we are targeting one other player such as a competitor or customer or supplier. We can perhaps handle 3 players with less certain outcomes.

Add more players and not only do the complexities increase but the chances arise of a maverick player entering who does not play by our rules.

Subtly, if you do not like the game, consider changing it. Can you change the rules? Perhaps change payoffs, perhaps distract the other players while you play another game.

In the cinema business in Australia, there is a key rule of the game. That is that the cinemas pay a proportion of the ticket price to the film distributors. This is typically 40 – 45% of the ticket price. This is just a rule that has been around for decades.

The effect of this rule is to give a benefit to cinemas charging low ticket prices. So if a cinema is charging $15 a ticket and the fee to the film distributor (Sony, Warner Bros, etc) is 40%, then $6 is paid to the film distributor. But if the cinema charges only $8 a ticket, then the fee paid to the distributor drops to $3.20. This is a major cost saving to the low price cinema.

This rule makes it more viable for discount price cinemas to operate. It is a dysfunctional rule to the film distributors too as they receive a lower fee. However, there is inertia among the film distributors to change the rule, partly as they now make less than 10% of their revenue from the film display - more is made from selling the associated merchandise and perhaps product placement in the film.

This rule is a disaster for the high price cinemas though and boosts competition from the discount cinemas.

The best tactic for the high price cinemas is to change the rule. They should be lobbying to scrap this rule and have a set fee for the film display, say $6 a ticket. This rule change immediately sets a floor price to the ticket price.

A strategy should be devised by the high priced cinemas to change the rule. Such a strategy would have several integrated decisions to it. We

could lobby the film distributors for the rule change. If they are not interested, could we try a legal challenge under trade practices legislation that the distributors are practicing price discrimination by selling the same product at different prices to similar customers? So far, nothing has changed because of personal inertia by the high priced cinemas.

13.8 Summary of the Strategy Game

In addition to our basic strategic analysis and decisions, we have added extra dimensions and advanced game playing.

At tactical levels, we can now also consider advanced game playing. How can we move competitors or customers to behave in a way that benefits us? This would be a zero sum game where we take profitability from the other parties

Perhaps we can motivate a competitor or customer to co-operate with us – usually to the detriment of some other players.

We can enhance the likelihood of a desired outcome by exaggerating the pay-offs for various actions,

If we still do not like the outcomes, can we perhaps change the rules of the game to our advantage?

14. STRATEGIC PLANNING

Strategic planning or budgeting is an oxymoron - Henry Mintzberg

Strategy lies between our mission and goals and the implementation of plans (actions) to achieve that mission and goals. Strategy is **how** we are going to achieve.

We have been focused on the devising of good strategies, from conducting the analysis to determining the appropriate decisions. This is where most managers have the gaps in their skill sets.

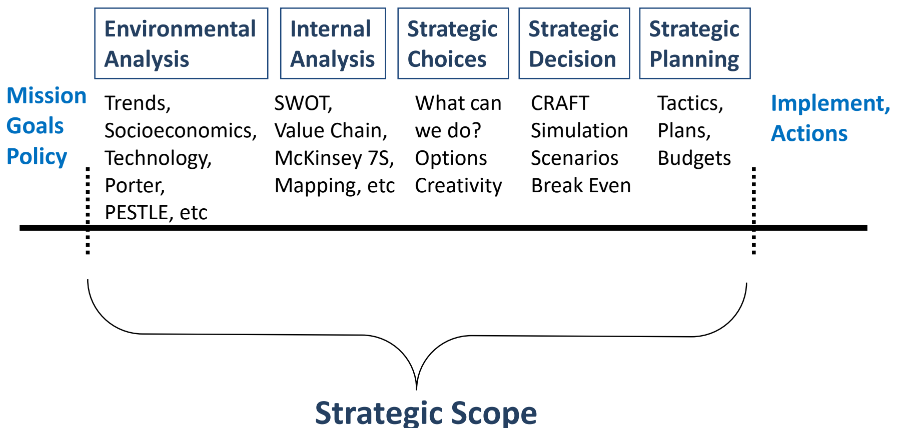


Figure 13.1 Strategic Scope

But strategies are barren if they are not translated into actions and movement. Developing plans (or strategic planning) is the step that details the strategic decisions into actions.

Strategic Planning as a concept has had several cycles of being in and out of favour. Strategy academics such as Mintzberg have panned the concept. Strategic Planning as a business activity was dealt a major blow when Jack Welch, legendary CEO of General Electric, sacked the entire 200 staff of the company's strategic planning department.

However, strategic planning has made a strong comeback in the new millennium, partly led by accountants who want to have a more exciting and strategic role.

14.1 Defining Strategic Planning

Much of the confusion and debate about the role of strategic planning is due to very loose use of the terminology.

So let us first attempt a working definition of strategic planning.

First, it is **not** about developing corporate strategy. The big picture and strategic positioning should already be done.

Second, strategic planning is **not** doing the budget with a few commentary lines at the start. The budget is the detailed allocation of resources and expected results, usually for the coming year. The budget is a sub-set of the detailed one year plan.

Strategic planning is most usually at the level of the business unit or product management. It is the plan to apply the strategic initiatives required to achieve that unit's part in the overall strategic goals or mission. The grand strategy of a large business does not usually become detailed in an explicit operating budget – although it may have a broad budget for major capital expenditure over the coming years.

Strategic planning is mapping out what the business or department unit is going to do in the short term about achieving its goals and objectives. The budget will be a sub-set of this planning process in that it will

forecast the revenue and expenditure plans of the unit over the strategic planning period.

So the budget should be an outcome of the strategic unit plan, within the fiscal constraints and directions of the whole organisation.

The strategic plan will consider what resources need to be deployed, the tactics that should be pursued and the milestones that need to be achieved. The plan will also be directional and not necessarily 100% prescriptive. We need to allow for a little uncertainty and opportunity.

We have previously defined strategy as a set of integrated decisions and choices to move us in our desired direction.

Strategic planning is similar but more short term. It is taking the myriad of daily decisions we make over a year about staffing, activities, resources and so on and giving them overall guidance. Instead of operating ad hoc, it is about integrating those decisions into a cohesive plan that has direction.

Strategic planning should be a tool to make your unit more **effective**. It may also aid your unit to be more **efficient**.

14.2 State of Play

Most organisations now require unit leaders to give thought to strategic considerations and provide strategic appraisal as background to their budget planning and presentations. We seek to lift the game so that strategic planning is more than a preamble to the budget presentations. Strategic planning should be the key determinant of budget preparation and a key defining role of the unit leader.

Not surprisingly, most organisations are still far short of this goal.

McKinsey Consulting researchers, Eric Beinhocker and Sarah Kaplan surveyed a number of US corporations and found considerable

cynicism among business unit leaders about Strategic Planning [Tired of Strategic Planning, 2007]. While senior executives agreed that crafting strategy was one of the most important aspects of their job, they generally thought the pay-off was low. CEO's complained that few fresh ideas arose and that there was considerable game playing and politics. This is typical of budget games and shows the lack of real strategic analysis and thought.

A common view was that the annual strategy review frequently amounted to *"little more than a stage on which business unit leaders present warmed-over updates of last year's presentations, take few risks in broaching new ideas, and strive above all to avoid embarrassment. Rather than preparing executives to face the strategic uncertainties ahead or serving as the focal point for creative thinking about a company's vision and direction, the planning process 'is like some primitive tribal ritual'."*

Surveys of large corporations indicate that CEO's would like to spend about a third of their time on strategy issues (determination, planning, measuring, implementing). Reality falls far short. As we move down the management hierarchy, allocation of time to strategy lessens and time spent managing current issues increases until near the bottom it is largely administration time. But we still need some strategic input to make the management and administration effective.

The following numbers are drawn from the Balanced Scorecard Collaborative which has been set up by Kaplan and Norton. Be wary of putting too much faith in the numbers as there is perceived bias of interest in the statistics. Remember that 93% of all statistics are made up.

Anyway, their data indicate that:

> 95% of a typical workforce does not understand its organisation's strategy
>
> 90% of organisations fail at successful execution of their strategies

86% of executive teams spend less than an hour a month discussing strategic issues

60% of organisations do not link budgeting to strategy.

14.3 Purposes of Strategic Planning

If we are finding poor results from the strategic planning process, why continue to invest in it?

Well, in socioeconomic environments of increased risk and uncertainty, developing and implementing appropriate strategies is increasingly important and useful. As we have seen, a strategic plan is no longer a direct road map to a destination. With increasing uncertainty and risk, it is now more a topographic map by which we set the general direction but are prepared (and flexible) to adjust as we journey towards our goal.

Strategic planning is like the daily route planning in a long trek or journey.

There are several goals claimed for strategic planning. The McKinsey researchers consider two overarching goals:

1. To **build prepared minds**. That is, for the business unit leaders to have a solid understanding of their operating environment and of their unit and to understand the strategy and assumptions behind that strategy. By this way, the unit leaders are well grounded and are prepared to quickly respond (even pre-empt) changes, challenges and opportunities thrown up along the way.

2. To **increase the innovativeness** of the unit's strategic initiatives. This will require real and meaningful dialogue with staff and cross functional units and even outside influences. The purpose is to throw up new insights, questions

and ideas. If however, there is only a desire to get the job done and present a safe, bland plan, then such innovation is unlikely.

14.4 Implementation

Alas, most studies show that organisations are poor at implementing their strategic plans, even when they have one.

The strategic plan must be a living plan – not something done to appease the hierarchy and then consigned to a bottom drawer.

To live, the plan needs to be:

Realistic

Related to the operating environment and organisational goals

Fluid – not cast in stone

Used (at least in monthly reviews)

Have responsibilities assigned

Have milestones

Linked to budget

To implement, we need:

A committed leadership

At least minimal levels of the McKinsey 7S factors: structure, staff, skills, strategy, systems, style, shared goals

A plan to implement (seriously, you need to plan to implement the plan to overcome the negative forces and obstructions)

Make strategic planning and implementation a habit rather than an annual retreat

Tips to better implementation:

Establish the goals and articulate into measurable objectives

Promote the suitable culture

Set some early and achievable goals (build success at winning)

Celebrate wins and successes

Seek new ideas and opinions – welcome diversity

Do not be distracted or be nibbled away by bureaucratic minutiae

Delegate

Empower by having inclusion

Build allies – up, down and sideways

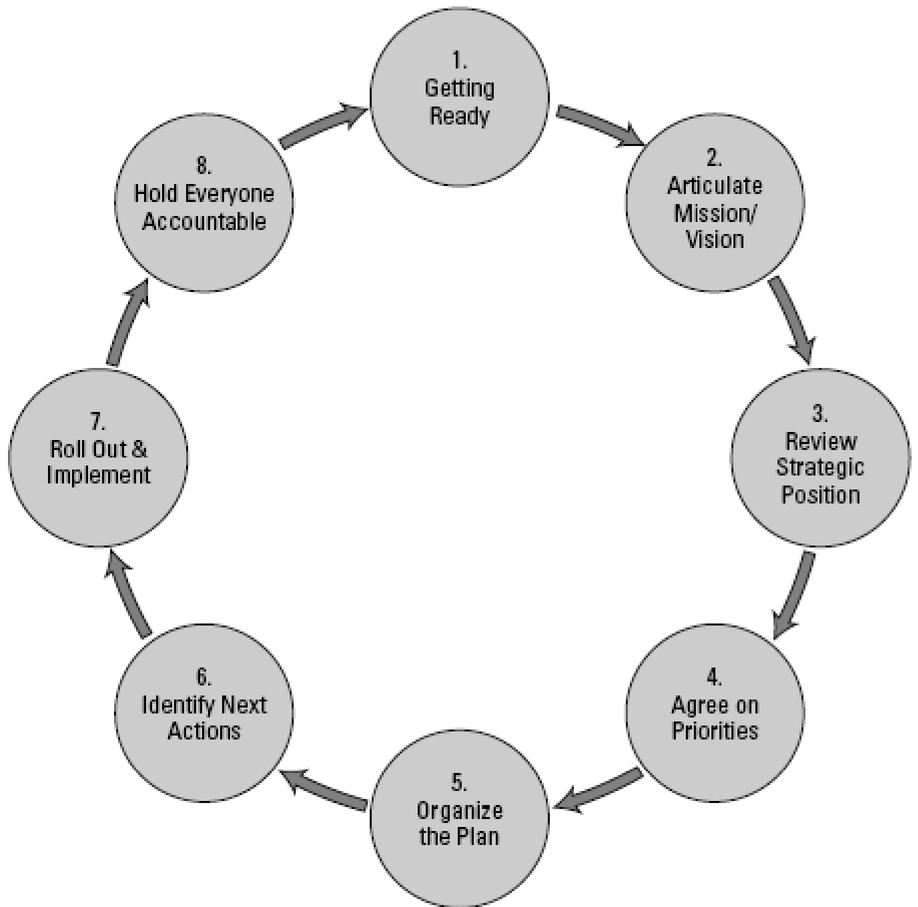
Neutralise the negative forces

Be passionate

Translate and communicate (and check that the message has been received)

Strategic Planning is an ongoing and continuous process (Erica Olsen)

Key steps are shown in the diagram on the next page.



