STRATEGIC MANAGEMENT

WHAT IS STRATEGY?

Phase 1: collect underpants → **Phase 2: ?** → Phase 3: profit

=> What is phase 2? Strategy questions:

- Long term performance of companies
- Positioning within your industry
- Choosing your Target Market
- Your Resources and Capabilities
- Globalization
- Technology Convergence
- Irreversibility of Decisions
- Sustainability
- Non-Market Strategies
- Communities
- Corporate Social Responsibility

Strategic decisions = A decision that is investigated or announced as part of the optimal strategy

- Important for direction of organization
- Important commitment effect
  - Size of the investment
  - Timing of the decision
- Coordination with other decisions → Coherence!
  - Fit
  - Trade-offs
- Standalone value = manager makes the best decision with the information he/she has
  Interaction value = manager makes the best decision with the alignment of other decisions

Strategy = Set of decisions announced or investigated by strategist

- Absent any strategy → each manager will choose locally optimal decisions
- Optimal strategy → investigate and announce a decision and other managers will align
- Strategy is valuable if **alignment** is needed!
- What if there are probabilities (no certainty)
  - Reliability of strategy: strategy is more valuable if it's more reliable
  - Irreversibility: Strategy is more valuable if decisions are more irreversible (irreversible decisions can align with strategy)
  - Option to commit: makes decision more strategic

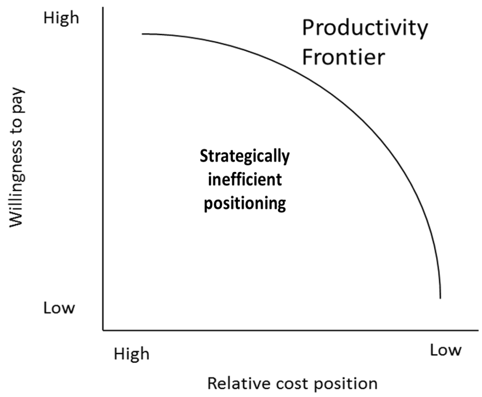
Strategy = The <u>choice</u> of a <u>future</u> for the organization and of a way to reach that future, understood as the <u>framework</u> that coordinates, unifies and <u>integrates</u> the company's decisions and actions.

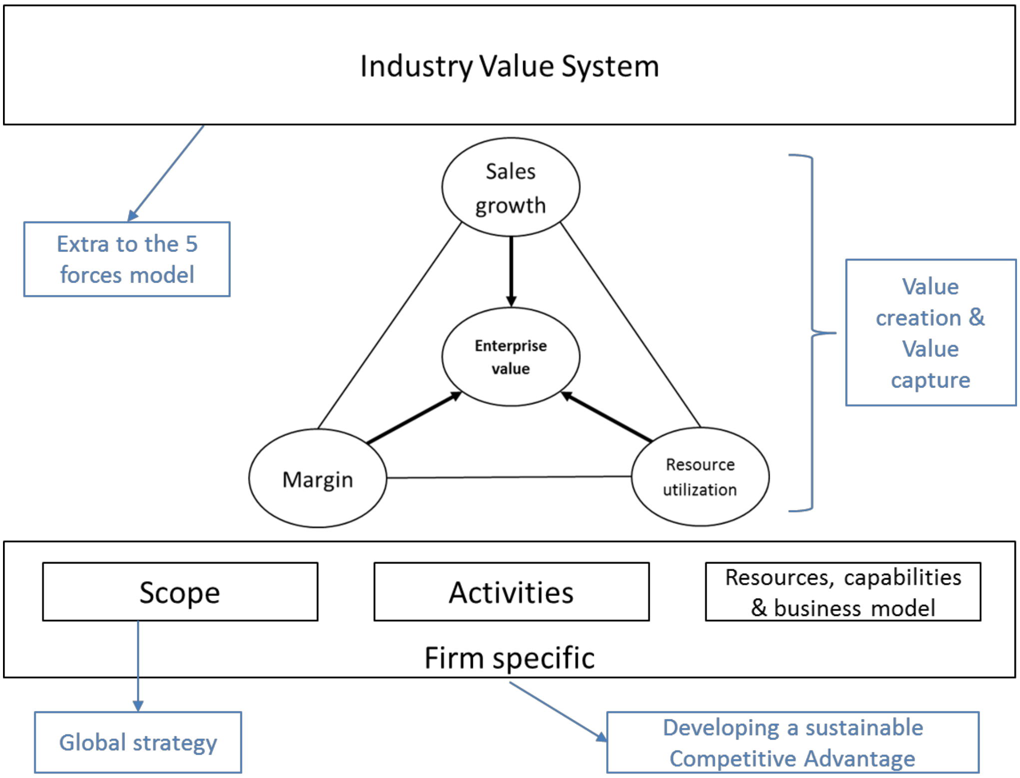
→ Framework: the smallest set of choices to optimally guide (or force) other choices

