

VALUE THROUGH STRATEGY

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Introduction

Transforming a corporation from one that is earnings based to one which is focussed on value has profound effects on almost all aspects of organizational life. New light is cast on the most appropriate portfolio of businesses making up the firm, and on the strategic thrust of individual business units. Acquisition and divestment strategies may be modified to put shareholder wealth creation center stage. Capital structure (proportion of debt relative to equity capital) and dividend payout policy are predicated on the optimal approach from the shareholders' point of view, not by 'safety first' or earnings growth considerations. Performance measures, target setting and managerial compensation become linked to the extent that wealth is created rather than the vagaries of accounting numbers.

To unite the organization in pursuit of wealth creation an enormous educational and motivational challenge has to be met. A change in culture is often required to ensure that at all levels, the goal is to create value. Retraining and new reward systems are needed to help lift eyes from the short-term to long-term achievements.

This chapter gives a taste of the pervading nature of value-based managerial thinking. Later chapters consider some specific aspects of value-based management such as the employment of metrics to gauge the extent of achievement in value terms, the way to calculate the opportunity cost of capital and the value to be destroyed or gained through mergers.

Value principles touch every corner of the business

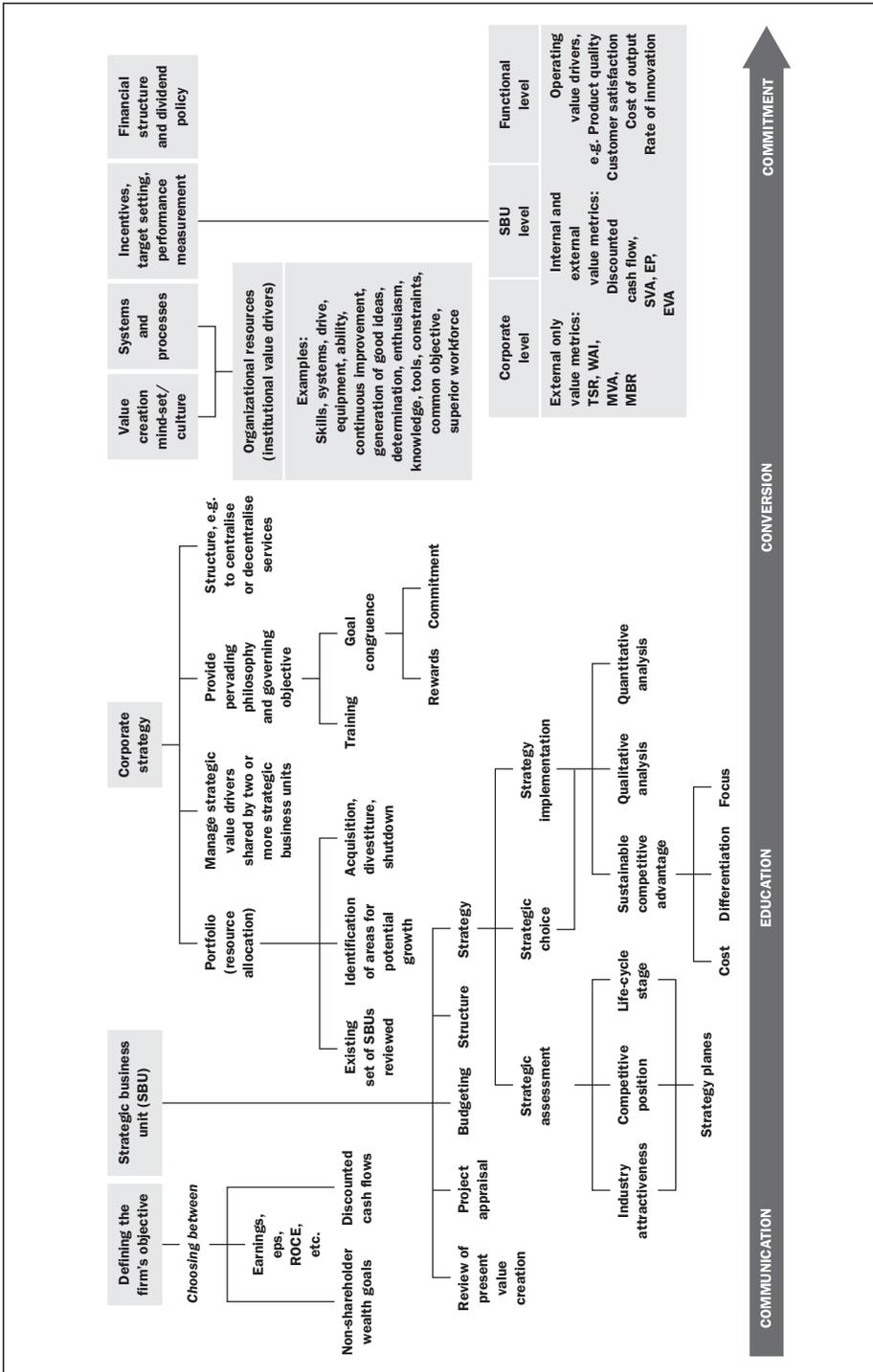
Figure 7.1 summarizes some of the most important areas where value-based management impacts on the firm. To describe them all fully would require a book as long as this one, so only the most important points are discussed below.

The firm's objective

The firm has first to decide what it is that is to be maximized and what will merely be satisfied. In value management the maximization of sales, market share, employee satisfaction, customer service excellence, and so on, are rejected as the objective of the firm. All of these are important and there are levels of achievement for each which are desirable in so far as they help to maximizing shareholder wealth, but they are not *the* objective. It is important that there is clarity over the purpose of the firm and crystal-clear guiding principles for managers making strategic and operational decisions. Objectives stated in terms of a vague balance of interests are not appropriate for a commercial organization in a competitive environment. The goal of maximizing discounted cash flows to shareholders brings simplicity and direction to decision-making.