14.5 Military Example

As you would expect, the military has been teaching planning for some time, at least short term planning. In their jargon, this is termed Course of Action (or COA). Typical of the military, they break down the process into short steps.

The following guidelines come from the Australian Army junior military officer's training handbook. The guidelines largely tie in with our assessment of the environment, consideration of our internal capabilities (and those of our enemy or competitor), development of strategic choices, decision on course of action and execution of that course. It even allows for contingencies and perhaps modifying the mission as events unfold. The processes are outlined below.

Situation Assessment

Before writing orders, the platoon commander should assess the situation and task at hand, ensuring understanding of the company commander's intent. [Company commander is the level above platoon commander, so this is ensuring congruence of the platoon commander's strategy to the level above]. The platoon commander's orders should be broken down to section level with the emphasis being on group and individual responsibilities.

Military Appreciation Process

Factors to be considered are:

Your commander's intent
Your mission
Your enemy's strengths and weaknesses
Your own strengths and weaknesses
The ground
Weather
Time and space

[This is the external environmental analysis and internal capability analysis of our strategic assessment].

Mission Revision?

At the end of the appreciation process (or during), ask yourself "has the situation changed so much that I must amend my mission in order to achieve my superior commander's intent?"

[Gap analysis and checking aptness or fit with the mission].

Course of Action
After consideration of these factors, a number of probable courses of action should be identified from which the best course of action will be decided. Contingencies will be considered.
[Assessing strategic options and deciding on the best option].

Resources
Naturally, as part of the planning, resource needs will be considered. Depending on the length and complexity of the course of action, there may be substantial logistical planning required: ammunition, food, medical reserves, preparation and training, rest, scenario running.
[Considering capabilities to sustain ongoing action].

The overall activities are summarised on the diagram below.

Table 1–1: The Individual Military Appreciation Process

Step 1 – Mission Analysis.	Changes to situation, intent, tasks, limitations, confirm mission.
Step 2 – Battlespace (Environmental) Analysis.	General use maps, air and satellite photographs, computer terrain visualisation, visual reconnaissance and patrol going maps used to identify obstacles, approaches, decisive terrain/key terrain, weather.
Step 3 – Enemy Analysis.	Weapons, locations, layout, intentions, tactics.
Step 4 – COA Development.	Main enemy weakness, own troops, assess tasks, broad COA.
Step 5 – COA Analysis.	Review enemy and own COA, wargame (action, reaction, counter-action), identify advantages and disadvantages.
Step 6 – Decision and Execution.	Compare COA, select best, develop and issue orders, execute, consider contingencies.

14.6 Planning Tools

There are a number of tools used to help in planning. Given the uncertainties of today, scenario planning and modelling are being used more frequently.

A few older tools help give a visual presentation of the steps to be covered and the timing. These can be particularly useful to keep in mind the big picture and also to ensure the timetable is running properly. Some of these tools such as Gannt charts and PERT or CPM (Critical Path Management) are methodologies that give a visual representation.

But that is enough for now!

Appendices

Growth: Strategic Options

Du Pont Analysis

Break Even Analysis

Creativity

Managing Risk

History of Strategic Models and Frameworks

Investment Evaluation

Discounted Cash Flow Analysis

Fundamental Analysis

Fads and Fur

Growth Strategic Options

1. Desirability of Growth

We have used maximisation of shareholder value as our ultimate corporate goal. This is largely true for businesses engaged in making profits.

Agency theory tells us the Board and senior executives are to act as agents for the shareholders and to act in the best interests of the shareholders. This is not always true. There are many instances where Boards and senior executives have operated in their own best interests before those of the shareholders who are the owners of the business.

Shareholder interest can also come under challenge as shown in the concept of triple bottom line reporting. Not only are we interested in the impact of the strategies on the financial bottom line (the profit figure at the bottom of the income statement) but also the impact of the business on its community and on the environment.

With not-for-profit organisations, it is a very different scene and much time must be spent canvassing the multiple stakeholders to derive a suitable mission to achieve.

Notwithstanding the above, a business with shareholders must give at least major attention to shareholder value.

We saw that the fundamentals of shareholder value are:

Returns
Risk

Indeed, everything in finance is about the risk / return trade-off. Are the returns sufficient to justify the risks? Thus our strategies are just as

much about managing and reducing risk as they are about boosting returns.

Risk and returns are the two fundamentals of shareholder value. But there is a third element that is the cream on top. That is **Growth**.

Growth is often ill defined by senior executives and sometimes refers to growth in sales, growth in market share, growth in power and more. If it has meaning to shareholders, it should be growth in long term earnings. For finance aficionados, we would normally measure growth as long term growth in earnings per share.

The "long term" proviso is to ensure it is sustainable growth and not a "quick buck" now that leaves the business vulnerable or floundering in the future.

We see the share market willing to pay a premium for companies above their risk / return value if there is belief in good growth prospects for earnings.

It would also seem that CEO's like to have a growth story for public relations benefits and for ego. So a strategy is very desirable if it can produce good long term returns commensurate with the risks and can deliver some earnings growth.

2. Broad Avenues for Growth

The growth matrix is depicted below. You could depict it as a 3 dimensional matrix by distinguishing Technology from Product into separate factors.

On our matrix, "Products" is intended to also include the technology to produce those products or services.

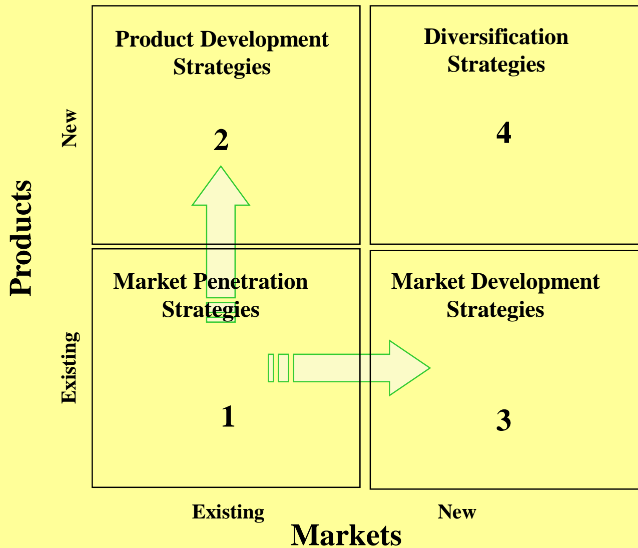


Figure 1 Expansion or Growth Opportunities Matrix

The numbers in each quadrant are a generalised assessment of the risk ranking although there are many exceptions.

Market Penetration Strategies

Quadrant 1 in the bottom left hand corner is the current sphere of operations. This is where you are serving existing, known markets with your current products and technology processes. This should be well known to you and hence the risks identified and customary.

To grow in this sector, you need strategies designed for market penetration. These strategies seek to increase your market share or your profitability per unit of sale.

McKinsey and Co have published a research paper describing how for large companies, growth rarely comes from this sector but from identifying new opportunities in the other quadrants or sectors.

It is difficult to be awed by this research as it is just a mathematical truism. If you already have 60% or more market share, gaining more market share will be difficult: competitor reactions and difficulty in satisfying the needs of a range of diverse customers. On the other hand, if you have just 6% market share and can manage to crib another 3 percentage points to go to 9% market share, then you have increased your sales by a dramatic 50%.

So small companies in this sector can look to grow market share with strategies of product broadening, enhancement of features, different distribution channels, market awareness tactics and so on. Large players are mainly pursuing defensive strategies.

If we cannot obtain our growth goals in quadrant 1 we will need to look beyond this zone to the other quadrants.

Product / Service Development Strategies

It is suggested that quadrant 2 of same markets but new products is generally the next safest place to move. [Note: even if it is safer it does not necessarily mean it is the best option since the returns might be commensurably greater in the other quadrants].

Strategies to move into quadrant 2 are cross selling and on selling to existing customers. We hear the buzz phrase of *"bigger share of wallet."*

So a bank might try and sell its existing customers insurance products or stock broking services or travel booking services or……. Of course, you will come up against competitors in this quadrant already selling such products and services to your customers so it will help to have some competitive advantage. In the case of a bank, their extensive branch network may be an advantage to retail customers. With the

Commonwealth Bank, they moved quickly and decisively into low fee stock broking and achieved scales of economy well ahead of competitors.

The counter to cross selling to your existing customers is that new competitors from other industries are also trying to do the same thing to your customers!

Market Development Strategies

Alternatively, we may take our existing products and technologies and seek a new market for them.

The new market may be a new geographic market such as rolling out to other States or exporting. They may be a new demographic market: different age group or education level or income level or…… Toyota is claimed to be the first major car maker to recognise and deliberately target the "pink demographic": gay couples without children and a luxuriant lifestyle. There was some tweaking of product and a significant change in marketing.

This quadrant is generally considered riskier than the product development quadrant due to the complexities of a new market. It is generally simpler to devise new products or utilise new technologies than to understand new customers, their preferences, decision making, distribution channels and the like.

Diversification Strategies

The final quadrant is full diversification: new products and technologies in new markets. Because everything is new to your company, the risks are generally the greatest.

Risk mitigation is thus a major feature of successful diversification strategies. Considerable market research is sensibly undertaken. We may use a reputable technology provider with proven turnkey

operations. Often a local partner is used although that can have problems of compatibility.

In the case of Woolworths entering the DIY building supplies market it used a US partner, Lowes, to understand hardware marketing but thought that they knew the market well enough themselves. Hundreds of millions of dollars later in losses, they are having second thoughts – a common outcome for a diversification strategy with no competitive advantage.

In summary, growth is cream on top of the basics. Ensure you have the basics in check first: fundamental risk / return parameters.

The old maxim from Jack Welch applies: if you do not have a competitive advantage, do not compete. Ensuring there is some competitive advantage before pursuing growth in any of the quadrants is a pre-requisite.

DU PONT ANALYSIS

1. Du Pont Analysis

Du Pont analysis was developed by the Du Pont Chemical Company. It is a simple but powerful analytic tool for improving an organisation's profit performance.

In its very basic form, it looks at return on investment (ROI). In most cases, this is defined as profit / assets. Return on Capital Employed (ROCE) or Return on Funds Employed (ROFE) is much the same concept. The result is expressed as a percentage. So if the profits are $2 million per annum and the assets invested in the business are $10 million then the ROI is: $2 million / $10 million = 20%

ROI is a key performance indicator. Managers and investors alike concentrate on it.

But it is merely descriptive. It does not tell you how to achieve a "good ROI" or how to improve ROI.

This is where Du Pont analysis helps. It breaks ROI into its component parts. The first incision is:

$$\text{ROI} = \frac{\text{Profit}}{\text{Assets}} = \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}}$$

Profit / Sales is the ***sales margin***. This is what percentage profit is made on each dollar of sales. If profit is $2 million and sales are $20 million, then the sales margin is:

$2 million / $20 million = 10%

Sales / Assets is the ***asset turnover*** ratio. It measures how much sales can be serviced by each dollar of assets. If sales are $20 million and assets are $10 million then the asset turnover is:

$20 million / $10 million = 2

Sales margin times asset turnover equals return on assets. In our example, it is 10% x 2 = 20%.

2. Improving ROI

This opening up of the ROI ratio still does not show how to improve ROI but it is more informative. We see the first components of ROI and can make a judgement if there are problems in either the sales margin or in the asset turnover ratio.

Any actions that improve the sales margin will improve the ROI.

Likewise, any actions that improve the asset turnover ratio will improve the ROI.

2.1 Improving Sales Margin

In general terms, there are only two ways to improve the sales margin:

1. Raise prices
2. Lower costs

2.2 Improving Asset Turnover

In general terms, there are only two ways to improve asset turnover:

3. Sell more
4. Use less assets

In the sell more method, we need to increase sales by a greater percentage than the assets increase. In the use less assets method, assets must be reduced by a greater percentage than sales perhaps fall.