Strategy Statement (in 35 words):

- Objective
- Scope (What, Who, Where, How)
- Competitive Advantage

<u>CHOICE</u>: Position on the productivity frontier

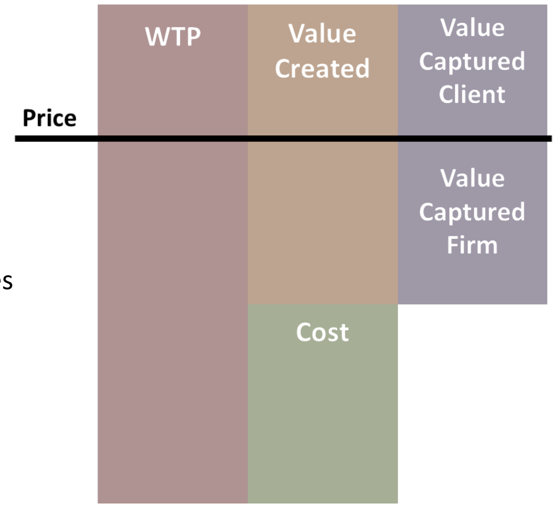




VALUE CREATION AND VALUE CAPTURE

FUNDAMENTAL QUESTIONS

- Is value CREATED → WTP
- Is value CAPTURED
- Is value SUSTAINED



IS VALUE CREATED?

= Willingness to Pay (WTP) – Costs of providing goods or services

- Drivers of value creation

IS VALUE CAPTURED?

→ Enterprise value: 3 levers:

- Margin
- Efficiency: resource utilization
- Growth

→ Calculation of value of strategy

1) Calculate NOPLAT

Sales
- costs

EBITDA — Earnings before Interest, Taxes, Depreciation and Amortization
- depreciation

EBIT — Earnings Before Interest and Taxes
- Taxes

NOPAT	Net Operating Profit After Taxes
- Tax advantage	
NOPLAT	Net Operating Profit Less Adjusted Taxes

2) Calculate Invested Capital (K)

Fixed assets
Current assets
- Current liabilities
- Cash

Invested Capital

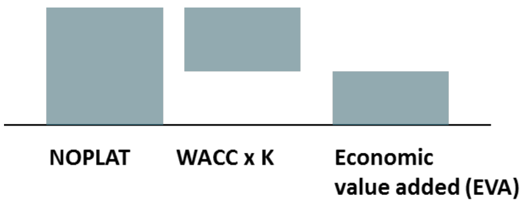
3) Calculate Return on Invested Capital (ROIC)

ROIC = NOPLAT/K = NOPLAT/Sales x Sales/K

= Margin *= Resource utilization*

Economic profit / Economic value added

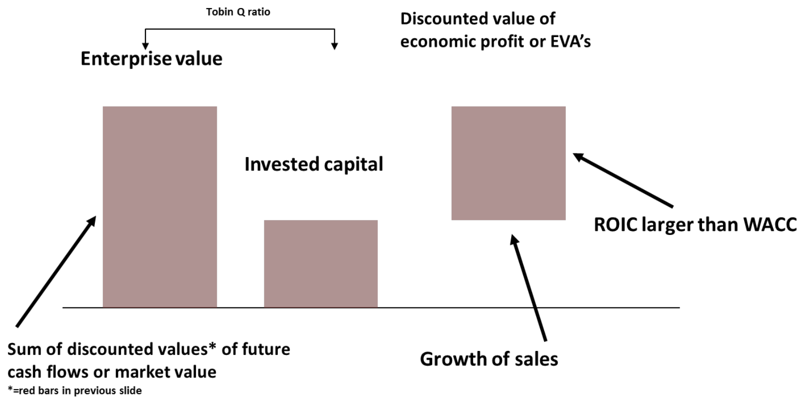
- Most important criteria for evaluating performance
- When ROIC (return on capital) > WACC (cost of capital)



IS VALUE SUSTAINED?