FIGURE 7.1

Value principles influence most aspects of management



Strategic business unit management

A strategic business unit (SBU) is a business unit within the overall corporate entity which is distinguishable from other business units because it serves a defined external market in which management can conduct strategic planning in relation to products and markets.

Large corporations often have a number of SBUs which each require strategic thought and planning. Strategy means selecting which product or market areas to enter/exit and how to ensure a good competitive position in those markets/products. Establishing a good competitive position requires a consideration of issues such as price, service level, quality, product features, methods of distribution, etc., but these issues are secondary to deciding which products to produce and which markets to enter or exit.

It is the managers of a SBU that are the individuals who come into regular contact with customers in the competitive market environment and it is important that SBU strategy be developed largely by those managers who will be responsible for its execution. By doing this, by harnessing these managers' knowledge and encouraging their commitment through a sense of 'ownership' of a strategy, the firm is more likely to prosper.

Before the creation of new strategic options it is advisable to carry out a review of the value creation of the present strategy. This can be a complex task but an example will demonstrate one approach. Imagine that the plastic products division of Red plc is a defined strategic business unit with a separable strategic planning ability servicing markets distinct from Red's other SBUs. This division sells three categories of product, A, B and C to five types of customer: (a) UK consumers, (b) UK industrial users, (c) UK government, (d) European Union consumers and (e) other overseas consumers. Information has been provided showing the value expected to be created from each of the product/market categories based on current strategy. These are shown in Figures 7.2 and 7.3.

FIGURE 7.2
Red plc's plastic SBU value creation profile – product line breakdown

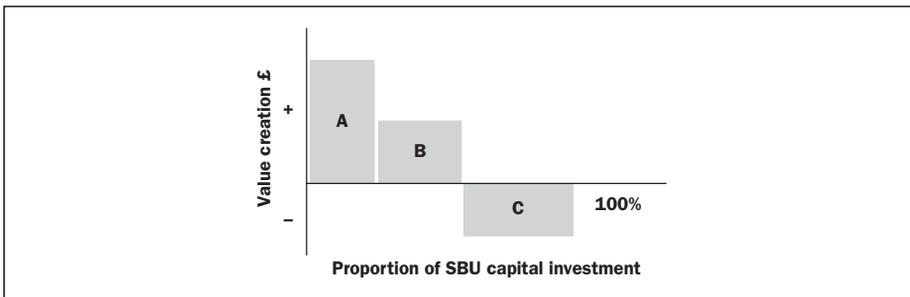
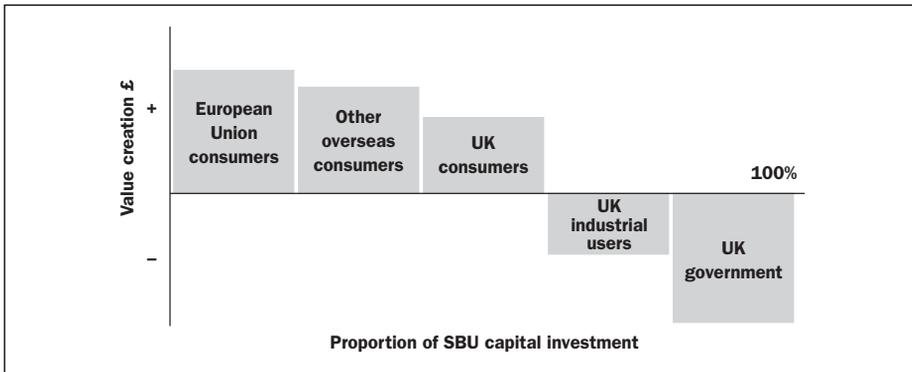


FIGURE 7.3

Red plc's plastic SBU value creation profile – customer breakdown



Product line C is expected to destroy shareholder value while absorbing a substantial share of the SBU's resources. Likewise this analysis has identified sales to UK industry and government as detrimental to the firm's wealth. This sort of finding is not unusual: many businesses have acceptable returns at the aggregate level but hidden behind these figures are value-destructive areas of activity. The analysis could be made even more revealing by showing the returns available for each product and market category; for example, product A in the UK consumer market can be compared with product A in the European market.

Warren Buffett, the financier, has made some pithy comments on the tendency for firms to fail to identify and root out value-destructive activities:

Many corporations that consistently show good returns both on equity and on overall incremental capital have, indeed, employed a large portion of their retained earnings on an economically unattractive, even disastrous, basis. Their marvellous core businesses, however, whose earnings grow year after year, camouflage repeated failures in capital allocation elsewhere (usually involving high-priced acquisitions of businesses that have inherently mediocre economics). The managers at fault periodically report on the lessons they have learned from the latest disappointment. They then usually seek out future lessons. (Failure seems to go to their heads.)

(Berkshire Hathaway 1984 Annual Report. © Warren Buffett, Reproduced with the permission of the author.)

To get a clear line of sight from the customer to the shareholder many businesses need to build an entirely new fact base showing the full economic cost and cash flows associated with customers and product markets. Recognizing that some activities are far more valuable than others prepares the ground for a shift of strategic resources. Attention can be directed at restructuring or eliminating value destructive operations, while building up value creative aspects of the business.

Furthermore, project appraisal, budgeting systems and the organizational structure of each SBU must be in harmony with the principle of value-based management. Project appraisal will be carried out using discounted cash flow techniques. Budgeting will not rely solely on accounting considerations, but will have value-based metrics (methods of measurement) – some of these are described in the next chapter. The lines of decision-making authority and communication will be the most appropriate given the market environment to achieve greatest returns. For example in a dynamic unpredictable market setting it is unwise to have a bureaucratic, hierarchical type structure with decision-making concentrated at the top of long chains of command. Devolved power and responsibility are likely to produce a more flexible response to change in the market-place, and initiative with self-reliance are to be highly prized and rewarded. In less dynamic environments low cost, close command and control management with an emphasis on continuous improvement is likely to be most appropriate.