So the four ways to improve ROI are:

1. Raise prices
2. Lower costs
3. Sell more
4. Use less assets

There is a 5th way: change the product mix. Aim to sell more of the high profit margin or low asset intensity products. The Du Pont formula does not readily show this method.

Typically, management has concentrated on just one of the above four methods: lower costs. This generally means reducing the number of employees.

But Du Pont analysis reminds us that there are three other methods that are important. Some managers are finally awakening to this fact.

Again, McKinsey & Co. have a research paper on Du Pont Analysis. Again, it is largely a mathematical truism. They find the factors that have the most impact on improving ROI are increasing prices and increasing sales volume. These are the two factors that make up the top line of the Income Statement: sales revenue.

Yet most managers fall back to the other two options of reducing costs or reducing assets.

Why? Well, reducing costs and reducing assets are internal to the business and are easier and faster to implement. They are largely controllable actions.

Increasing prices or increasing sales volume are external to the business and are less controllable and much more difficult to achieve. But they deliver the highest payoff.

To be able to raise prices and increase sales volume requires you to have an attractive value proposition to customers. It requires a competitive advantage. It requires all the hard work you have put in to devise and implement successful strategies!

3. How to Do It

This is the difficult part. So far, the analysis is still mostly descriptive.

It now requires detailed information about a business's operations in order to come up with feasible actions to raise prices, lower costs, sell more or reduce assets.

Some possible actions might be:

- changing the product mix
- more effective marketing (perhaps telemarketing)
- product rationalisation
- sale and lease back of assets
- lower overheads
- cheaper sources of finance
- more productive staff (e.g. multi skilling)

4. Detailed Du Pont Analysis

Du Pont analysis goes beyond just the asset turnover ratio and sales margin. It details the various costs and assets that make up the business. This is usually put on a large chart.

It also quantifies the analysis. Actual numbers are put in for the sales, costs, different assets and so on. From this the ROI is calculated. We can even go further and include gearing and then calculate return on equity.

Then any changes made to assets, prices, costs and so on are adjusted on the chart. The new ROI is then calculated.

Simple Du Pont charts are attached. In reality, they would be more detailed. For example, current assets would be broken down into debtors, stock and other assets.

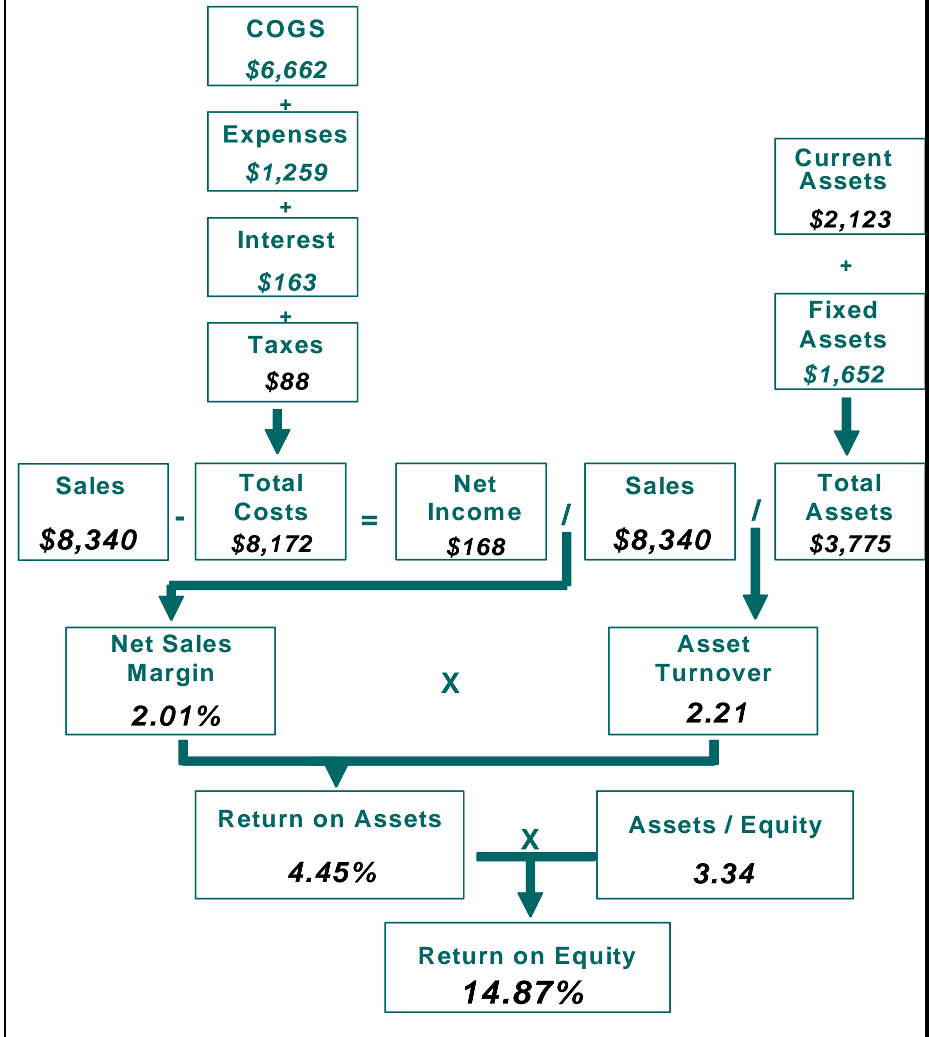
For those of you with accounting knowledge, you will see that the model basically maps the Income Statement (down the left hand column) and the Balance Sheet or Statement of Financial Position (down the right hand column).

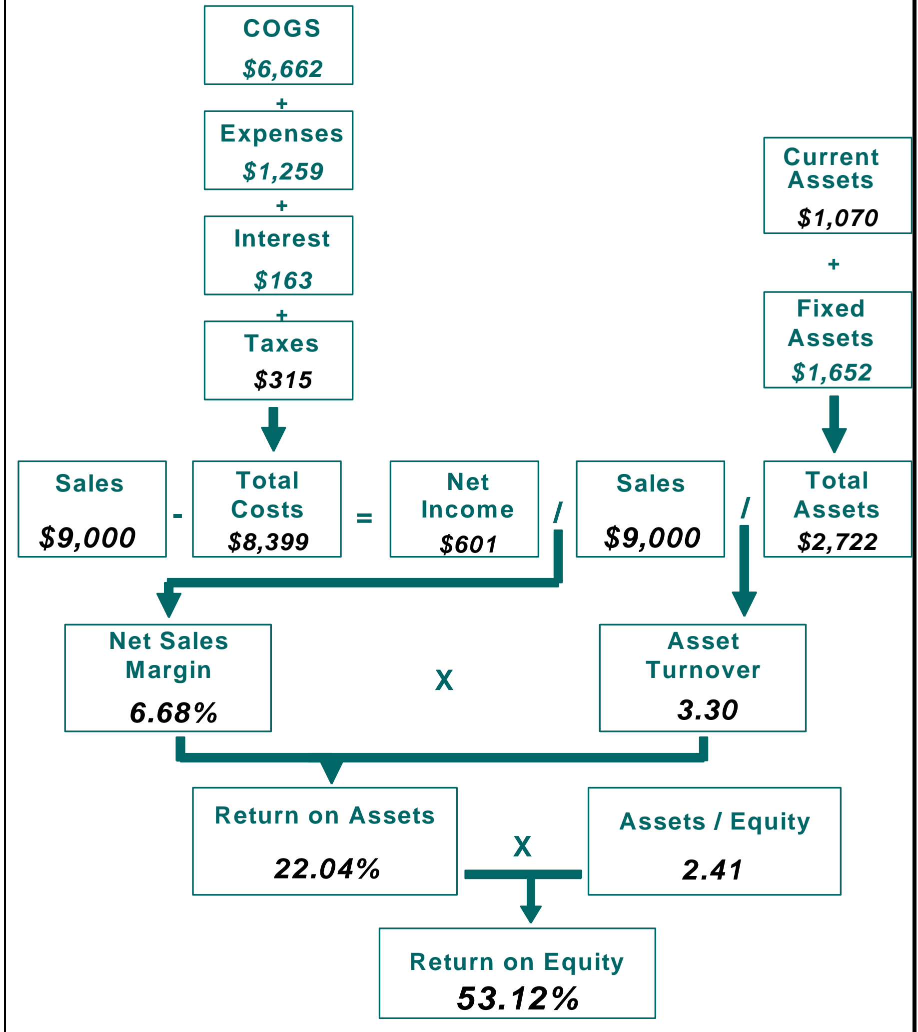
The model is a financial representation of the business. The power of the model is that quantifies all the components of the business on the one page. We can see where problems may lie and we can determine the changed outcomes on return on assets and return on equity as we take decisions to change any of the inputs.

The first two Du Pont charts are for a US boat manufacturer. The first chart is the original operations and straight away, our attention should be turned to the very low sales margin made on the boats. The new CEO immediately raised prices by about 4%, which trebles the miserly 2% margin. She then supported the price with improved marketing. She also reduced the range and thus amount of floor stock which reduces current assets.

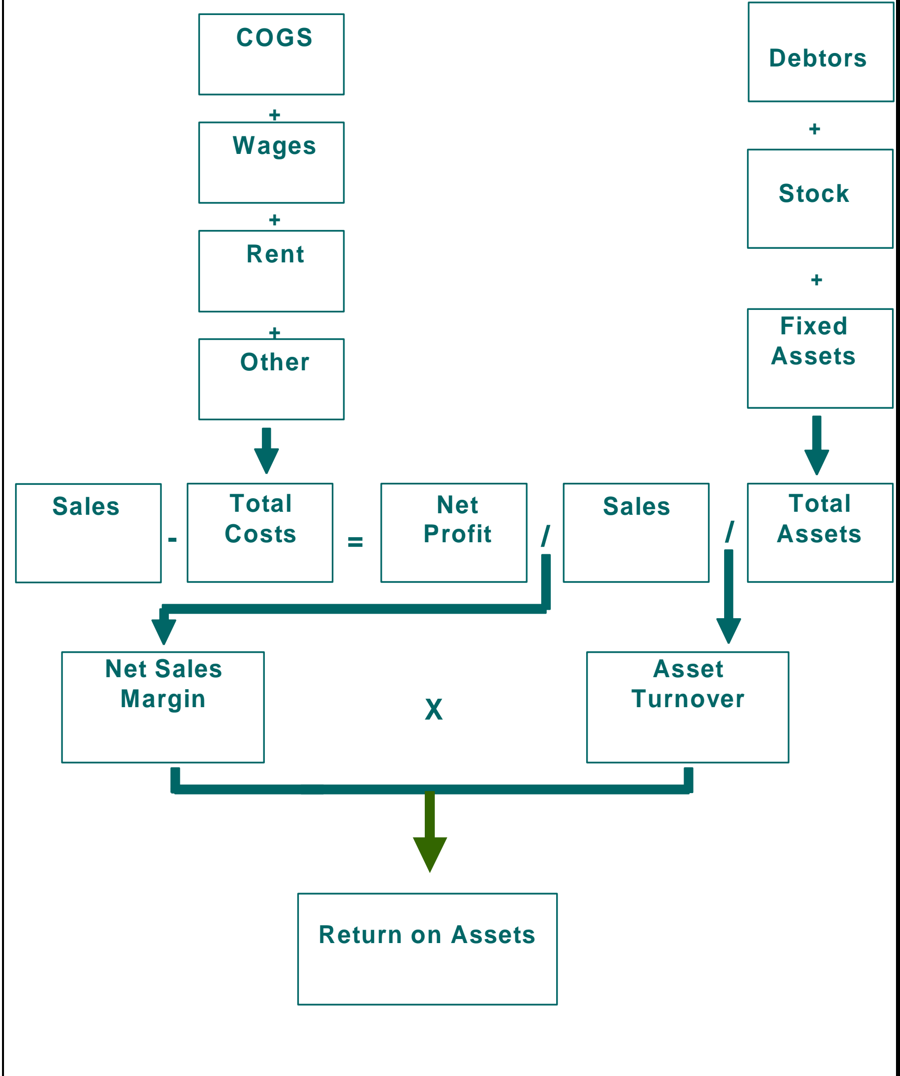
Just these two changes deliver the improved results shown on the second chart.

The third chart is for you to put in the numbers for your own business operations.