→ Time dimension → Free cash flow

Drivers of value creation: ROIC and growth

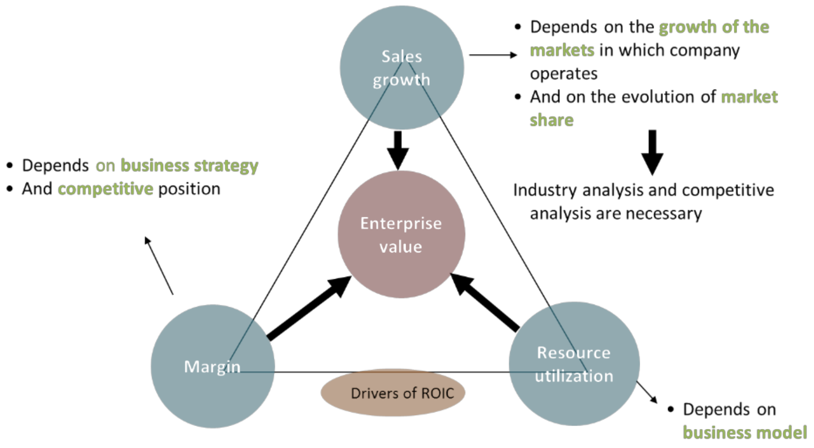


Drivers of ROIC: margin, resource utilization, growth, ROIC>WACC (levers)

A strategy creates economic value…

- When:
    - Enterprise value > invested capital
- This implies:

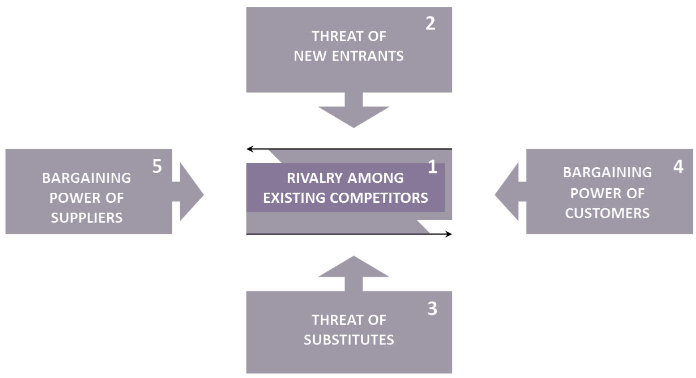
    - Sum of discounted values of economic profit must be positive
- Only possible when:
    - In several periods ROIC > WACC. This is possible when:
        - Margins are larger
        - Or the use of capital is more efficient
    - Growth is realized in activities where ROIC > WACC



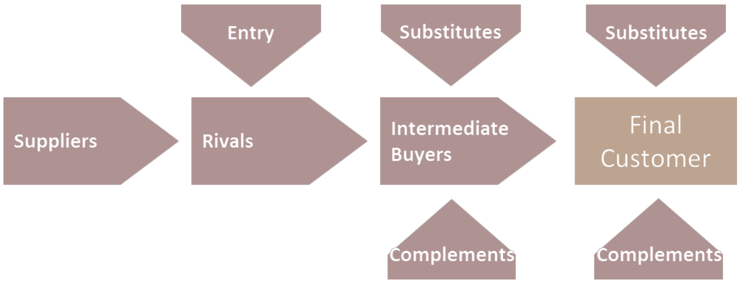
Competitive Strategy – The Building Blocks

Industry Value System – Industry Attractiveness

- **Industry attractiveness** = the <u>future average returns</u> expected for firms operating in this industry
- Depends on:
    1. Long term Trends: expectations about the obsolescence of <u>activities</u> linking buyers and suppliers and/or <u>core assets</u>
       Do: trend analysis, scenario planning,…
    2. Definition of Industry: Product-Technology Combination (Markets interact industries with customers)
    3. Drivers of Value Capture at Industry Level
- 'attractive industry' = average player → value capture
- Porter's 5-Forces Model