Strategic analysis can be seen as having three parts.¹

- 1. Strategic assessment** – in which the external environment and the internal resources and capability are analyzed to form a view on the key influences on the value-creating potential of the organization.
- 2. Strategic choice** – in which strategic options are developed and evaluated.
- 3. Strategic implementation** – action will be needed in areas such as changes in organizational structure and systems as well as resource planning, motivation and commitment.

Strategic assessment

There are three primary strategic determinants of value creation.

Industry attractiveness

The economics of the market for the product(s) have an enormous influence on the profitability of a firm. In some industries firms have few competitors, and there is low customer buying power, low supplier bargaining power and little threat from new entrants or the introduction of substitute products. Here the industry is likely to be attractive in terms of the returns accruing to the existing players, which will on average exhibit a positive performance spread. Other product markets are plagued with over-capacity, combined with reluctance on the part of the participants to quit and apply resources in another product market. Prices are kept low by the ability of customers and suppliers to ‘put the squeeze on’ and by the availability of very many close-substitute products. Markets of this kind tend to produce negative performance spreads.²

The strength of resources

Identifying a good industry is only the first step. Value-based companies aim to beat the average rates of return on capital employed within their industries. To beat the averages, companies need something special. That something special comes from the bundle of resources that the firm possesses. Most of the resources are ordinary. That is, they give the firm competitive parity. However, the firm may be able to exploit one or two extraordinary resources – those that give a competitive edge. An extraordinary resource is one which, when combined with other (ordinary) resources enables the firm to outperform competitors and create new value-generating opportunities. Critical extraordinary resources determine what a firm can do successfully.

The ability to generate value for customers is crucial for superior returns. High shareholder returns are determined by the firm either being able to offer the same benefits to customers as competitors, but at a lower price; or being able to offer unique benefits that more than outweigh the associated higher price.

Ordinary resources provide a threshold competence. They are vital to ensure a company's survival. In the food retail business, for example, most firms have a threshold competence in basic activities, such as purchasing, human resource management, accounting control and store layout. However, the large chains have resources that set them apart from the small stores: they are able to obtain lower-cost supplies because of their enormous buying power; they can exploit economies of scale in advertising and in the range of produce offered.

Despite the large retailers having these advantages it is clear that small stores have survived, and some produce very high returns on capital invested. These superior firms provide value to the customer significantly above cost. Some corner stores have a different set of extraordinary resources compared with the large groups: personal friendly service could be valued highly; opening at times convenient to customers could lead to acceptance of a premium price; the location may make shopping less hassle than traipsing to an out-of-town hypermarket. The large chains find emulation of these qualities expensive. If they were to try and imitate the small store they could end up losing their main competitive advantages, the most significant of which is low cost.

The extraordinary resources possessed by the supermarket chains as a group when compared with small shops are not necessarily extraordinary resources in the competitive rivalry *between* the chains. If the focus is shifted to the 'industry' of supermarket chains factors like economies of scale may merely give competitive parity – scale is needed for survival. Competitive advantage is achieved through the development of other extraordinary resources, such as the quality of the relationship with suppliers, a very sophisticated system for collecting data on customers combined with target marketing, ownership of the best sites. However, even these extraordinary resources will not give superior competitive position forever. Many of these can be imitated. Long-term competitive advantage may depend on the capabilities of the management team to

continually innovate and thereby shift the ground from under the feet of competitors. The extraordinary resource is then the coherence, attitude, intelligence, knowledge and drive of the managers in the organizational setting.

Many successful companies have stopped seeing themselves as bundles of product lines and businesses. Instead they look at the firm as a collection of resources. This helps to explain the logic behind some companies going into apparently unconnected product areas. The connection is the exploitation of extraordinary resources. So, for example, Honda has many different product areas: motor boat engines, automobiles, motorcycles, lawn mowers and electric generators. These are sold through different distribution channels in completely different ways to different customers. The common root for all these products is Honda's extraordinary resource that led to a superior ability to produce engines. Likewise, photocopiers, cameras and image scanners are completely different product sectors and sold in different ways. Yet, they are all made by Canon – which has extraordinary capabilities and knowledge of optics, imaging and microprocessor controls.

The analyst should not be looking for a long list of extraordinary resources in any one firm. If one can be found, that is good – it only takes one to leap ahead of competitors and produce super-normal returns. If two are found then that is excellent. It is very unusual to come across a company that has three or more extraordinary resources. Coca-Cola is an exception with an extraordinary brand, a distribution system with connected relationships and highly knowledgeable managers.

The TRRACK system

To assist the thorough analysis of a company's extraordinary resource I have developed the TRRACK system. This classifies extraordinary resources into six categories – see Figure 7.4.

FIGURE 7.4
The TRRACK system

T	Tangible
R	Relationships
R	Reputation
A	Attitude
C	Capabilities
K	Knowledge

Notice that the vast majority of extraordinary resources are intangible. They are qualities that are carried within the individuals that make up organizations, or are connected with the interaction between individuals. They are usually developed over a long time rather than bought. These qualities cannot be scientifically evaluated to provide objective quantification. Despite our inability to be precise it is usually the case that these people-embodied factors are the most important drivers of value creation and we must pay most attention to them.

Tangible

Occasionally physical resources provide a sustainable competitive advantage. These are assets that can be physically observed and are often valued (or misvalued) in a balance sheet. They include real estate, materials, production facilities and patents. They can be purchased, but if they were easily purchased they would cease to be extraordinary because all competitors would go out and buy. There must be some barrier preventing other firms from acquiring the same or similar assets for them to be truly valuable in the long run. Microsoft's ownership of its operating system and other standards within the software industry gives it a competitive edge. McDonald's makes sure that it takes the best locations on the busiest highways, rather than settle for obscure secondary roads. Many smaller businesses have found themselves, or have made smart moves to ensure they are, the owners of valuable real estate adjacent to popular tourist sites. Pharmaceutical companies, such as Merck, own valuable patents giving some protection against rivalry – at least temporarily.