Du Pont Analysis
Yellow Tail Marine Example
COGS
$6,662
+
Expenses
$1,259
+
Interest
$163
+
Taxes
$88
Current Assets
$2,123
+
Fixed Assets
$1,652
Sales
$8,340
-
Total Costs
$8,172
=
Net Income
$168
/
Sales
$8,340
/
Total Assets
$3,775
Net Sales Margin
2.01%
X
Asset Turnover
2.21
Return on Assets
4.45%
X
Assets / Equity
3.34
Return on Equity
14.87%



Du Pont Analysis
Yellow Tail Marine Example
COGS
$6,662
+
Expenses
$1,259
+
Interest
$163
+
Taxes
$315
Current Assets
$1,070
+
Fixed Assets
$1,652
Sales
$9,000
-
Total Costs
$8,399
=
Net Income
$601
/
Sales
$9,000
/
Total Assets
$2,722
Net Sales Margin
6.68%
X
Asset Turnover
3.30
Return on Assets
22.04%
X
Assets / Equity
2.41
Return on Equity
53.12%


Du Pont Analysis
Your Business Unit
COGS
+
Wages
+
Rent
+
Other
Debtors
+
Stock
+
Fixed Assets
Sales
-
Total Costs
=
Net Profit
/
Sales
/
Total Assets
Net Sales Margin
X
Asset Turnover
Return on Assets

BREAK EVEN

1. Contribution Analysis

Break even analysis is a simple but powerful tool for testing our strategies, especially when launching a new product or entering a new market.

Contribution analysis is a method of determining the break even point: how many sales are needed just to break even i.e. no longer make a loss. It is also known as marginal analysis, variable costing and contribution margin analysis.

It is "back of the envelope" calculations but is a very useful "first screen" to see if the project is worthwhile before conducting more extensive and more expensive detailed analysis.

It is a particularly useful tool for start-up projects. In such cases, there is no detailed history on which to conduct ratio or some other analysis. The break even analysis, allied with some market analysis and common sense can help determine if the project can be viable.

The basics of break even analysis lie in understanding the fixed and variable costs of the project or business.

All businesses have some ***fixed costs***. These are costs that are borne whether there are any sales or not. Examples may include rent, salaries, interest on loans and so on. They are a fixed amount paid per period of time, regardless of the level of output or sales. They are often referred to as period costs – so much to be paid per period of time.

The other costs in a business are ***variable costs***. These increase as sales increase. Examples may include raw materials, packaging, sales commissions, transport and so on

In real life it can be complex to split costs between fixed and variable. However, it is a worthwhile exercise if you want to make logical management decisions. You do not have to be perfectly accurate – just sufficiently correct to make sensible decisions.

When you model a project or a business for sensitivity analysis, it is essential that your model splits fixed and variable costs. Within a relevant range, the fixed costs should not change as sales volume changes but the variable costs should be directly proportional to sales volume.

For an airline flight, most of the costs are fixed. Interest on plane financing or lease costs, crew salaries, landing fees, insurance, maintenance and so on are fixed for the flight. Even the fuel would be mostly fixed if you are flying to a schedule anyway. There would be some variable fuel as you take on more passengers and their luggage.

This means that the flight is very volume sensitive. When Qantas first floated, its profit forecasts were based a 76% seating utilisation (i.e. 76% of all seats would have a paying passenger in them). If the seating utilisation rose by 2% to 78%, then profit doubled. On the other hand, if seating utilisation fell 2% to 74%, then profit was wiped out. This volume of sales sensitivity was far greater than changes in fuel prices or other operating costs.

This is why an airline like Qantas no longer hangs on to poor routes in the hope it will improve. Code share it or drop it fast!

2. Break Even

The break even point is one of the most fundamental pieces of information we need to know in business. For any project or product or even for the whole company, how many units do we need to sell just to cover all our costs?

To calculate break even, we need to split our costs into **fixed costs** and **variable costs**.

Fixed costs do not change when we change the volume of sales – we have to pay them anyway. Variable costs are directly linked to the sales volume. The more you sell, the more variable costs you have.

The break-even point is calculated using fixed and variable costs and the ***contribution margin*** per unit of sale.

Every time we make a sale, we get money into the business. But to make a sale it costs us for the variable costs: the raw materials, packaging, commissions and so on.

What we have left over after making each sale and paying for the variable costs is the **contribution margin** per sale. We give it the symbol "m" for margin. The contribution margin is sales price per unit minus variable costs per unit.

The contribution margin is <u>not</u> profit yet because we have not paid for the fixed costs yet. It is contribution towards paying for the fixed costs. The fixed costs are **<u>NOT</u>** broken down to a per sale cost. They are a lump that must be paid each month or year or whatever period - regardless of how many sales are made. They are the ***period costs***. They are so much per period of time.

After the fixed costs have been covered - the break even point - any additional sales will make contribution to profit.

The break even equation is: **fixed costs / contribution margin per unit.**

If our sales unit was tickets or beds or widgets, then the break even is in those units. If our unit of sale was per dollar, then the break even is in dollars. Likewise with the time period. If we used fixed costs per month, then the break even result is in sales units per month. If we used

annual fixed costs, then the break even result is in sales units per annum.

Example
We have a shop that has fixed costs per month of $20,000 (for rent, salaries, power, advertising, etc). For every dollar of sales, it costs 75 cents for variable costs (for goods purchased for resale and a little gift wrapping).

So how many sales (in dollars) does the shop need each month just to break even?

The contribution margin on each dollar of sales is 25 cents ($1.00 of sales minus $0.75 cents of variable costs).

The break even point is: $20,000 / $0.25 = $80,000

The shop needs to sell $80,000 of goods each month just to break even. The break even is a monthly figure because our fixed costs were per month. If we used annual fixed costs then the break even point would be how many sales per annum. If we use fixed costs per plane flight, then it is how many passengers per flight.

3. Break Even With Multiple Products

Break-even calculations can be quite simple if there is only one product category. The break-even calculation is one whether there are enough sales of that product to cover the fixed costs: bunches of flowers, bottles of wine or passengers or cars (on a toll road).

Real life is often more complex. There may be multiple products and they share some or all of the fixed costs.

This can lead to very complex cost allocation problems. Activity Based Costing and transfer pricing can be very complex issues involved in allocating costs.

For conducting break even with multiple products, the process can still be simple providing we do not have to worry about trying to allocate fixed costs or overheads to actual products.

Even so, we need to simplify the situation. Imagine conducting a break-even analysis for a supermarket with thousands of different shelf items. Typically, we simplify the vast product range down to a few product categories – groupings of products with similar characteristics. The unit of sale can no longer be bunches of flowers and so on. The common unit now is dollars. We express the sales price, variable costs and contribution margin in dollar of sales. The fixed costs remain a lump of dollars per time period.

Example of a Liquor Store

We have a local liquor store. For simplicity, we assume that there are three major product categories: 1. beer; 2. wine & spirits; 3. other (cigarettes, chips, etc). The fixed costs are $15,000 per month (wages, depreciation, advertising, interest, etc).

We now calculate the contribution margin for this store. The variable costs are basically the purchase cost of the items. We also allow some variable electricity for the cold room for the beer.

Note that we still need to understand how costs operate. For example, in most places, there is a liquor retail tax or licensing fee. If this fee is calculated on dollar turnover or per bottle then it is a variable cost. If it is a flat monthly or annual fee, then it is a fixed cost.

Product	**Beer**	**Wine & Spirits**	**Other**
Price	$1.00	$1.00	$1.00
Variable Costs	$0.92	$0.65	$0.50
Contribution Margin	$0.08	$0.35	$0.50

So what is the break even sales per month?

Unlike our previous examples, we cannot calculate the break-even point in dollars of sales from the above information. We need one additional piece of information.

We need to know the product mix. What proportion of the sales are beer, wine & spirits and other? Once we know that we can calculate the break-even.

We use the product mix to calculate the **weighted average contribution margin**. We multiply the variable costs and the contribution margin by the weighting of sales shown by the product mix.

Product	**Beer**	**Wine & Spirits**	**Other**	**Weighted Average**
Price	$1.00	$1.00	$1.00	$1.00
Variable Costs	$0.92	$0.65	$0.60	$0.85
Contribution Margin	$0.08	$0.35	$0.40	$0.15
Product Mix	75%	20%	5%	

In doing the weighting, we took 75% of the variable costs for beer (69cents), plus 20% for wine & spirits (13 cents), plus 5% for other (3 cents) to give a weighted average 85 cents variable cost. We do the same for the contribution margin to find a weighted average contribution margin of 15 cents per dollar of sales.

The break even point is now found by the simple equation of fixed costs divided by contribution margin. In this case it is $15,000 divided by $0.15 = $100,000 per month (i.e. $1.2 million per year).

Unless our liquor store can turn over this much in sales, we will be making a loss.

What if we want to make $5,000 per month profit instead of just breaking even. What dollar volume of sales is needed now?

We would divide the fixed costs + profit by the contribution margin:

($15,000 + $5,000) / $0.15 = $133,333 per month ($1.6m p.a.)

Alternatively, we can use the equation to work out the volume needed to make say 5% profit margin. We would treat this margin like another variable cost of 5 cents in the dollar.

So now our contribution margin would be $0.10.

The "break-even" volume to make 5% sales margin would be:

$15,000 / $0.10 = $150,000 per month (or $1.8 million p.a.).

On this level of sales, we actually make 5% profit, which is $7,500 per month.

So it is quite a versatile little equation!

4. Du Pont Revisited

We now have an additional factor to use in running the business and improving profit. The Du Pont Framework gave us:

Raise Prices

Lower Costs

Increase Sales

Decrease Assets

The additional factor is: Change Product Mix.

How can changing the product mix affect the profits? Concentrate on the highest profit margin lines!

Product mix can also affect the asset intensity. For example, sell products that need less inventory or less equipment to make. We can also change the customer mix, for example, prefer those customers that pay faster or are less price sensitive. Plus there are other ideas.

If feasible, what is the best product line to promote? "Would you like fries with that champagne?"

CREATIVITY - THE CRITICAL 5%

Weekly comedy writing to a deadline is something like 95% experience and technique and 5% creativity.

This may sound as if the 5% is hardly worth it, but unless it is there you are on a dying fall. Frank Muir, Comedy writer and BBC Executive

In warfare, one generally uses the direct force to engage the enemy, but uses the indirect force to win. (The indirect force "qi", is something surprising, indirect, extraordinary or deceptive).

In all fighting, the direct method may be used for joining battle, but indirect methods will be needed to secure victory. Sun Tzu, Military Strategist and General 500B.C.

Opportunities for innovative strategies don't emerge from sterile analysis & number crunching-they emerge from novel experiences that can create opportunities for novel insights. Gary Hamel

This discovery is almost of that kind that I call serendipity.
Horace Walpole in 1754 coining the term "serendipity" one of the key factors in creativity in large organisations. ["Serendipity" comes from the Sri Lankan story of the Three Princes of Serendip which is an old name for Sri Lanka.]

Creativity has been "around" for millennia.

It is not a "fad". It is the critical 5% that determines whether organisations stay with the mediocre or whether they shine (or yield outstanding shareholder value or whatever).

However, creativity in an organisation needs to be consciously and continuously nurtured. Too often it is seen as too difficult, soft, troublesome or even threatening.

Wherever we look around, we see organisations that complain that they are operating in mature industries and with commoditised products. Yet how could it be otherwise - they have done nothing different for decades.

There is little soft or magical about creativity. It is a "hard" subject in that it relates to an organisation's systems, culture, structure and strategy. It requires numbers and is measured.

Robinson and Stern compared the number of suggestions for cost savings submitted per employee in Japan and America. While the American suggestions were on average more valuable per suggestion, the number of suggestions per employee in America was only 0.16. This compared to 1.85 suggestions per employee in Japan so that Japanese employees were nearly 10 times more valuable per employee in their suggested savings.

Note that this is not an issue of Japanese culture any more than W. Edwards Deming ("*The American Who Taught the Japanese About Quality*") was not Japanese. Western companies can readily apply the principles required to achieve corporate creativity. Indeed, culturally, Americans, New Zealanders and Australians could well have advantages in thinking creatively. It remains to be seen if Japanese workers continue to offer suggestions as retrenchments occur more commonly in Japan.

So what is the catch? Why is not already applied?

Creativity in an organisation is not easy. It can be disruptive and risky. It challenges hierarchies and threatens status. It is also crucial.

We have the ability to be creative: as individuals and as organisations.

In the end, creativity is NOT just some technique and it is NOT solely a gift only for the talented.

Learning some techniques and having some intelligence may help.

But creativity is more a state of being - both for the individual and the organisation. You will need to challenge personal and organisational belief and value systems as well as some of the myths about creativity.

