13. Strategic Evaluation (c.10.3)

Possible ways to enter into new related or unrelated businesses:

1. Acquisition
2. Internal start-up/internal development/organic development
3. Joint ventures or strategic alliances

Managers must decide what strategy they will adapt. They need to apply some criteria in order to enable them to decide what strategy the organisation should pursue.

For example they can apply three types of criteria:

1. Suitability
2. Acceptability
3. Feasibility

For each criterion there are tools that can be used.

**Suitability** – does the strategy address the key issues relating to the strategic position of the organisation?

1. Whether the strategy option fits the key drivers and expected changes in the environment.
2. Whether the strategy has exploited the strategic capabilities.
3. Whether it is appropriate to the expectations of the stakeholders.
4. Whether it is appropriate to the cultural influences.

For example

Churchill Pottery was under pressure from cheaper imports. It was considering to go up-market by a new range of dishes. However it could not go into diversification or retailing because it would not fit the capabilities of Churchill and cultural influences. The choice was to go for investment in cost reduction or go for ‘add value’ to enter the growing up-market segments. Churchill chose to grow into up-market segments.

Exhibit 10.5 p.366 shows how the strategy is evaluated against the many strategic concepts to identify the suitability of the strategy to achieve the strategic position of the organisation. A manager must be able to discern/distinguish these key strategic issues as shown in this exhibit.

Exhibit 10.5 Suitability of strategic options in relation to strategic position

|  |  |  |
| --- | --- | --- |
| Concept | Helps with understanding | Suitable strategies must address (examples) |
| PESTEL | Key environmental driversChanges in industry structure | Industry cyclesIndustry convergenceMajor environmental changes |
| Scenarios | Extent of uncertainty/riskExtent to which strategic options are mutually exclusive | Need for contingency plans or ‘low-cost probes’ |
| Five-forces | Industry attractivenessCompetitive forces | Reducing competitive intensityDevelopment of barriers to new entrants |
| Strategic groups | Attractiveness of groupsMobility barriersStrategic spaces | Need to reposition to a more attractive group or to an available strategic space |
| Core competencies | Industry threshold standardsBases of competitive advantage | Eliminating weaknessesExploiting strengths |
| Value chain | Opportunities for vertical integration or outsourcing | Extent of vertical integration or possible outsourcing |
| Stakeholder mapping | Power and interest of stakeholders  | Which strategic options are likely to address the interests of which stakeholders |
| Cultural web | The links between organisational culture and the current strategy | The strategic options most aligned with the prevailing culture |

Next, what strategic direction should the managers take?

Consolidation, market penetration, product development, market development or diversification? (Ansoff matrix)

What methods to use?

Organic development, Merger or acquisition or Joint development.

Examples for the use of both (strategic direction and methods) are shown in Exhibit 10.6 in p. 367 Johnson, Scholes and Whittington, 8th edition, 2008. In each of the applications the choice of the options available is dependent on three situations such as environment, capabilities and stakeholder and/or cultural influences. It is imperative that students study the examples given in this Exhibit 10.6 in order to have a deeper sense of understanding and knowledge of the application of the strategic options in accordance to their suitability.

Exhibit 10.6 summaries the available directions and methods to an organisation

|  |  |
| --- | --- |
| Strategic option | Why this option might be suitable in terms of: |
| Environment | Capability | Stakeholder and/or cultural influences |
| Direction |  |  |  |
| Consolidation | Withdraw from declining marketsMaintain market share | Build on strengths through continued investment and innovation | Stick to what the organisation and its stakeholders know best |
| Market penetration | Gain market share for advantage | Exploit superior resources and competencies |
| Product development | Exploit knowledge of customer needs | Exploit R & D | Minimise the risk of alienating stakeholders with interests in preserving the status quo or making counter cultural decisions |
| Market development | Current market saturated New opportunities for:geographical spread, entering new segments or new uses | Exploit current products and capabilities |
| Diversification |  |  |  |
|  |  |  |  |
| Methods |  |  |  |
| Organic development | Partners or acquisitions not available or not suitable | Building on own capabilities Learning and competence development | Cultural/political ease |
| Merge/acquisition | SpeedSupply/demandP/E ratios | Acquire competences Scale economies | Returns: growth or share value But potential for culture clash |
| Joint development | Speed Industry normrequired for market entry | Complementary competencesLearning from partners | Dilutes risk Fashionable  |

Next we examine the tools available for assessing suitability of the application of a strategy.

1. The SWOT analysis (TOWS matric)

|  |  |  |
| --- | --- | --- |
| ExternalFactors |  |  Internal Factors |
|  Strengths (S) |  Weaknesses (W) |
| Opportunity (O) | *SO strategic options*Generate options here that use strengths to take advantage of opportunities. | *WO strategic options*Generate options here that take advantage of opportunities by overcoming weaknesses. |
|  Threat (T) | *ST strategic options*Generate options here that use strengths to avoid threats | *WT strategic options*Generate options here that minimise weaknesses and avoid threats  |

2. The relative suitability of options that is more or less suitable than others that may be available to an organisation.

3. Ranking strategic options i.e. assess options against key factors relating to the strategic position of the organisation and then get a score (ranking) for each option. (See Churchill Pottery, p. 369.)