Relationships

Over time companies can form valuable relationships with individuals and organizations that are difficult or impossible for a potential competitor to emulate. Relationships in business can be of many kinds. The least important are the contractual ones. The most important are informal or implicit. These relationships are usually based on a trust that has grown over many years. The terms of the implicit contract are enforced by the parties themselves rather than through the court – a loss of trust can be immensely damaging. It is in all the parties' interests to cooperate with integrity because there is the expectation of reiteration leading to the sharing of collective value created over a long period. South African Breweries (SAB) has 98 percent of the beer market in South Africa. It has kept out foreign and domestic competitors because of its special relationships with suppliers and customers. It is highly profitable, and yet, for the last two decades it has reduced prices every year – the price of beer has halved in real terms. Most of South Africa's roads are poor and electricity supplies are intermittent. To distribute its beer it has formed some strong relationships. The truck drivers, many of whom are former employees, are helped by SAB to set up their small trucking businesses. *Shebeens* sell most of the beer. These are unlicensed pubs. Often, they are tiny – no more than a few benches. SAB cannot sell directly to the illegal *shebeens*. Instead it maintains an informal relationship via a system of wholesalers. SAB makes sure that distributors have refrigerators and, if necessary, generators. A new entrant to the market would have to develop its own special relationship with truck drivers, wholesalers and retailers. In all likelihood it would have to establish a completely separate and parallel system of distribution. Even then it would lack the legitimacy that comes with a long-standing relationship. Relationships between employees, and between employees and the firm, can give a competitive edge. Some firms seem to

possess a culture that creates wealth through the cooperation and dynamism of the employees. Information is shared, knowledge is developed, innovative activity flows, rapid response to market change is natural and respect for all pervades. The quality of the relationships with government can be astonishingly important to a company. Defence contractors cultivate a special relationship with various organs of government. The biggest firms often attract the best ex-government people to take up directorships or to head liaison with government. Their contacts and knowledge of the inside workings of purchasing decisions, with the political complications, can be very valuable. A similar logic often applies to pharmaceutical companies, airlines and regulated companies.

Reputation

Reputations are normally made over a long period. Once a good reputation is established it can be a source of very high returns (assuming that all the necessary ordinary resources are in place to support it). With car hire in a foreign country the consumer is unable to assess quality in advance. Hertz provide certification for local traders under a franchise arrangement. These local car hirers would see no benefit to providing an above-average service without the certification of Hertz because they would not be able to charge a premium price.³ It is surprising how much more consumers are willing to pay for the assurance of reliable and efficient car hire when they travel abroad compared with the hiring of a car from an unfranchised local. Companies pay a large premium to hire Goldman Sachs when contemplating an issue of securities or a merger. They are willing to pay for 'emotional reassurance'.⁴ The CEO cannot be sure of the outcome of the transaction. If it were to fail the penalty would be high – executives may lose bonuses, and, perhaps their jobs, shareholders lose money. The CEO therefore hires the best that is available for such once-in-a-lifetime moves. The cost of this hand-holding is secondary. Once an adviser has a history of flawless handling of large and complex transactions it can offer a much more effective 'emotional comfort-blanket'⁵ to CEOs than smaller rivals. This principle may apply to pension fund advisers, management consultants and advertising agencies as well as top investment bankers. Perhaps the most important manifestation of the importance of reputation is branding. Branded products live or die by reputation. A strong brand can be incredibly valuable.

Attitude

Attitude refers to the mentality of the organization. It is the prevalent outlook. It is the way in which the organization views and relates to the world. Terms such as disposition, will and culture are closely connected with attitude. Every sports coach is aware of the importance of attitude. The team may consist of players with the best technique in the business or with a superb knowledge of the game, they may be the fastest and the most skilful, but without a winning attitude they will not succeed. There must be a will to win. Attitude can become entrenched within an organization. It is difficult to shake off a negative attitude. A positive attitude

can provide a significant competitive edge. Some firms develop a winning mentality based on a culture of innovation, others are determinedly oriented towards customer satisfaction while some companies are quality driven. 3M, has a pervasive attitude of having-a-go. Testing out wild ideas is encouraged. Employees are given time to follow up a dreamed-up innovation, and they are not criticized for failing. Innovations such as 'Post-it' notes have flowed from this attitude. Canon has the attitude of *Tsushin* – 'heart-to-heart and mind-to-mind communication' between the firm and its customers. In this way trust is developed.

Capabilities

Capabilities are derived from the company's ability to undertake a set of tasks. The term skill can be used to refer to a narrow activity or a single task. Capability is used for the combination of a number of skills.⁶ For example, a company's capability base could include abilities in narrow areas such as market research, innovative design and efficient manufacturing that, when combined, result in a superior capability in new product development. A capability is more than the sum of the individual processes – the combination and coordination of individual processes may provide an extraordinary resource. Sony developed a capability in miniaturization. This enabled it to produce a string of products from the Walkman to the Playstation.