As Robert Heinlein wrote: *To stay young requires unceasing cultivation of the ability to unlearn old falsehoods.*

Techniques For Enhancing Creative Thinking

Caveat: These techniques are typically what are taught in creativity programs. They are, however, predicated with a particular problem to be solved. But with business development, we are also looking for totally new ideas to which we do not have a problem defined!

The caveat having been stated, we shall now look at some of the many methods promoted for enhancing or achieving creative thinking in the context of solving a particular problem.

Just looking at some of the literature:

- Ω Edward de Bono has 13 tools in his book *Serious Creativity*
- Ω Grace McGartland has 25 tips and techniques in *Thunderbolt Thinking*
- Ω Arthur VanGundy has 29 tools in *Idea Power*
- Ω Michael Michalko has 35 techniques in *Thinkertoys*
- Ω Roger von Oech has 64 methods in *Creative Whack Pack*
- Ω Koberg and Bagnall show 67 tools in *The Universal Traveler*
- Ω James Higgins has 101 Creative Problem Solving Techniques

Source: Paul Plsek of Paul E Plsek & Associates, Inc, Roswell Georgia

While many of these techniques and tools overlap, it still comes to over 250 tools and techniques!!!!!

Some have a theoretic basis; some are gimmicks; some work for one group of people but not for other people; some work in a one situation or set of circumstances but are less useful in other circumstances and so on.

Paul Plsek distils all the methods in to 3 basic elements. To work, all the methods cover at least one of these 3 elements - they just do it by different means.

Plsek's three elements or principles are:

Attention
Escape
Movement

Attention

To be creative, we must first focus our attention on something - typically something we have not given much attention to before.

The techniques begin with a method to focus attention on the issue, situation, problem, whatever. For example, Wonder and Donovan suggest we play a mental slow motion picture of the situation to look for previously neglected aspects. Nadler and Hibino suggest writing alternative statements of an issue and placing them in a hierarchy but still together, rather than compartmentalising the various components of an issue.

Attention to:

elements in the current reality
features, attributes, categories
assumptions, patterns and paradigms
metaphors and analogies
what works and what does not work
anything you don't normally pay attention to

Escape

Once we have focused attention on the issue and how it is currently undertaken, the next stage is to escape from our previous thinking patterns. We try to break from our current limitations and shift to a new paradigm for the issue.

Sometimes the escape is physical. We get up and go for a walk to both physically and mentally break our current bonds. Other techniques seek to have us mentally make new connections such as forced analogies.

Escape from:

- current mental patterns
- time and place
- early judgment
- barriers and rules
- your past experiences

Movement

Having paid attention and escaped from current patterns of thinking, we need to move on. Come up with new ideas without being slowed down too quickly by all the reasons to reject an idea. Brainstorming is a classic example of this moving on with its rule of no judging of ideas until they are all in.

Movement:

- in time or place
- to another point of view
- by free association
- by building on ideas

MANAGING RISK

The International Standards definition of risk is anything that inhibits us from achieving our goals. A broad but strategic definition!

To put it mildly, there are a multitude of risks associated with most businesses or projects.

This does not mean give up and do not do anything. Doing nothing is risky! We should identify any key risks out there and outline what we can do about them.

Step 1: Identify the Risks

These can include generically:

Raw Materials Risk: can we obtain the necessary inputs e.g. can a new brewery find enough supplies of hops or a hotel have enough beds for a special promotion

Completion Risk: will it be completed on time and to the required operating standards (e.g. hotels, cinemas toll ways)

Operating Risk: all the risks involved in operations, including break downs, strikes, environmental, non-performance of our product or service

Marketing Risk: prices changing, quantities falling, a major customer going broke, will demand grow as forecast

Competitive Risk: rival operations taking sales or cutting prices

Management Risk: are we up to it

Foreign Exchange Risk: the obvious issues

Political Risk: changing tax regimes, nationalisation, legislation affecting demand, political whim (Victoria and the toll roads)

Sovereign Risk: only if operating in another country, can include legal issues, riots, insurrection, squatting, claims, restrictions on movement of money or people

Regulatory Risk: changes in regulations affecting operating efficiency or market demand

Casualty Risk: accidents and other events

Force Majeure Risk: one of the many parties can invoke a force majeure clause to break contract obligations e.g. a buyer facing strike action

You will need to be more specific and detailed when identifying risks for a particular business or project.

Step 2: Assess the Risks

After identifying the possible risks, we need to assess their likelihood and impact i.e. their severity.

In part this is done in sensitivity testing of the project models. However, it also requires experience and input from experts. With a large project for example, we may need to bring in a team of engineers, technology experts, marketers and even tax specialists to assess the project.

The overall severity of a risk is its likelihood or probability of occurring multiplied by its impact if it does occur.

Severity = Likelihood x Impact

The following ranking comes from the Institute of Chartered Accountants. They have basically followed the ISO3100 guidelines. Alas, the accountants cannot help but count the events probabilities:

LIKELIHOOD	
Criteria	**The potential for the Risk to occur**
Almost Certain	Occurs more than 20 times per year or >90% of the time
Likely	Occurs up to 20 times per year or 50%-90% of the time
Possible	Occurs up to 5 times a year or 10%- 50% of the time
Unlikely	Occurs once during the year or 5%-10% of the time
Rare	Very unlikely in next 5 years or <5% of the time

Next, the Accountants assess the impact such an event would have. The criteria used is

CRITERIA	GENERAL
CATASTROPHIC	Very high impact with consequences that could shut down that part of the business / objectives not achieved at all
MAJOR	Important objectives cannot be achieved in current situation. Major material impacts
MODERATE	Noticeable impacts on the business with clearly visible consequences – objectives impacted
MINOR	Some minor impact easily remedied
INSIGNIFICANT	Consequences not readily visible to others around the Institute

Within these criteria, the Institute of Chartered Accountants has also broken the assessments down to:

- Financial impacts
- Operational impacts
- Member impacts

- Reputational impacts
- Regulatory impacts
- Project impacts
- People / safety impacts

The impact is not necessarily expressed in monetary units. It could be in lives or welfare or even embarrassment (sometimes called reputation risk).

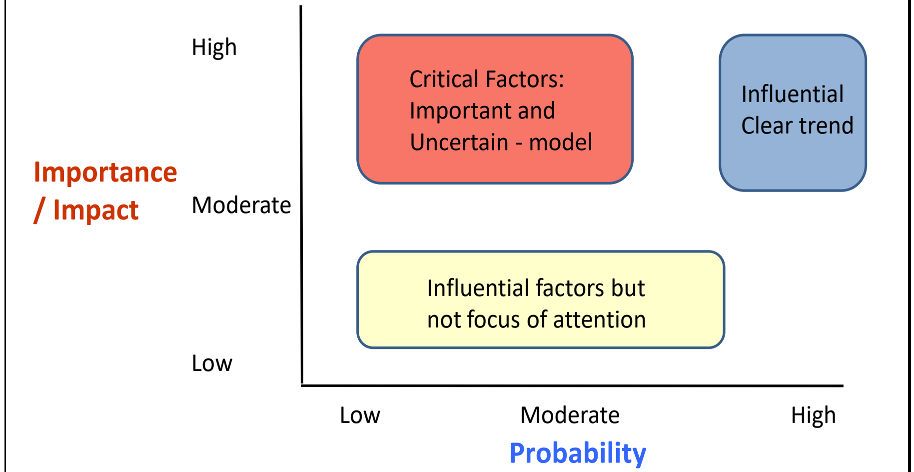
The combination of Likelihood and Impact provides a level of **severity**. We do not need to be so precise as the Chartered Accountants. Even the Actuaries Society of Australia is content to have only 3 categories of likelihood: high; medium; low.

Unless we are a bank or similar which must quantify potential losses in monetary terms, we can also be satisfied with listing the impact as high; medium; or low.

This is graphed on the diagram on the next page. It is a useful pictorial tool to let us understand which risks demand our attention.

The top right hand corner of high probability of occurring and high impact if it does occur is <u>not</u> a scenario we model. It is so clearly our main priority that our base case strategy must address these risks.

The bottom of the diagram and to the left of the matrix does not command much attention from us. Otherwise we will waste too much time chasing shadows and considering every minor possibility.



Decision Impact Matrix

Step 3: Manage the Risks

It is the factors with the high to very high impact but with possible to even rare likelihood of occurring that attract our simulation and scenario testing.

What will happen if these events occur and what should we do about them? Perhaps we need some contingency plans. Perhaps we may need to modify our base case strategy so that it is more flexible and can more readily handle an occurrence of these critical factors.

Some of the risk management or mitigation tools include:

- SEP (make it Somebody Else's Problem)
- Pass On
- Insure, hedge
- Design a new process with better risk control
- Take or Pay contracts
- Partner
- Limit fixed costs
- Limit commitments
- Low Regret
- Monitor
- Contingency Plan
- Cut and Run (e.g. shut down and abandon high risk venture)

If we are a retailer for example and we are not sure about long term market trends, we might seek only short term leases from Westfield, etc with options to extend at our discretion. This will involve extra costs but they may be worth it for the higher flexibility.

HISTORY OF STRATEGIC MODELS

1. Background Development – Military Strategy

"Strategy" comes from the Greek "strategia", meaning generalship.

Not surprisingly, most of the historical development of strategy is from the military perspective. We have the writings of Sun Tzu from around 400 BC to 500 BC. The Spartans in Greece were recording strategy concepts at much the same time.

Certainly there is a long history of strategic study of battles, including the campaigns of the Romans against Hannibal (use of guerrilla tactics at home and sea power to block supplies), Alexander the Great, Julius Caesar and Qin Shi Huang to mention a few.

In 1520, Machiavelli published his *Dell'arte della guerra* (Art of War), although this was more concerned with the relationship between civil and military issues in the **grand strategy**.

The "father of modern military strategy" is often referred to as Carl Philipp Gottfried von Clausewitz (1780-1831). A Prussian soldier and theorist, he helped reform the Prussian army. His publication, Vom Kriege [On War] set out several principles of strategy. He wrote of the **fog of war**, describing how confused leaders and their plans become when deep in battle. He also saw war as more art than science.

Von Clausewitz defined strategy as “the art of the employment of battles as a means to gain the object of war.” He thus elevated strategy to beyond the immediate battle to a higher goal.

Von Clausewitz has been criticised by Hart [Liddell Hart, Strategy, 1967] for extending strategy back into policy formation and for focusing on military success as the sole means of achieving ends. Indeed, von Clausewitz later amended his definition to that of Moltke: “the practical adaptation of the means placed at a general’s disposal to the attainment of the object in view.”

Hart offers his own definition of military strategy: “the art of distributing and applying military means to fulfill the ends of policy.”

This definition puts military strategy as just one of the means towards political ends.

This fits with the thoughts of French Statesman, Georges Clemenceau, who stated that "war is too important a business to be left to soldiers."

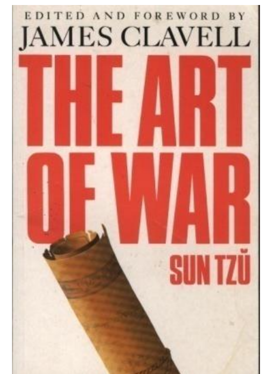
Thus military strategy becomes a subset of the grand strategy, where the entire nation is mobilised to achieve the goals. In this environment, much of military strategy is reduced to **operational strategy**.

With technological advances in communication and politicisation of military forces, grand strategy and operational strategy have tended to merge and be blurred in recent times. The “war on terrorism” cannot be confined to a battle field. It requires an integrated strategy across the entire social system and across the globe.

Interestingly at the other end of the spectrum, strategy and tactics have tended to blur, leaving a very indistinct field called strategy (see later section on strategic planning). The danger here is we lose sight of the overall picture provided by the grand strategy.

2. Can Military Strategy be Translated into Business

Vast tomes have been written transcribing military thought into business strategy.



In the absence of business sector studies, military thoughts have been a reasonable starting point for first principles on strategy.

In 1962 Alfred Chandler published Strategy and Structure which presented his thoughts on the development of business strategy out of military strategy taught at West Point. Chandler became the forerunner of the "Design School" in strategic theory.

Igor Ansoff published Corporate Strategy in 1965. He too developed strategy from the military model. His model is virtually a flow chart of strategic decisions broken into small steps – typical of military training and processes. His followers developed the "Planning School" of strategic theory.

Many business writers have used military thoughts to exemplify and sometimes amplify their ideas. For example, Ries and Trout in their popular book, Marketing Warfare, quote extensively from Von Clausewitz. Sun Tzu has had thousands of more pages written about his ideas than he ever wrote.