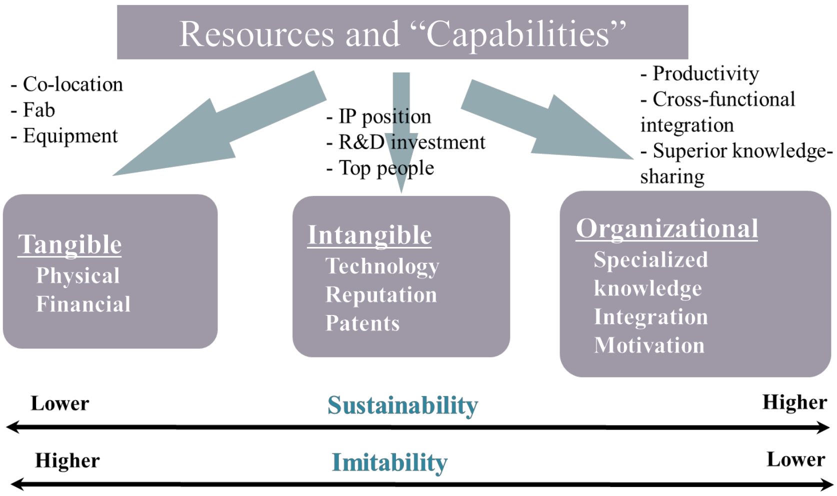
- The Industry Value System



- Complements: raises WTP
- Substitutes: lowers WTP

Firm Specific – Competitive advantage

- **Competitive advantage** = driven a wider wedge between willingness to pay and costs than its competitors have achieved (created more value than rivals)
  - If you create more value, you can offer the same tot the buyer, but capture more value
  - 2 sides: Costs / WTP
- **Added value of a player** = the maximum value that can be created by all participants in the vertical chain minus the maximum value that would be created without that particular player
- A firm with a **competitive advantage** cannot capture more value than its **added value**
- How do firms position themselves relative to their environment?
  1) Define the Scope of your Business
     - 3 dimensions
       - Geographical scope
       - Product/service scope
       - Customer scope.
       - Niche focus
     - = strategic territory = space in which they are competing
  2) Select the Activity set of your Business
     - Catalog firm's activities: value chain
     - Analyze the value chain: relocating and outsourcing
       → How are activities <u>connected</u> to each other and to the comp. advantage
     - Examine the costs associated with each activity. Use *differences* in costs to understand how and why costs differ from those of the competitors.
       = Comparative Cost Analysis
     - Analyze how each activity generates WTP and try to understand differences in WTP → Value curve
     - Consider changes in activities to widen the wedge between costs and WTP
  3) Assemble the needed Resources and develop the key Capabilities
     - **Resources** = things that firms *have*
     - **Capabilities** = things that firms *do* → Tacit, hard to copy

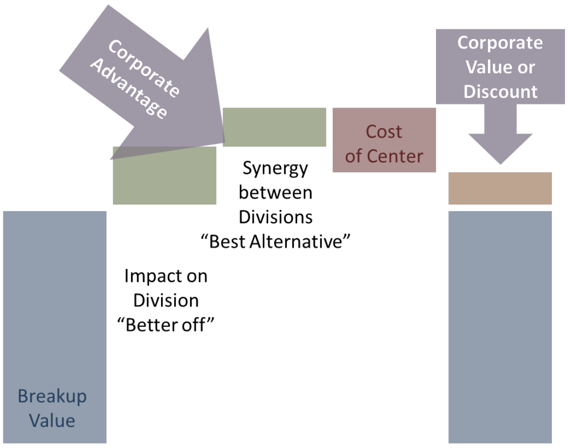


4) Set up the Business Model to link Value Creation and Value Capture and create a Virtuous Cycle
   - Consists of choices (policy, assets, governance …) and consequences of these choices
   - Successful business model → generate virtuous cycles or feed-back loops that are self-reinforcing
5) Understand the Sustainability of your Competitive Advantage
   - Threats to sustainability
     1. **Imitation**
        - Increases the supply of what a firm 'uniquely' provides
        - Others are choosing/converging on your position on the productivity frontier
     2. **Substitution**
        - Reduces the 'demand' for what a frim uniquely provides by shifting the demand elsewhere
        - Impact on value creation by providing higher WTP/ lower Costs
     3. **Holdup**
        - Diverts value to customers, suppliers, or complementors who have some bargaining power
        - Impact on value captured
     4. **Slack**
        - Extent to which the value appropriated by a firm falls short of the amount potentially available
        - Impact on value captured
6) Test your Strategy (does it make sense?)
   - **Internal consistency – coherence**
     Do the elements of the strategy fit well with each other? Are there <u>complementarities</u> between the different elements of the strategy?
   - **External consistency – coherence**
     Does the strategy neutralize the threats posed by the external environment? Does it take advantage of the opportunities?
   - **Dynamic consistency**
     Is the strategy set up to help sustain competitive advantage over time?