Knowledge

Knowledge is the awareness of information, and its interpretation, organization, synthesis and prioritization, to provide insights and understanding. The retention, exploitation and sharing of knowledge can be extremely important in achieving and maintaining competitive advantage. All firms in an industry share basic knowledge. For example, all publishers have some knowledge of market trends, distribution techniques and printing technology. It is not this common knowledge that I am referring to in the context of extraordinary resources. If a publisher builds up data and skills in understanding a particular segment of the market, say investment books, then its superior awareness, interpretation, organization, synthesis, and prioritization of information can create competitive advantage through extraordinary knowledge. The company will have greater insight than rivals into this segment of the market. There are two types of organizational knowledge. The first, *explicit* knowledge, can be formalized and passed on in codified form. This is objective knowledge that can be defined and documented. The second, *tacit* knowledge, is ill- or undefined. It is subjective, personal and context specific. It is fuzzy and complex. It is hard to formalize and communicate. Examples of explicit knowledge include costing procedures written in company accounting manuals, formal assessment of market demand, customer complaint data and classification. Explicit knowledge is unlikely to provide competitive advantage: if it is easily defined and codified it is likely to be available to rivals. Tacit knowledge, on the other hand, is very difficult for rivals to obtain. Consider the analogy of a baseball: explicit knowledge of tactics is generally available; what separates the excellent from the ordinary player is the application of tacit knowledge, e.g. what becomes

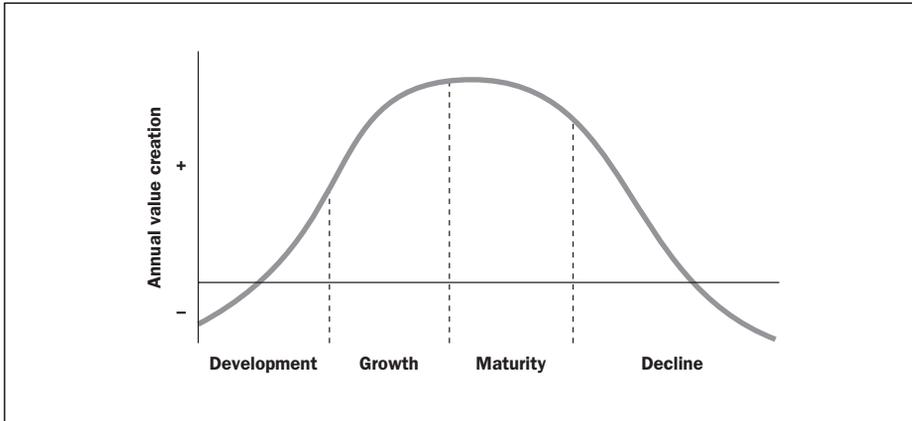
an instinctive ability to recognize types of pitches and the appropriate response to them. Tacit knowledge is transmitted by doing, the main means of transferring knowledge from one individual to another is through close interaction to build understanding, as in the master-apprentice relationship.

If you would like to delve more deeply into competitive resource analysis there are fuller discussions in Chapter 10 of *Valuegrowth Investing*, Arnold (2002) and Chapter 15 of *The Financial Times Guide to Investing*, Arnold (2004).

Life-cycle stage of value potential

A competitive advantage in an attractive industry will not lead to superior long-term performance unless it provides a *sustainable* competitive advantage and the economics of the industry *remain* favorable. Rival firms will be attracted to an industry in which the participants enjoy high returns and sooner or later competitive advantage is usually whittled away. The longevity of the competitive advantage can be represented in terms of a life cycle with four stages: development, growth, maturity and decline (*see* Figure 7.5). In the development phase during which competitive advantage (and often the industry) is established, perhaps through technological or service innovation, the sales base will be small. As demand increases a growth phase is entered in which competitive strength is enhanced by factors such as industry leadership, brand strength and patent rights. A lengthy period of competitive advantage and high return can be expected. Eventually the sources of advantage are removed, perhaps by competitor imitation, or by customers and suppliers gaining in bargaining power. Other possibilities pushing towards the maturity stage are technological breakthroughs by competitors able to offer a superior product, or poor management leading to a loss of grip on cost control. Whatever the reason for the reduction in the performance spread, the firm now faces a choice of three routes, two of which can lead to a repositioning on the life cycle; the third is to enter a period of negative performance spreads. The two positive actions are (a) to erect barriers and deterrents to the entry of firms to the industry. Barriers put in the path of the outsiders make it difficult for those insects to advance on your honey pot. Also, a clear message could go out to the aspiring entrant that if they did dare to cross the threshold then they will be subject to a massive retaliatory attack until they are driven out again, and (b) to continually innovate and improve the SBU's product offering to stay one step ahead of the competitors. An example of the simultaneous use of those two actions is provided by Microsoft. It is able to dominate the operating software market and the application market because of the network effect of Office being a standard system used throughout the world and because of its close working relationships with hardware producers; this makes life very difficult for any potential new entrant. It is also pumping billions into new products – it has thousands of software engineers. But even Microsoft will find its business units eventually fall into a terminal decline phase of value creation because of a loss of competitive advantage. When it does, even though it will be extremely difficult for it to do so, the company must withdraw from value-destructive activities and plow the capital retrieved into positive performance-spread SBUs.

FIGURE 7.5
The life-cycle stages of value creation

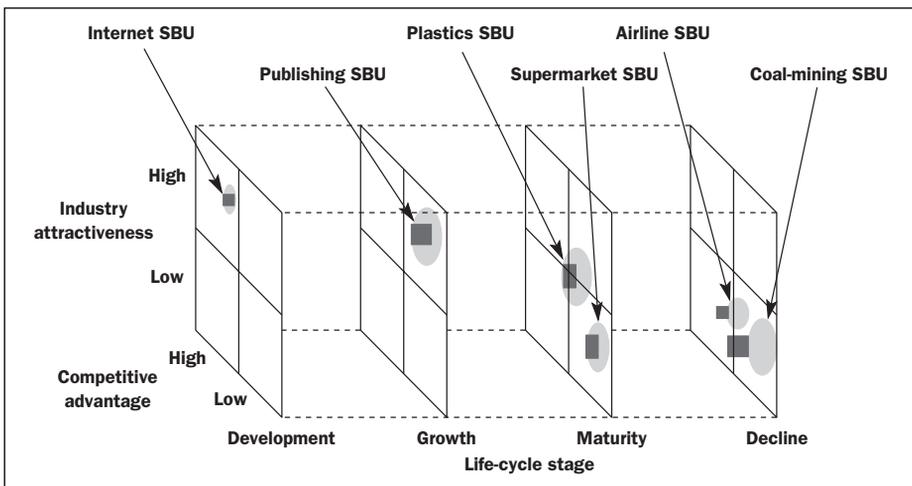


Strategy planes

The three elements of strategic assessment can be summarized on a strategy planes chart like the one shown in Figure 7.6 for Red plc which, besides the plastics SBU, also has a young internet games division, a coal-mining subsidiary, a publishing group with valuable long-term copyrights on dozens of best sellers, a supermarket chain subject to increasingly intense competition in an over-supplied market and a small airline company with an insignificant market share.