Certainly there are some good common sense thoughts presented that can be generally applied. General Sir Rupert Smith in The Utility of Force, 2005 synthesised much of the military ideas into the following principles:

The principle of mass – fighting with equal forces has equal chance of losing or suffering high ratios of casualties. [Sun Tzu was more specific, giving the ratios of when to withdraw, when to defend and when to attack.]

Select decisive objectives.

Take the initiative from your foe.

Concentrate your resources at the decisive point.

Economise your resources by reducing waste.

Coordinate the movement of your resources to meet your objective.

Maintain unity of command.

Coordinate your tasks to achieve maximum effectiveness.

Maintain secrecy until it is too late for your opponent to react.

Employ unexpected elements such as deception, speed, creativity, and audacity.

Keep your plans as simple as is needed to accomplish the task.

Choose a flexible strategy so you can adapt to changing conditions.

Organise for maximum efficiency.

Maintain a positive morale even in the face of set-backs.

Maintain momentum until success is accomplished.

These are all good points to keep in mind when setting plans and tactics.

Nonetheless, there are fundamental differences between military strategy and strategy used in business sector. These include:

There are usually more players in business than in military theatres (we have suppliers, consumers / users, various stakeholders and usually more than one opponent). This makes business strategy **exponentially more complex**.

As well, the players often change and evolve in business sector environments.

There are more restrictive rules of behaviour in business sector strategy than in military strategy. While there are rules of war, they are not as strict – hence the dismissive term of “collateral damage” in military jargon.

At least at the operational level, military strategy is normally involved in the present battle. Business strategy is normally first played at the grand strategy level. The grand strategy then needs to be broken down to operational strategy and then micro strategies or tactics.

The time frame for business strategy can be open ended. The business “war” often continues indefinitely in business sector missions.

Most of military strategy can be implemented by command or force. Most of strategy in the business sector can only be implemented by coercion, influence or payment.

As a consequence, military strategy ideas are useful beginnings to strategy in business. However, business strategy is generally far more complex than military strategy.

3. Strategic Planning

George Steiner, in his book Strategic Planning, 1979, brought to the fore disparate writings about strategic planning in business. Strategic

Planning is something many companies think they do annually as part of the budget process.

Steiner never articulated a clear definition of strategy. This left the scope of strategy and the role of strategic planning somewhat vague.

Generally, strategic planning is seen as the detailed, short term course of action that follows from long term strategic analysis and thinking. It rose to prominence in the 1970's and 1980's in business as a response to more turbulent and traumatic times. This was the age of the oil shock price increases, stagflation, deregulation of industries and currencies and explosion in financial instruments.

Strategic planning was used as a tool to obtain some order and direction in a bewildering world.

"Strategic planning is a management tool, period. As with any management tool, it is used for one purpose only: to help an organization do a better job - to focus its energy, to ensure that members of the organization are working toward the same goals, to assess and adjust the organization's direction in response to a changing environment. In short, strategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does it, with a focus on the future." *(Adapted from Bryson's Strategic Planning in Public and Nonprofit Organizations)" from Alliance Online*

However, the vague definitions and the actual turbulence of the times probably worked against strategic planning being effective and achieving its purpose.

By 1983, Jack Welch had taken over the reins at General Electric and he disbanded the planning department with its 200 senior staff – a move seen as symbolising the death of strategic planning. Welch's view was that they were too concerned with producing reports based on detailed financial and operational outcomes rather than getting the key fundamentals right such as competitive position.

By 1994, Henry Mintzberg wrote The Rise and Fall of Strategic Planning. He noted that strategy is more evolutionary and that it emerges as intentions (policies?) clash with reality and decisions are required. Kenneth Andrews had pursued similar ideas earlier and had even considered the concept of **competitive position**.

Today, there has been re-emergence of strategic planning in many organisations. However, the planning is now generally far more decentralised – line managers have the skills and tools to implement the strategic planning locally (albeit with reviews from head office). There is even some blurring of definition between budgeting and strategic planning. Strategic planning at the level of a line manager is seen as the planning and tactics required at the local level to achieve the overall grand strategy.

Strategic planning has survived well into the new millennium but still has trouble delivering benefits. McKinsey & Co published a paper in July 2007 entitled "Tired of Strategic Planning?" by Eric D Beinhocker and Sarah Kaplan. The paper opens with the comment that: *"Senior executives generally agree that crafting strategy is one of the most important parts of their job. As a result, most companies invest significant time and effort in a formal, annual strategic-planning process that typically culminates in a series of business unit and corporate strategy reviews with the CEO and the top management team. Yet the extraordinary reality is that few executives think this time-consuming process pays off, and many CEO's complain that their strategic-planning process yields few new ideas and is often fraught with politics."*

4. Strategic Positioning

Michael Porter developed his 1979 thesis into a commercial work and published Competitive Strategy in 1980. Porter is very much about deciding on a competitive position such as low cost or differentiation. He is the forerunner of the "Positioning School".

Porter "translated" microeconomic theory about firms and industries into strategic positions that might sustain supernormal profits, which the microeconomist's perfect competition is meant to compete away. There remains today a struggle between businesses seeking above average profits and academic economists setting Government policy on competition.

5. Radicals

There have been voices to rise against the schools of thought.

Henry Mintzberg wrote of the rise and fall of strategic planning in 1994.

Mintzberg was critical of the various schools of strategic thought saying they do not correspond with reality – what companies actually do.

Mintzberg leans towards the Learning School – we learn and adapt as circumstances move.

The philosophy in this tome has largely agreed. No "pure" school of thought is deemed entire or completely satisfactory. We have taken a pragmatic approach and been eclectic in the selection of tools and methodologies to answer our strategic questions.

Gary Hamel is another old time radical who often agrees with Mintzberg. He sees the use of strategy to stretch a firm beyond a "stay in business" approach. Strategy is used to attain more than would otherwise be achieved.

Hamel wrote Competing for the Future in 1994 and Leading the Revolution in 2001. There are numerous other articles. We used his levels of strategy model, developed with C K Prahalad. Together, they promoted the concept of core competencies. A core competency is *"a harmonized*

combination of multiple resources and skills that distinguish a firm in the marketplace”. They embody *“collective learning across the corporation.”* [Prahalad & Hamel, The core competence of the corporation, HBR, 1990]

Such a core competency can be taken as a competitive advantage into different markets. Virgin is often described as a brand to young professionals. As such, the brand has taken it into music, airlines, resorts, credit cards, mobile phone services and more.

Alas for Richard Branson with his resorts and airlines, Covid19 has led to his investments being labelled *“the portfolio from hell”* That assessment was made by Richard Branson as he was putting up more of his personal assets as collateral for loans to seem some of his businesses try to survive the pandemic.

Strategic thought continues to evolve. So too should your strategic thinking.

INVESTMENT EVALUATION

Investment evaluation or capital budgeting is the process for evaluating the worth of projects and the allocation of funds to those projects. It is generally involved with investments that last for more than a year, although this is a somewhat arbitrary decision.

Examples for capital budgeting include where a firm is considering purchasing some additional machinery, evaluating a long term lease, investigating the switch to a new technologic process in its manufacturing, valuing a potential takeover target or the costs of changing its borrowing structures.

1. Need for Investment Evaluation

To earn adequate returns for their shareholders, firms need to allocate their scarce funds to those projects and investments that yield a return above the cost of the firm's capital.

A major shortcoming of accounting and associated measures such as ROI, is that it does not take into account **risk.**

Capital budgeting seeks to evaluate projects to find which ones meet this criterion. Not only must returns be adequate, but so too the level of risk to the providers of capital (lenders and shareholders).

2. Processes

Each firm has its own particular process for capital budgeting. However, each method must at least:

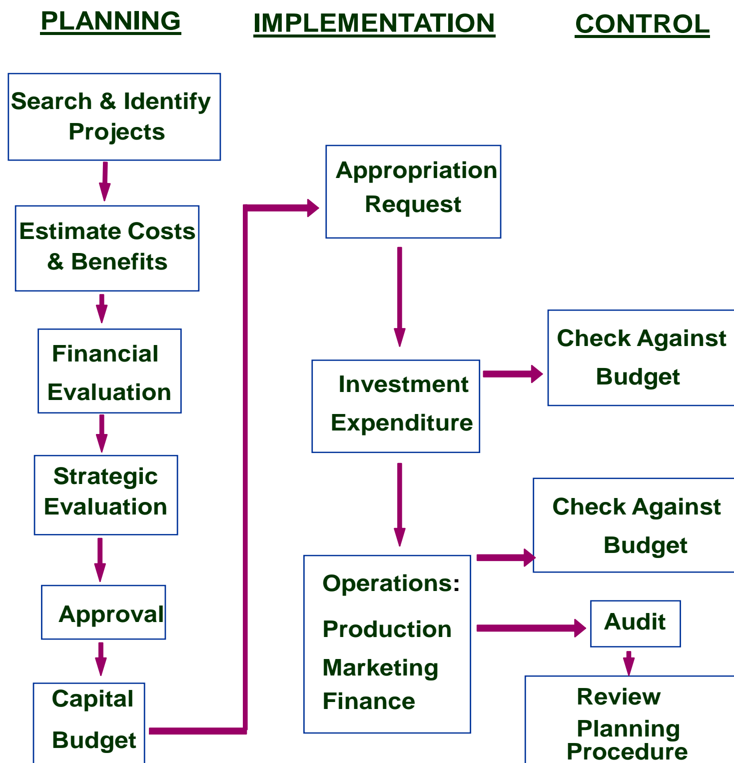
identify potential investments;

evaluate the worth of these investments;

decide amongst competing investments for funds;

allocate the funds and authorise expenditure.

Hopefully, each method monitors the investments and carries out a post-audit to determine compliance with criteria. These functions of the capital budgeting process are shown below.



Note the box for strategic evaluation in the Planning Phase. Even a project that passes the financial evaluation test can be rejected because it does not align with our mission and goals. We only have scarce funding and other resources and they should be devoted towards achieving our mission.

Also, studies show that acquisitions would have a lower failure rate if more consideration was given to the strategic aspects of the acquisition: its fit with our capabilities including culture; its congruence with our mission; does the acquisition have a sustainable competitive advantage.

3. Investment Evaluation Criteria

Most of the literature on capital budgeting deals with the various models and techniques for evaluating investments.

The more common methods are:

Accounting Rate of Return

Return on Investment (ROI)

Payback Period

Price:Earnings Multiple (P:E)

Discounted Cash Flow Analysis

Accounting Rate of Return is calculated as the average annual increase in profit divided by either the initial investment or the average investment in the project.

For example, you buy a painting for $10,000 in 2010 and ten years later you sell it for $50,000. The accounting rate of return is $4,000 per annum ($50,000 - $10,000 over 10 years) divided by $10,000. The return is 40%.

Accounting rate of return is very simple. It does not take into account the effects of inflation or the risks in the investment.

Return on Investment is basically the same as accounting rate of return except that it is calculated only for each year, not an average over a span of years. It is profits divided by the assets invested.

For example, if the firm has profits of $10 million and assets invested of $100 million, then the ROI is 10%.

ROI is a good tool for measuring the performance of a company or division for a particular year. It has problems looking over several years: we have a different ROI result for each year. Nor does it take into account the time value of money. Finally, "profit" can be a rubbery figure subject to manipulation.

Payback Period is the time taken for an investment to return the amount of funds invested. For example, if the firm invests $1 million in a project that yields funds or profits of $400,000 per annum, it will take about 2.5 years to "payback" the initial $1 million investment.

Payback period does not normally take into account the time value of money or risks involved. Nor does it take into account how well an investment performs beyond the payback period. Yet it is widely used.

Price:Earnings Multiple is mostly applicable to investments in other companies. Quite simply, it is how many times you multiply last year's earnings (profits) to obtain the current value of the company.

Rental Yield for properties follows the same principles.

For example, a company earned a profit of $5 million dollars last year. We apply whatever is the appropriate P:E multiple, say 5. The value of the company is then $25 million.

The major problem is determining what is the "appropriate" P:E multiple. Another problem is how indicative is last year's profits for future profits?

Further assessment of the problems with P:E multiples is provided later.

Discounted Cash Flow Analysis is the most theoretically valid method for evaluating an investment.

First, it uses cash rather than profits. Cash is less subject to creative manipulation than profits. It is also more useful because we can spend and use cash whereas profit can be tied up in assets never to be released.

Second, it discounts the value of a future stream of cash flows to obtain the **Net Present Value** of the investment. Thus it takes into account the time value of money. It can also determine the **Internal Rate of Return** of the investment.