CORPORATE STRATEGY

Competitive advantage = driven a wider wedge between willingness to pay and costs than its competitors have achieved
Corporate or parental advantage = driven a wedge between the break-up value of its businesses and the enterprise value

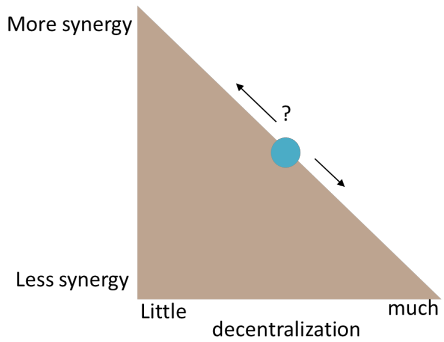
- **<u>Step 1:</u>** Building your Portfolio of Businesses and Defining your model for Corporate Advantage
    - Brief history of portfolio management
        - Learning curve
        - Growth/Share Matrix (BCG)
        - Industry Attractiveness/Competitive Advantage (McKinsey)
    - Problems
        - No Strategy
        - Oversimplification: using historical data, basically finance/cash driven
        - Actual positioning depends on measurement techniques (market definition)
        - Assumed independence between businesses
        - No (potential) competition
    - Value Based Portfolio Management
        - **"Better off" Test**
            - Industry attractiveness:
                - mitigate 5 forces (rivalry, entry barriers, buyer power, supplier power, substitutes) (PepsiCo: dinks and Frito Lays)
                - Migrate out of structurally poor industry (Apple)
            - Competitive Advantage:
                - Cost Effects: shared cost economies (Scale & Scope) "synergies"
                - Willingness-to-Pay and Pricing Effects: one-stop shopping (Amazon), umbrella branding (Virgin), cross-promotion (Banking, new media)
        - **"Best Alternative" Test** – Natural Owner
            - Complexity and contractual incompleteness
            - Unclear property rights
            - Relationship-specific or co-specialized assets: Hold up
            - Example: Coca-Cola and Bottlers



    - Finding the ideal portfolio
      → Building businesses is the essence of corporate strategy

When to Create Value?	One Time	Continuous
How to Create Value? Stand Alone	Builder of Businesses	Best Owner
Across Business	Aquire, Integrate and Grow	Creator & Manager of Synergy

- **<u>Step 2:</u>** Designing your Group and Organizing for Corporate Advantage
    - Specialization versus coordination trade-off
    - Building blocks: Basic units needed to set strategy and control performance
    - Superstructure: Instruments to integrate building blocks
    - A key challenge for a multi-business group:

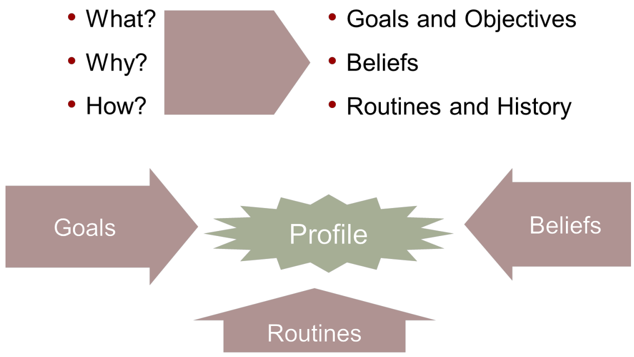


Diversification Strategy

- Diversification discount
- Does corporate diversification create or destroy value (Martin & Sayrak, 2003)
    - Why diversify?
        - Agency theory (not good)
            - Increase compensation, power, prestige
            - Make position in firm more secure due to manager-specific skills
            - Reduce risk personal investment portfolio
        - Resource based firm (good)
            - Excess capacity in resources and capabilities transferable across industries (economies of scope)
        - Market power (good)
            - Sustain predatory pricing from one business to another
            - Multi-market contact
            - Reciprocal buying to squeeze out small firms
    - Benefits of being diversified:
        - Dealings of customers, suppliers, lenders etc
        - Corporate management brings costs but also the possibility to manage combined assets
        - Reduce variance future cash flows increase debt capacity (leverage) firm
        - Internal capital market