The strategy planes framework can be used at the SBU level or can be redrawn for product/customer segments within SBUs.

FIGURE 7.6
Strategy planes



Note: The size of the circle represents the proportion of the firm's assets devoted to this SBU. The size of the rectangle represents the current performance spread. If the spread is negative it is shown outside the circle.

Strategic choice

Managers need to consider a wide array of potential strategic options. The process of systematic search for alternative market product entry/exit and competitive approaches within markets is vital. The objective of such a search is to find competitive advantage in attractive markets sustainable over an extended period of time yielding positive performance spreads.

There are two proven types of strategies to achieve sustainable competitive advantage:

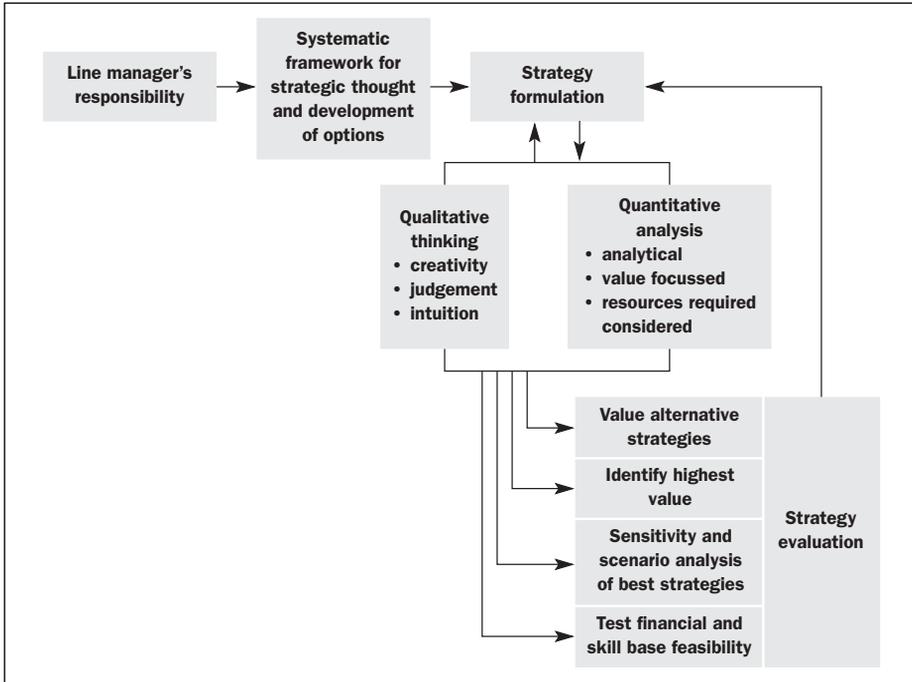
- *A cost leadership strategy* – a standard no-frills product. The emphasis here is on scale economies or other cost advantages.
- *A differentiation strategy* – the uniqueness of the product/service offering allows for a premium price to be charged.

To fall between these two stools can be disastrous.

Once a sufficiently wide-ranging search for possible strategic directions has been conducted the results that come to the fore need to be evaluated. They are usually considered in broad descriptive terms using qualitative analysis with written reports and reflective thought. This qualitative thinking has valuable attributes such as creativity, intuition and judgment in the original formulation of strategic options, the assessment of their merits and in the subsequent reiterations of the process. The qualitative strategy evaluation is complemented by a quantitative examination for which accounting terms such as profit, earnings per share (eps), return on capital employed (ROCE) and balance sheet impact are traditionally used. This has the advantage of presenting the strategic plans in the same format that the directors use to present annual results to shareholders. However these metrics do not accurately reflect the shareholder value to be generated from alternative strategic plans. The value-based metrics such as economic profits and discounted cash flow described in the next chapter are more appropriate.

Figure 7.7 shows the combination of qualitative assessment and quantitative analysis of strategic options. When a shortlist of high-value-creating strategies has been identified, sensitivity and scenario analysis of the kinds described in Chapter 5 can be applied to discover the vulnerability of the 'most likely' outcome to changes in the input factors such as level of sales or cost of materials. The company also needs to consider whether it has the financial resources necessary to fund the strategy. The issues of finance raising, debt levels and dividend policy come into the equation at this point. Other aspects of feasibility include whether the organization has the skill base necessary to provide the required quality of product or service, whether it is able to gain access to the required technology, materials, services and so on.

FIGURE 7.7
Strategy formulation and evaluation



Strategy implementation

Making the chosen strategy work requires the planned allocation of resources and the reorganization and motivation of people. The firm's switch to value-based principles has an impact on these implementation issues. Resources are to be allocated to units or functions if it can be shown that they will contribute to value creation after taking into account the quantity of resources used. Managers are given responsibilities and targets set in accordance with value creation.

What use is the head office?

So far the firm has been described as consisting of a group of strategic business units. So where does the head office fit into this picture if each of these units has separately identifiable market and is capable of independent strategic action?

We know that companies need to apply value-based principles to all its activities and so this must include the center. Everything the head office does must create value for shareholders. This means awareness of the quantity of assets used in each task and the return generated by those assets in that task. Many companies fail to think this through; head office costs spiral as new activities are

taken to the center to add to those traditionally carried out, without thought as to whether these tasks are (a) necessary, or (b) if necessary, most efficiently executed by the center.