By correctly determining the discount rate, the appropriate risk factors can also be allocated.

While discounted cash flow analysis is more complex than the other evaluation methods, it is the more valid and generally the more useful method. It is suited to sensitivity analysis.

Further notes on discounted cash flow analysis are provided later.

4. Valuation Using Price:Earnings Multiples

One of the most common methods of valuing businesses or projects from large to small is using the price:earnings ratio. This is used by the merchant banks and other sophisticated financial advisors.

The price:earnings ratio (commonly just called the P:E) has several advantages:

It is quick
It is simple
It is widely known and used

Unfortunately, it is too simplistic!

The P:E is simply the ratio of the price or value of the business to its current earnings or profit. (With publicly listed companies it is usually calculated on the share price and earnings per share).

For example, if a firm's market value is $1 million and the latest profit was $100,000, then the P:E ratio is calculated as $1,000,000 : $100,000 = 10:1. The firm has a P:E of 10.

With valuations, it is usually calculated the other way around. The latest earnings (profit) are multiplied by the appropriate P:E to obtain the market value.

The problem is in knowing what is the appropriate P:E. Is it 3 or 5 or 10 or 25?

On the stock exchange, industrial companies used to trade at a share price that was generally about 8 or 12 times the earnings per share. Before the great crash of October 1987, the average P:E had risen to over 23. The crash merely brought the ratios back closer to normal (but still too high?). During the new millennium, P:E ratios rose even higher than in the 1980's. On the S&P 500 in New York, the average was over 50 in the heady days of 2006. By 2009, PE multiples for many industries (especially banking) were single digit. Once again, recession and crash brought us back to reality. Today PE multiples are generally around 14 times.

Another way to reduce P:E ratios is for profits to rise but with the share price to remain steady.

Private businesses typically have lower P:E ratios than public companies (around 5 to 8). However, there can be massive variations depending upon the circumstances.

To help determine what is the appropriate P:E ratio to use in a valuation, we sometimes look at the ratios for other firms in the same or similar industries.

Even if we can find an appropriate P:E ratio, there is another problem of determining which earnings (profit) to multiply. First, "profit" is not objective. It is subject to creativity and manipulation. Second, should we apply the ratio to just one year's profit or to several years? It is most appropriate to look to future earnings anyway. (Sometimes the ratio is applied to predicted earnings but the multiple is discounted to reflect the uncertainty).

A better method is discounted cash flow techniques.

DISCOUNTED CASH FLOW ANALYSIS

Discounted Cash Flow (DCF) is simply a matter of discounting a future stream of cash flows.

Why Discount?

If we invest money today, it is sometime in the future when we get our returns on that money. But money sometime in the future is not as valuable as money received today.

This is so for several reasons, including:

diminished purchasing power due to inflation

risk (you might not get any returns)

liquidity preference

So a dollar in the hand today is preferable to a dollar received in a year's time. A dollar in two years' time is even less desirable.

Therefore, if we want to evaluate an investment, we have the problem that the dollars we invest today have a different value to the dollars we receive back in the future. This is overcome by discounting the future dollars to see what they are worth at today's values.

This is the discounting part of Discounted Cash Flow analysis.

Why Cash?

Why refer to cash returns rather than profit or some other measure? Well, in the end, it is only cash that matters. You can only spend cash not profit.

As well, there are several problems with profit. Not the least of which, are the rubbery definitions used for profit. Also, profit is not the full story of a business. It is not what the investors receive. For example a profitable and growing business actually requires more cash to be invested in it to increase working capital and other assets.

Thus cash is the most relevant measure for returns to investors. And discounting the cash flows means we compare items of equal value, regardless of when the cash is received.

Compounding and Discounting

Compounding and discounting are simply inverse mathematical functions.

For example, **compounding** at a rate of 10% per annum, $1 would grow like:

Period:	Year 0	Year 1	Year 2	Year 3
	1.000	1.100	1.210	1.331

(In finance, Year 0 means today, the present)

Mathematically, the value or price in any year n is found by:

$$P_n = Po\,(1 + i)^n$$

Where: P_n is the value in year n

Po is the initial amount invested in year 0

i is the interest rate or compounding factor

Similarly, **discounting** at a rate of 10% per annum, $1 is only worth the following amounts if received in the future:

Period:	Year 0	Year 1	Year 2	Year 3
	1.00	.909	.826	.751

Mathematically, the value in today's terms of $1 received "n" years in the future is found by:

$$PV = \frac{1}{(1 + i)^n}$$

Where PV is the present value of the future dollar.

For a stream of cash flows (rather than just one payment in the future), the present value is the sum of the individual discounted cash flows.

The cash flows could be written as: C_0, C_1, C_2,......C_n

Mathematically, it would be written as:

$$PV = \sum_{t=0}^{n} \frac{C_t}{(1 + i)^t}$$

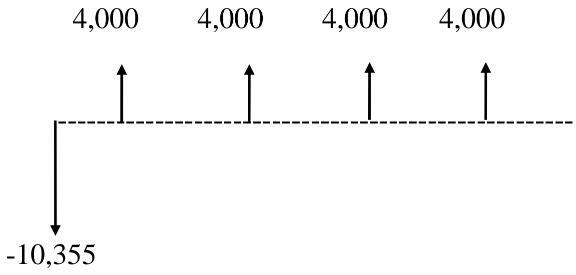
EXAMPLE:

We invest $10,355 today to receive back $4,000 at the end of each of the next 4 years. For example, it may be a machine we buy for $10,355, which earns us $4,000 per year and at the end of the fourth year the machine is scrapped.

End of Year	Cash Flow
0	-10,355
1	+4,000
2	+4,000
3	+4,000
4	+4,000

(By convention, now is written as being at the end of year 0).

Diagramatically, the cash flows look like:



Below, calculate the present value of the cash flows, using discount rates of 10%, 30% and then 20%.

1. Discounting at 10%

End of Year	Cash Flow	Present Value
0	-10,355	-10,355
1	+4,000	+3,636
2	+4,000	+3,306
3	+4,000	+3,005
4	+4,000	+2,732
Present Value of future cash flows		+12,679

If we subtract the initial investment of $10,355 needed to earn these future cash flows, we obtain the **Net Present Value** (NPV). The NPV in this example is +$2,324.

2. Discounting at 30%

End of Year	Cash Flow	Present Value
0	-10,355	-10,355
1	+4,000	+3,077
2	+4,000	+2,367
3	+4,000	+1,821
4	+4,000	+1,401
Present Value of future cash flows		+8,666

The NPV in this case is -$1,689

Note that the cash flows in this scenario remain the same. Just the discount rate has risen markedly. This is most likely due to perceived higher risk and so lenders and shareholders demand a higher return which means a higher cost of capital.

The discount rate should be the cost of capital. It is the weighted average of the after tax cost of debt and the expected return required by shareholders.

Meaning of Net Present Value (NPV)

What does the "answer" mean?

The most significant part of the answer is the sign in front of the number. If it is a positive number, then the project is financially desirable - at least in our calculations.

This is because after discounting the future project cash flows at our cost of capital rate, the project is still positive, still ahead. We have covered the cost of capital (the discount rate) and still have a surplus.

Who receives the surplus? Well, not the lenders of the debt. They receive their contracted returns only. The surplus goes to the shareholders, They receive more from this project than they expected.

We now have a link back to our concept of shareholder value.

Projects with a positive NPV increase shareholder value.

Shareholders gain returns greater than they expected for the risk of the project.

The reverse holds true, of course. If a project has a negative NPV, then the lenders will still want their contracted return. The shortfall goes to the shareholders. They receive less than they expected and shareholder value is reduced.

3 . Discounting at 20%

End of Year	Cash Flow	Present Value
0	-10,355	-10,355
1	+4,000	+3,333
2	+4,000	+2,778
3	+4,000	+2,315
4	+4,000	+1,929
Present Value of future cash flows		+10,355

The NPV in this case is zero.

The discount rate which yields an NPV of zero is called the **Internal Rate of Return** (IRR). It is found by iteration (trial and error). It is the discount rate that brings the future positive cash flows back to the initial negative cash flow.

An IRR greater than the discount rate gives the same information as a positive NPV: the project is financially desirable as it yields returns greater than the cost of capital. On the other hand, a negative IRR means the project does not yield shareholders the returns they expect given the risk of the project.

The IRR is of interest to finance people. It is also known as the bond yield and the true interest rate. This is the number you will see that banks must now put on their home loan advertising as the "comparison rate."

However, IRR can have several problems when used to assess the financial merits of an investment decision. IRR does not take into account the scale of projects when doing comparisons. We will have multiple IRR rates if the future cash flows change direction more than once. (Most projects start off negative cash flow with the initial investment and then turn positive as the project is operating.)

The best "answer" to use is NPV.

The major outcomes of investment evaluation modelling in order are:

1. Assumptions must be stated in numerical form (and thus can be tested for reasonableness)

2. We can carry out sensitivity analysis to assess risk

3. The "answer": NPV and IRR

To complete this Appendix on investment evaluation and DCF, the following two pages are time value of money tables. They show what a dollar in the future is worth today, depending on the discount rate used. Alternatively, use the =npv function in Excel.

Present Value of $1 $1 / (1+i)^n$

Year	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091	0.9009	0.8929	0.8850	0.8772	0.8696
2	0.9803	0.9612	0.9426	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8264	0.8116	0.7972	0.7831	0.7695	0.7561
3	0.9706	0.9423	0.9151	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513	0.7312	0.7118	0.6931	0.6750	0.6575
4	0.9610	0.9238	0.8885	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830	0.6587	0.6355	0.6133	0.5921	0.5718
5	0.9515	0.9057	0.8626	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209	0.5935	0.5674	0.5428	0.5194	0.4972
6	0.9420	0.8880	0.8375	0.7903	0.7462	0.7050	0.6663	0.6302	0.5963	0.5645	0.5346	0.5066	0.4803	0.4556	0.4323
7	0.9327	0.8706	0.8131	0.7599	0.7107	0.6651	0.6227	0.5835	0.5470	0.5132	0.4817	0.4523	0.4251	0.3996	0.3759
8	0.9235	0.8535	0.7894	0.7307	0.6768	0.6274	0.5820	0.5403	0.5019	0.4665	0.4339	0.4039	0.3762	0.3506	0.3269
9	0.9143	0.8368	0.7664	0.7026	0.6446	0.5919	0.5439	0.5002	0.4604	0.4241	0.3909	0.3606	0.3329	0.3075	0.2843
10	0.9053	0.8203	0.7441	0.6756	0.6139	0.5584	0.5083	0.4632	0.4224	0.3855	0.3522	0.3220	0.2946	0.2697	0.2472
11	0.8963	0.8043	0.7224	0.6496	0.5847	0.5268	0.4751	0.4289	0.3875	0.3505	0.3173	0.2875	0.2607	0.2366	0.2149
12	0.8874	0.7885	0.7014	0.6246	0.5568	0.4970	0.4440	0.3971	0.3555	0.3186	0.2858	0.2567	0.2307	0.2076	0.1869
13	0.8787	0.7730	0.6810	0.6006	0.5303	0.4688	0.4150	0.3677	0.3262	0.2897	0.2575	0.2292	0.2042	0.1821	0.1625
14	0.8700	0.7579	0.6611	0.5775	0.5051	0.4423	0.3878	0.3405	0.2992	0.2633	0.2320	0.2046	0.1807	0.1597	0.1413
15	0.8613	0.7430	0.6419	0.5553	0.4810	0.4173	0.3624	0.3152	0.2745	0.2394	0.2090	0.1827	0.1599	0.1401	0.1229
20	0.8195	0.6730	0.5537	0.4564	0.3769	0.3118	0.2584	0.2145	0.1784	0.1486	0.1240	0.1037	0.0868	0.0728	0.0611
25	0.7798	0.6095	0.4776	0.3751	0.2953	0.2330	0.1842	0.1460	0.1160	0.0923	0.0736	0.0588	0.0471	0.0378	0.0304
30	0.7419	0.5521	0.4120	0.3083	0.2314	0.1741	0.1314	0.0994	0.0754	0.0573	0.0437	0.0334	0.0256	0.0196	0.0151
35	0.7059	0.5000	0.3554	0.2534	0.1813	0.1301	0.0937	0.0676	0.0490	0.0356	0.0259	0.0189	0.0139	0.0102	0.0075