        - Lower transaction costs and asymmetric information costs
        - Winner picking
        - Covering institutional voids
    - Costs of being diversified:
        - Makes managerial agency problems worse: free cash flow
        - Inefficient allocation resources due to information asymmetry central management and management operating divisions

Competitive Dynamics



- Game Theory
    - What is a "game"?
    - Static Games
    - Dynamic Games
- Competitor Profiling
- Connecting Game Theory and Competitor Profiling
- Strategic Groups

Behavioral game:

- Goals: *What* players maximize
- Beliefs: *Weights* players put on outcomes or actions
- Routines: *Constraints on* or *Opportunities for* the players' maximization problem
- Competitor Profiling leads to the analysis of *Best Response*
- Game Theory leads to the analysis of *Equilibrium*: all players using their *Best Response*

Global Strategy

- Internationalization → changing scope → implications for overall strategy
  → 1st question: Where? → needs to make sense!
- CAGE Distance Framework (Ghemawat, 2001)
    - Cultural distance (e.g.: 'Ideale Wereld' would not work in US → Humor)
    - Administrative distance (e.g.: Uber: regulatory differences)
    - Geographic distance (e.g.: Cement is a local business)
    - Economic distance (e.g.: BMW cars in emerging markets)
- 3 Strategies to bridge distance
    - **Adaptation**: boost revenues and market share by maximizing a firm's local relevance
        - But what is your competitive advantage? Why would you be better than the ones already there?
        - E.g.: McDonalds: Croque McDo, McArabia Kofta
        - In value chain: Sales office
    - **Aggregation**: deliver economies of scale by creating regional or sometimes global operations
        - E.g.: HP printing in Barcelona
        - In value chain: R&D
    - **Arbitrage**: exploitation of differences between national and regional markets
        - E.g.: IT in India, Manufacturing in China
        - In value chain: Low cost → Operations

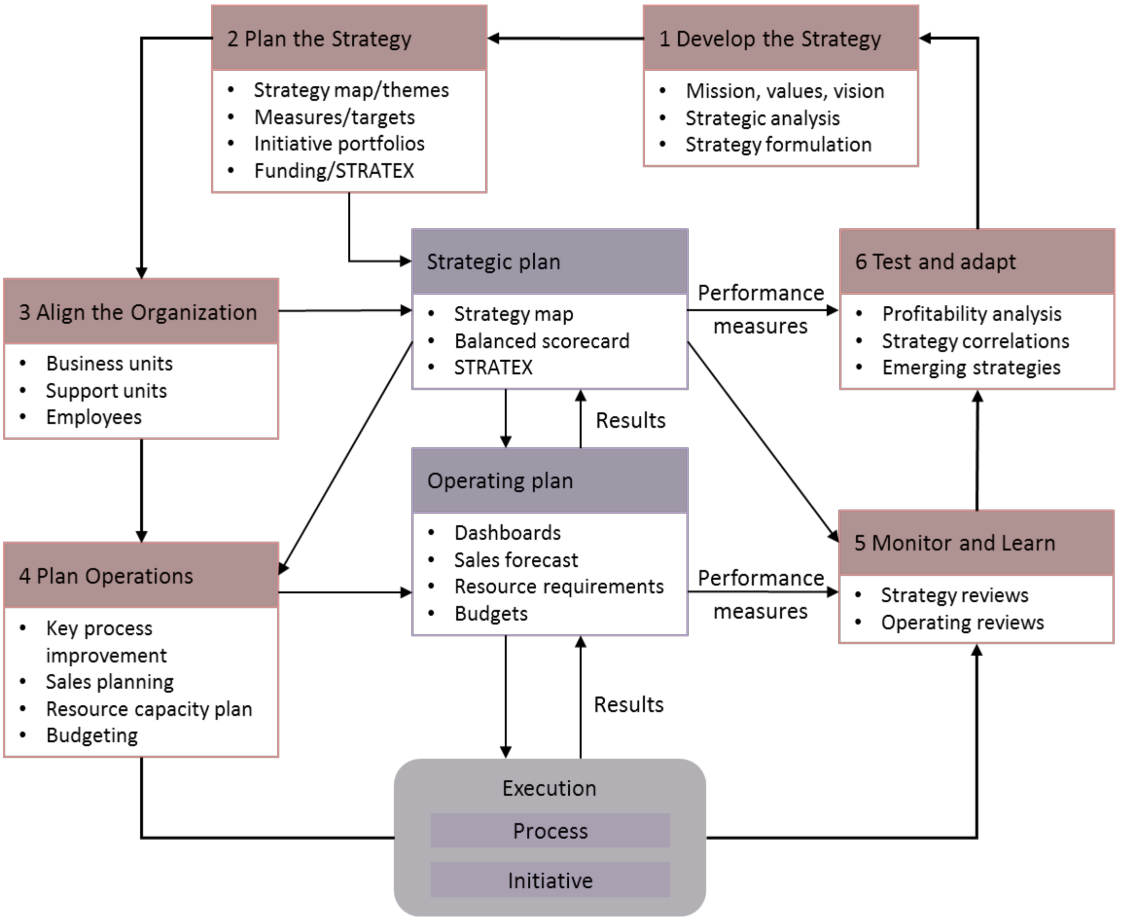
⇨ Different strategies might affect different parts of the value chain
⇨ Most companies are not good at all 3 → favor 2 out of 3