In a value-based company the role of the corporate center (head office) has four main aspects:

- *Portfolio planning* – allocating resources to those SBUs and product and/or customer areas offering the greatest value creation while withdrawing capital from those destroying value.
- *Managing strategic value drivers shared by two or more SBUs* – these crucial extraordinary resources, giving the firm competitive advantage, may need to be centrally managed or at least coordinated by the center to achieve the maximum benefit. An example here could be strong brand management or technological knowledge. The head office needs to ensure adequate funding of these and to achieve full, but not over-exploitation.
- *Provide the pervading philosophy and governing objective* – training, goal setting, employee rewards and the engendering of commitment are all focussed on shareholder value. A strong lead from the center is needed to avoid conflict, drift and vagueness.
- *The overall structure of the organization* needs to be appropriate for the market environment and designed to build value. Roles and responsibilities are clearly defined with clear accountability for value creation.

We can apply the principles of portfolio planning to Red plc. The corporate center could encourage and work with the plastics division in developing ideas for reducing or eliminating the value losses being made on some of its products and markets – recall that it is destroying value in product line C and in sales to UK industrial customers and the UK government. Once these have been fully evaluated head office could ensure that resources and other services are provided to effectively implement the chosen strategy. For example, if the highest value-creating option is to gradually withdraw capital from product line C and to apply the funds saved to product line A, the management team at C are likely to become demotivated as they reduce the resources under their command and experience lower sales (and profit) rather than, the more natural predisposition of managers, a rising trend. The center can help this process by changing the targets and incentives of these managers away from growth and empire building towards shareholder value.

On the level of corporate-wide resource allocation, the directors of Red plc have a great deal of work to do. The publishing division is already creating high value from its existing activities, yet it is still in the early growth phase. The subsidiary management team believe that significant benefits would flow from buying rights to other novels and children's stories. By combining these with its present 'stable' it could enter more forcefully into negotiations with book retailers, television production companies wishing to make screen versions of its

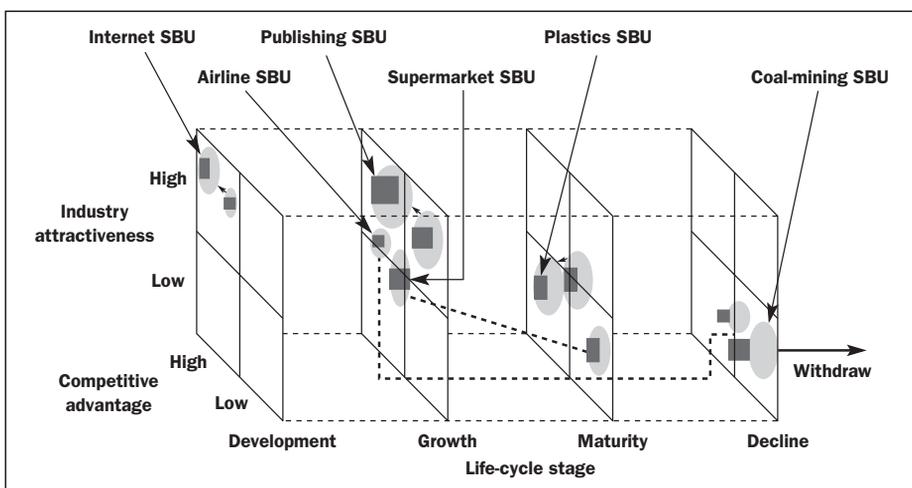
stories and merchandising companies intending to put the image of some of the famous characters on articles ranging from T-shirts to drink cans. This strategy will involve the purchase of rights from individual authors as well as the acquisition of firms quoted on the stock exchange. It will be costly and require a substantial shift of resources within the firm. But, as can be seen from Figure 7.8, the value created makes the change attractive.

The internet division has been put on a tight rein in terms of financial resources for its first three years because of the high risk attached to businesses involved in speculative innovation in this market. However, the energetic and able managers have created a proven line of services that have a technological lead over competitors, a high market share and substantial barriers to entry in the form of copyrights and patents. The directors decide to expand this area.

The plastics division as a whole is in a mature market with positive but gradually declining performance spreads. Here the strategic approach is to reduce the number of product lines competing on cost and transfer resources to those niche markets where product differentiation allows a premium price to be charged. The intention is to move gradually to a higher competitive advantage overall but accept that industry attractiveness will decline. Overall resources dedicated to this division will remain approximately constant, but the directors will be watching for deterioration greater than that anticipated in the current plan.

The supermarket division is currently producing a positive performance spread but a prolonged price war is forecast for the industry, to be followed by a shake-out, leading to a withdrawal of many of the current firms. Some directors are in favor of supporting this division vigorously through the troublesome times

FIGURE 7.8
Using strategy plane analysis.
Red plc's shifting strategy planes



Note: The size of the circle represents the proportion of the firm's assets devoted to this SBU. The size of the rectangle represents the current performance spread. If the spread is negative it is shown outside the circle.

ahead in the expectation that when many of the weaker players have left the field, margins will rise to abnormally high levels – producing large performance spreads and high value in the long run. In terms of the value-creating life cycle this SBU would be shifted from the maturity strategy plane to the growth plane (shown in Figure 7.8). Other directors are not willing to take the risk that their firm will not be one of the survivors from the battle for market share. Furthermore, they argue that even if they do win, the enormous resources required, over the next five years, will produce a value return less than that on the publishing or internet SBUs. Therefore, if financial resources are to be constrained, they should put money into these ‘star’ divisions.

The coal-mining division is hemorrhaging money. The industry is in terminal decline because of the high cost of coal extraction and the increasing tendency for the electricity-generating companies to source their coal needs from abroad. Moreover Red is a relatively small player in this market and lacks the economies of scale to compete effectively. To add insult to injury a large proportion of the corporation’s capital is tied up in the coal stockpiles required by the electricity firms. The decision is taken to withdraw from this industry and the best approach to achieve this is investigated – sale to a competitor or liquidation.