4. Decision trees – assess strategic options against a list of key factors.

 For example a strategic decision tree for a law firm

 Growth Investment Diversification Examples of strategic options

 Yes 1. Enter matrimonial law by acquisition of other firms

 High No 2. Expand geographically by acquisition of other firms

 Yes 3. Enter matrimonial law by appointing new partners

 Growth Low No 4. Gain market share, hire legal assistants

Current business

(house conveyancing) \*

 Yes 5. Enter matrimonial law; move premises; retrain partner

 High

 No 6. Stay in conveyancing; major investments in IT

 No growth

 Yes 7. Enter matrimonial law; retrain partners

 Low

 No 8. Stay as currently

5. Scenarios – strategic options are created against a range of possible future situations. This is done in situations of high degree of uncertainty and suitable options are developed subject to contingency plans.

**Acceptance -** the expected performance outcomes of a strategy must be acceptable to the expectation of the stakeholders.

There are 3 types:

1. Returns
2. Risks
3. Stakeholder reactions.

These are summarised in Exhibit 10.7 p. 371.

Exhibit 10.7: Some Criteria for assessing the acceptability of strategic options

|  |  |  |  |
| --- | --- | --- | --- |
| Criteria | Used to understand | Examples | Limitations |
| **Returns**ProfitabilityCost-benefitsReal optionsShareholder value analysis (SVA) | FinancialROI in major projectsWider costs/benefits (including intangibles)Sequence of decisionsImpact of new strategies on shareholder value | RO capitalPayback periodDiscounted Cash Flow (DCF)Major infrastructure projectsReal option analysisMergers/acquisitionsAssessment of new ventures | Apply to discrete projects Only tangible costs/benefitsDifficulties of qualificationQualificationTechnical detail often difficult |
| **Risk**Financial ratio projectionsSensitivity analysis | Robustness of strategyTest assumptions/robustness | Break-even analysisImpact on gearing and liquidity‘What if?’ analysis | Tests factors separately |
| **Stakeholder reactions** | Political dimension of strategy | Stakeholder mapping | Largely qualitative |

Stakeholder Mapping

 Level of Interest

 Low High

 Low A B

 Minimal Effort Keep informed

 Power

 C D

 Keep satisfied Key players

 High

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**1. Returns**: benefits stakeholders expect to receive from a strategy. There are different approaches to understanding returns – look at three of them.

1. Financial analysis – such as ROCE, Payback period and Discounted Cash Flow (IRR).
2. Cost benefit – a money value can be put on all the costs and benefits of a strategy, including tangible and intangible returns to the people and organisations other than the one sponsoring the project or strategy.
3. Real options – a strategy can be seen as a series of real options i.e. choices of direction at a particular point in time as the strategy takes shape. This gives rise to three benefits:
4. Bringing strategic and financial evaluation closer together.
5. Valuing emerging options.
6. Coping with uncertainty.

Shareholder Value Analysis – two measures of shareholder value:

1. Total shareholder return (TSR)

 Increase in the price of the share + dividend received per share (at the end of financial year)

 TSR = -----------------------------------------------------------------------------------------------------------------------------------

 Share price at the start of financial year

1. Economic profit or economic value added (EVA)

E.g. Given:

* Operating profit after tax = $10 m
* Capital employed = $100m
* Cost of capital 8% = 100 x .08 = $8m

 Then, the capital/financial charge required to produce the operating profit after tax is the capital employed $100m x the cost of capital of 8% = $8m.

EVA

Operating profit after tax = $10m

Less the cost of the capital = $8m

 EVA = $2m

**2. Risk**

It concerns the risk the organisation faces in implementing the strategy. It is about the probability and consequence of the failure of a strategy. Risk can be high if the investment for an innovation is long term and the uncertainty is high.

Financial ratios are used to determine the risk such as the debt/equity ratio.

Another one is sensitivity analysis. E.g. an increase in a certain % of raw materials, how it can affect the profit or the market demand has declined by 5% what would be its effect on the profit of the organisation.

Stakeholder Reactions

Use shareholder mapping to understand the reactions of stakeholders to new strategies, how to manage their reactions and the acceptability of the strategy.

Situations where stakeholder reactions can be crucial to the implementation of the strategy:

1. Financial restructuring – such as issuance of new shares may be unacceptable to shareholders since it can dilute their voting power.
2. An acquisition or merger could be unacceptable to an union, government.
3. A new business model may cut off channels such retailers and it may cause of backlash which affect the success of the strategy.
4. Outsourcing – results in loss of jobs.

**3. Feasibility –** whether the organisation has the resources and competencies to deliver a strategy.

* Financial feasibility – cash availability/financial sources to implement the strategy.
* Resource deployment – resources and competencies to avail the capabilities for implementing the strategy. E.g. geographical expansion in a market is dependent on the marketing and distribution expertise and the available cash to fund the expansion. Or the development of a new product for the current market will depend on the availability of technical skill, capability of machinery and the quality aspect to enable customers to accept the value of the new product. A resource deployment assessment should look into:
1. The extent to which the current capabilities of the organisation need to change to reach the threshold requirement of a strategy.
2. How unique resource and/or core competencies can be developed to sustain CA.

 Evaluation Criteria: 3 qualifications:

1. Conflicting conclusions and management judgement.

A proposed strategy may look eminently suitable by the manager but the major shareholders may not accept it.

1. Consistency between the different elements of a strategy.

Competitive strategy (low price or differentiation), strategy direction (such as product development or diversification) and strategic method (internal, acquisition or alliances) need to be consistent. They must come together as a sensible or logical package.

1. The implementation and development of strategies may bring out issues that might make the organisation to reconsider whether a particular strategy is feasible or uncover factors that change the idea of suitability or acceptability of a strategy. This may lead to reshaping or abandoning the strategy.

Read “Tesco Conquers the world?” on pages 389-391 JSW, 2008 and answer questions 2 and 3.