	16%	17%	18%	19%	20%	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.8621	0.8547	0.8475	0.8403	0.8333	0.8264	0.8197	0.8130	0.8065	0.8000	0.7937	0.7874	0.7813	0.7752	0.7692
2	0.7432	0.7305	0.7182	0.7062	0.6944	0.6830	0.6719	0.6610	0.6504	0.6400	0.6299	0.6200	0.6104	0.6009	0.5917
3	0.6407	0.6244	0.6086	0.5934	0.5787	0.5645	0.5507	0.5374	0.5245	0.5120	0.4999	0.4882	0.4768	0.4658	0.4552
4	0.5523	0.5337	0.5158	0.4987	0.4823	0.4665	0.4514	0.4369	0.4230	0.4096	0.3968	0.3844	0.3725	0.3611	0.3501
5	0.4761	0.4561	0.4371	0.4190	0.4019	0.3855	0.3700	0.3552	0.3411	0.3277	0.3149	0.3027	0.2910	0.2799	0.2693
6	0.4104	0.3898	0.3704	0.3521	0.3349	0.3186	0.3033	0.2888	0.2751	0.2621	0.2499	0.2383	0.2274	0.2170	0.2072
7	0.3538	0.3332	0.3139	0.2959	0.2791	0.2633	0.2486	0.2348	0.2218	0.2097	0.1983	0.1877	0.1776	0.1682	0.1594
8	0.3050	0.2848	0.2660	0.2487	0.2326	0.2176	0.2038	0.1909	0.1789	0.1678	0.1574	0.1478	0.1388	0.1304	0.1226
9	0.2630	0.2434	0.2255	0.2090	0.1938	0.1799	0.1670	0.1552	0.1443	0.1342	0.1249	0.1164	0.1084	0.1011	0.0943
10	0.2267	0.2080	0.1911	0.1756	0.1615	0.1486	0.1369	0.1262	0.1164	0.1074	0.0992	0.0916	0.0847	0.0784	0.0725
11	0.1954	0.1778	0.1619	0.1476	0.1346	0.1228	0.1122	0.1026	0.0938	0.0859	0.0787	0.0721	0.0662	0.0607	0.0558
12	0.1685	0.1520	0.1372	0.1240	0.1122	0.1015	0.0920	0.0834	0.0757	0.0687	0.0625	0.0568	0.0517	0.0471	0.0429
13	0.1452	0.1299	0.1163	0.1042	0.0935	0.0839	0.0754	0.0678	0.0610	0.0550	0.0496	0.0447	0.0404	0.0365	0.0330
14	0.1252	0.1110	0.0985	0.0876	0.0779	0.0693	0.0618	0.0551	0.0492	0.0440	0.0393	0.0352	0.0316	0.0283	0.0254
15	0.1079	0.0949	0.0835	0.0736	0.0649	0.0573	0.0507	0.0448	0.0397	0.0352	0.0312	0.0277	0.0247	0.0219	0.0195
20	0.0514	0.0433	0.0365	0.0308	0.0261	0.0221	0.0187	0.0159	0.0135	0.0115	0.0098	0.0084	0.0072	0.0061	0.0053
25	0.0245	0.0197	0.0160	0.0129	0.0105	0.0085	0.0069	0.0057	0.0046	0.0038	0.0031	0.0025	0.0021	0.0017	0.0014
30	0.0116	0.0090	0.0070	0.0054	0.0042	0.0033	0.0026	0.0020	0.0016	0.0012	0.0010	0.0008	0.0006	0.0005	0.0004
35	0.0055	0.0041	0.0030	0.0023	0.0017	0.0013	0.0009	0.0007	0.0005	0.0004	0.0003	0.0002	0.0002	0.0001	0.0001

FUNDAMENTAL ANALYSIS

Merchant bankers, equity analysts and credit officers all make their living from analysing companies.

So what are the tools they use do this job?

There are many and varied tools available – some authors claim 80 or more techniques. In reality, many are just variants of a basic technique.

We can do a first split of the techniques into:

A. Technical Analysis
B. Fundamental Analysis

Most academics and practitioners quickly dismiss technical analysis. Despite its lofty title, it is only really "charting". We look at how share prices or exchange rates or housing prices or whatever have moved over time. The "technical analyst" then tries to discern patterns in the graphs that may repeat in the future to allow some prediction. It is akin to voodoo and reading the entrails of chickens or tea leaves.

Fundamental Analysis on the other hand, requires us to do some serious study and analysis of many of the basics of a business such as:

Financial strength
Competitive position
Industry attractiveness
Structure
Management strength

We will look at fundamental analysis tools here.

Categories of Techniques

We can categorise the analytic techniques or tools into 3 broad levels:

Macroeconomic: what is happening in the economy e.g. recession, boom, interest rates, exchange rates)

Industry: industry characteristics e.g. intensity of competition, industry attractiveness, product life cycle, technological change, risk factors

Firm: Company safety and profitability e.g. SWOT analysis, competitive positioning, gearing, profit margins, capital asset intensity, asset turnover, management ability and depth.

We can add a fourth dimension by also considering cash flows (as a viability measure) in addition to profitability (which is a performance measure).

Cash Flow: Cash cycle e.g. working capital needs, capital expenditure plans, funding, forecasts

Interestingly, the firm level analysis usually dominates the macroeconomic and industry analysis. Bad companies can still fail even in a booming economy and attractive industry.

2. Analytic Tools

In short, there are many analytic tools available. None is sufficient by itself. None gives the "answer" without applying thought, knowledge and experience.

Some of the tools available include:

Economic forecasting

Trend analysis

Industry Analysis e.g. "Porter Analysis", microeconomics, product life cycle, legal and environmental issues, technology

SWOT analysis (Strengths, Weaknesses, Opportunities & Threats)

Competitive mapping

Value chain analysis
Market position
Appropriateness and fit of strategy
Market growth and development forecasts
Ratio analysis
Pro forma (forecast) financial statements
Capital expenditure plans
Key staff
Sustainable growth rate
Break even analysis
Historical cash flows
Forecast cash flows (modelling)
Due diligence, including risk assessments such as legal and environmental
Funding issues including share prices and ability to make issues or otherwise refinance
Portfolio analysis
Management – quality, breadth of skills, depth, succession

We have covered strategic analyses such as trend analysis, forecasting and SWOT

But there is always more that can be done. Probably the most common form of analysis and the one that is usually conducted first is ratio analysis. So some notes follow on ratio analysis.

Please note that ratio analysis is often at the end of the story. A famous study by John Argenti showed that most companies go through several stages before the distress is obvious in the financial accounts and financial ratios. The problems usually start several years earlier and nearly always can be traced to poor management systems that weaken the company in a competitive environment.

Unless management recognises and rectifies the problems, the conditions worsen and deteriorate.

So if we want early signs of disaster or good performance, we need to employ our industry and competitive analysis.

Also included are some notes about interpreting the cash flow statement and some notes on the sustainable growth rate technique.

FADS and FUR

The competitive world has been changing rapidly. What has been happening to strategic thought?

To be frank, there has not been much conceptually new and good in the past 20 years! There have been many empirical studies of companies and industries with lessons purported to be shown. There have been many fads and old ideas dressed up for marketing to executives. But there has been little that is radically different other than greater need for flexibility and seeing strategy more as a directional map than definite road.

There have been a few exceptions. Gary Hamel is an elder statesman of strategy and one of the few with fire still in his belly, exhorting companies to revolution. In 2000, he was warning of strategic convergence where our strategies converge to basic and similar ideas despite very different needs and differing environments. We see this move to bland populist positions as a safe way to operate. It is seen in politics and sports as well as business.

Hamel also coined the term “strategic decay”: even good strategies decay over time and need to be replaced. In tougher times, some of Hamel’s more radical ideas will be shelved in the cause of financial conservatism.

Generally, we have had a popular press promoting some simple notion with a few key principles that are easy to implement and then you can have superior performance. Add some jazzy terms and promise great returns. Just send $50 and the book and success is yours.

Such marketing techniques have been around for decades although Peters and Waterman in their “In Search of Excellence” refined the hype and motherhood statements. Supposedly in response to the

success of Japanese businesses in the 1970's, Peters and Waterman published their study of 62 businesses (later culled to 43) and developed 8 practices for the excellent company (and who can argue with "*searching for excellence*")? The fact that many of these companies were soon poor performers (some companies on the database had to be culled because they were failing before the study was published) was not even a blip on the sales charts. That we are now revising the success measures of the very Japanese companies and economy that gave rise to the study is not considered.

In Search of Excellence was followed up in 1985 with Peters and Nancy Austin writing about Hewlett-Packard's Management by Walking Around.

Today, the flavour seems to be animals.

We have had some flirtation with the sea: Blue Ocean – proposed by Charles Hill and written by Kim and Mauborgne – which looks at entering white spaces of opportunity that competitors (and maybe even customers) do not yet know about. We have had "It's Your Ship" by Michael Abrashoff – perhaps a throwback to all the 1980's writers trying to draw analogies between military and business strategy.

However, animals are the current fad.

Hedgehogs

Jim Collins from his study of companies drew upon the Greek fable of the fox and the hedgehog. The fox, sleek, cunning and well-armed tries to catch and eat the hedgehog. The hedgehog, however, only knows one thing: when in danger, roll into a ball and present a formidable defence of spines.

Each time, the fox tries something new and each time, the hedgehog survives by its impregnable defence.

So, the analogy runs, build a hedgehog for your business to gain sustainable defence (somewhat similar to sustainable competitive advantage). Of course, if the fox ever figures out a way to flip over the hedgehog or get through its defence, we may be looking at a soon-to-be extinct species.

Elephants

John Argenti's first impact was looking at the failure of large companies in the mid 1970's. He perceived the key issue was management and that failure did not happen overnight. It took many years and several stages for the downward spiral to be complete, by which time it was obvious to all and even evidenced in the financial ratios.

In his semi-retirement, Argenti has developed a system (and a management game) whereby the big issues are identified (the elephants) which must be adequately addressed by management. The Argenti system received a large boost in Australia in 2005 when Michael Chaney, former CEO of Wesfarmers and then Chairman of NAB strongly endorsed the Argenti system and credited it with a large part of the focus on shareholder return in Wesfarmers. It is a pity that Wesfarmers later struggled with Coles (now improved) and NAB has some elephantine credit problems.

Rats and Mice and Grizzly Bears

Other animal analogies abound. Some are only used as examples to make a point without trying to be overly analytic. If a customer segment is best served by rats and mice (backyard operators), do you really want to play in that space with your corporate overheads and other costs?

Similarly, if an industry has a large grizzly bear, leave it alone. To awake the bear risks a bad tempered swipe that may kill you. Avoid price wars or other retaliation from grizzly bears.

More animals are used. We even have Nassim Taleb using the black swan hypothesis when discussing the impact of the highly improbable.

The Halo Effect

In 2007, **Phil Rosenzweig**, Strategy Professor in Lausanne, Switzerland saw fit to warn about management fads in his book: *The Halo Effect: . . . and the Eight Other Business Delusions That Deceive Managers*, New York: Free Press, 2007

You can try his blog on clear management thinking at **www.the-halo-effect.com**

In his book, he is critical, not just of the book publishing snake oil salesmen but also strategy journals including McKinsey & Co's publications and the Harvard Business Review.

McKinsey & Co. must have missed his criticism when they asked Rosenzweig in 2011 to comment on whether there was anything new in strategy. Rosenzweig typically answered that there was plenty that was new, but the more pertinent question to be asked was there anything new that was good?

The halo effect comes into play when a company is successful. We say that it must be due to the CEO and/or the brilliant strategy and/or the great culture. Often, it is just because the company was doing things differently to its peers at the time or fortuitous circumstances. Management performance is relative, not absolute. We then describe what these companies are doing and say that all you need to do is emulate it.

But is the difference sustainable or was it just successful under those circumstances at that time? The problem is, because of the halo effect,

we say that particular company is brilliant and must be emulated. Such admiration not only colours our analysis but even colours the data selected and its interpretation. The data is made to fit the predetermined outcome.

Hence the belief that Japanese business was wonderful and we had to emulate it with Deming and Co, and TQM. We now find it was not so.

Or we believe General Electric is wonderful and we all need Six Sigma, with its seductive jargon of black belts and excellence.

If you would like to pursue these thoughts with other writers, you can try:

> Micklethwait, John; Wooldridge, Adrian. The Witch Doctors: Making Sense of the Management Gurus
>
> Wheen, Francis *How Mumbo-Jumbo Conquered the World* (2004)

They point out the typical jargon, propaganda and other pointers to snake oil, such as high priced gurus and no developed school of thought to train more practitioners.

You have the knowledge and skill to use the tools of strategy and know what is good and what is dubious.