The airline operation has never made a satisfactory return and is resented by the managers in other divisions as a drain on the value they create. However, the recent deregulation of air travel and especially the opening up of landing slots at major European airports has presented a major new opportunity. Despite being one of the smallest operators, so unable to compete on price, it provides a level of service which has gained it a high reputation with business travelers. This, combined with its other major value driver, the strength of its marketing team, leads the divisional managers and the once skeptical directors to conclude that a sufficiently high premium ticket price can be charged to produce a positive performance spread. The new European rules enable the division to be placed on the growth plane as the spread is thought to be sustainable for some time.

The analysis in Figure 7.8 of Red’s corporate strategy is an extremely simplified version of strategy development in large corporations where thousands of man-hours are needed to develop, evaluate and implement new strategic plans. Strategy is a complex and wide-ranging practical academic discipline in its own right and we can only scratch the surface in this chapter.

Targets and motivation

The remaining aspects of management affected by a switch from an earnings-based approach to a value-based approach shown in Figure 7.1 have already been touched on and, given the scope of this book, will not be explained any further here. The interested reader can consult some of the leading writers in this area (see McTaggart *et al.* (1994), Copeland *et al.* (1996), Rappaport (1998), Stewart (1991) and Reimann (1989)). The financial structure debate concerning

the proportion of debt in the overall capital mix of the firm is discussed in Chapters 10 and 18 and the dividend payout ratio debate is described in Chapter 14.

One final point to note with regard to Figure 7.1 is the importance of having different types of value-creating targets at different levels within the organization. At board room and senior executive level it seems reasonable that there should be a concern with overall performance of the firm as seen from the shareholders' perspective and so total shareholder return, wealth added index, market value added and market to book ratio (metrics described in Chapter 9) would be important guides to performance, and incentive schemes would be (at least partially) based upon them. Economic profit, economic value added and discounted cash flow are also useful guides for senior managers. These metrics are described and critically assessed in the next chapter.

Moving down the organization, target setting and rewards need to be linked to the level of control and responsibility over outcomes. Strategic business unit performance needs to be expressed in terms of value metrics such as discounted cash flow, economic profit, and economic value added. Outcomes are usually under the control of divisional and other middle-ranking managers and so the reward system might be expressed in terms of achieving targets expressed in these metrics. At the operating level where a particular function contributes to value creation but the managers in that function have no control over the larger value center itself, perhaps the emphasis should shift to rewarding high performance in particular operational value drivers such as throughput of customers, reduced staff turnover, cost of production, faster debtor turnover, etc.

Key rule: All managers should agree to both short- and long-term targets. This counters the natural tendency in all of us to focus on short-term goals that might not be optimal in the long run.

Case study 7.1

Strategy, planning and budgeting at Lloyds TSB

Although business units are responsible for their own strategy development, the Lloyds TSB group provides guidelines on how strategy should be developed. ... These unit plans are then consolidated into an aggregate plan for the value centre. The process undertaken is then subjected to scrutiny by the centre. The strategic planning process consists of five stages:

- (1) **Position assessment.** Business units are required to perform a value-based assessment of the economics of the market in which the business operates and of the relative competitive position of the business within that market. Market attractiveness and competitive position must include a numerical rather than a purely qualitative assessment.
- (2) **Generate alternative strategies.** Business units are required to develop a number of realistic and viable alternatives.
- (3) **Evaluate alternative strategies.** Business units are required to perform shareholder value calculations in order to prioritise alternatives. Even if a potential strategy has a high positive

net present value, this does not necessarily mean that it will be accepted. An assessment of project risk or do-ability is overlaid across the net present value calculations.

- (4) **Agree chosen strategy with the centre.** Whilst it is perceived to be vital that the managers who best understand their business are given sufficient authority to develop strategies which they consider to be most appropriate, it is nevertheless considered equally important that there is a challenge mechanism at the centre to ensure that appropriate analyses have been performed and assumptions made are credible.
- (5) **The chosen strategy becomes a contract.** Once the preferred strategy has been agreed with the centre, resource allocation and milestones are agreed. Budgetary performance targets are derived from the projections included within the strategic plan. Beyond this, however, business unit managers are free to choose whatever structures and performance indicators are considered to be relevant and appropriate.

Source: 'Lessons from practice: VBM at Lloyds TSB', by M. Davies in G. Arnold and M. Davies (eds), *Value-Based Management*. 2000 © John Wiley & Sons Limited. Reproduced with permission.

Conclusion

A commercial organization that adopts value principles is one that has an important additional source of strength. The rigorous thought process involved in the robust application of these principles will force managers to review existing systems and product and market strategies and to bring an insistence on a contribution to shareholder value from all parts of the company. A firm that has failed to ask the right questions of its operating units or use the correct metrics in measuring performance will find its position deteriorating *vis-à-vis* its competitors.

Notes

- 1 See Johnson and Scholes (2001) for more detail.
- 2 For more detail on market attractiveness analysis consult Arnold, G. (2002) *Valuegrowth Investing*. London: Financial Times Prentice Hall (Chapter 9) of Arnold, G. (2004) *The Financial Times Guide to Investing*. London: Financial Times Prentice Hall (Chapter 14) or any major textbook on strategy. Michael Porter is a leading writer in the field of strategy.
- 3 Kay, J. (1993) *Foundations of Corporate Success*. New York: Oxford University Press. A study of corporate strategy.
- 4 Martin, P. (1998) 'Goldman's goose', *Financial Times*, 11 August, p. 14. Why Goldman Sachs can charge a large amount for advice.
- 5 *Ibid.*
- 6 De Wit, B. and Meyer, R. (1998) *Strategy: Process, Content, Context*. 2nd edn. London.