Strategy process

Strategy formulation and strategy execution (implementation)

	Strategic Thinking	Strategic Execution
Decision-Making	Focus on new, potentially radical strategies	Translating strategy into actions
Resource Allocation	Issue drive, not tied to budgeting	Tied to budgeting, capital allocation
Learning	Create awareness, strategic preparedness	Analystic skills, financial skills
Control	Not tied to incentives	Tied to incentives (KPI's)
Communication	Communciation	Vertical

The management system



Top management team

- The CEO matters (Bertrand and Scholar, 2003)
  - Significant effect of CEO changes on investment policies, dividend policy, cash management, number of acquisitions, R&D, advertising and SG&A
- Top management team & Strategy

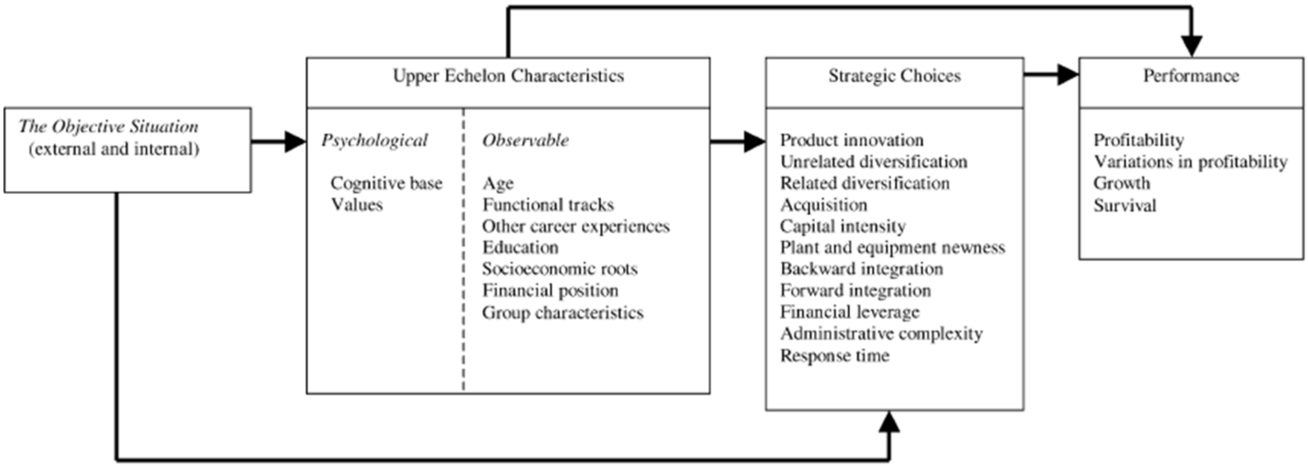


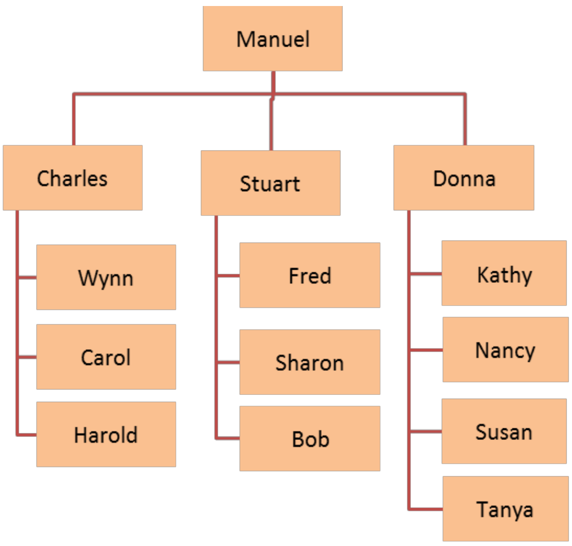
Figure 1. Hambrick and Mason's (1984) upper echelons perspective of organizations.

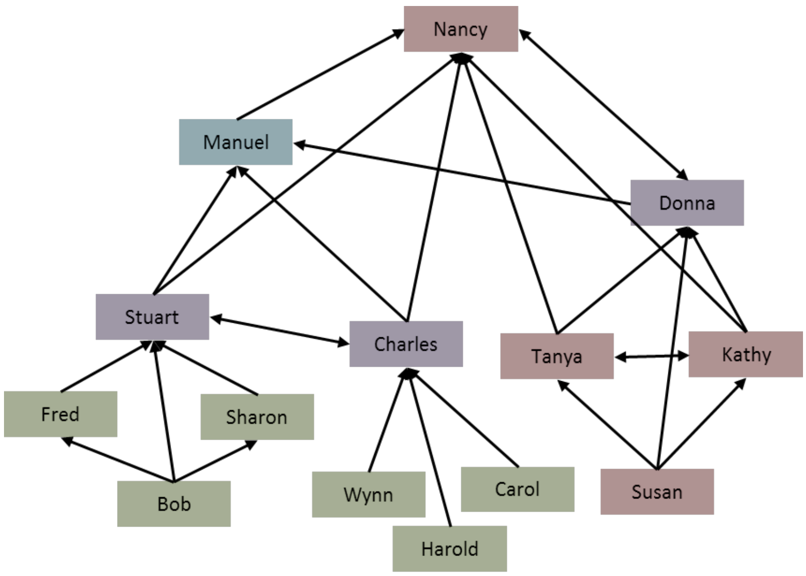
CHALLENGES IN DEALING WITH STRATEGY EXECUTION

- **Biases in decision making**
  - **Overconfidence & over-optimism**
    - Overestimating our skill relative to others, taking credit for past outcomes, and neglect the role of chance. Overestimate the likelihood of positive events.
    - How to counter:
      - Test strategies under a much wider range of scenarios
      - Add 20-25% more downside to the most pessimistic scenario.
      - Build more flexibility and options into your strategy to allow the company to scale up or retrench as uncertainties are resolved (learn-to-burn rate).
  - **Confirmation bias & groupthink**
    - Overweighting of evidence consistent with a favored belief, or the failure to search impartially for evidence.
    - Striving for consensus at the cost of a realistic appraisal of alternative courses of action
    - How to counter:
      - Create a culture of challenge.
      - Strong checks and balances with independent review
      - Establish a challenger team
      - Do a "pre-mortem" analysis
  - **Loss aversion (Prospect theory)**
    - Tendency to feel losses more acutely than gains of the same amount, making us more risk averse than a rational calculation would suggest.
    - How to counter:
      - Establish stretch targets that are impossible to achieve through "business as usual."
      - Zero-based (or clean-sheet) budgeting
  - **Status quo bias**
    - Preference for the status quo in the absence of pressure to change it

- How to counter:
    - Adopt a radical view of all portfolio decisions. View all businesses as "up for sale".
    - Subject status quo to a risk analysis as rigorous as any change options
- **Sunk-cost fallacy**
  - Paying attention to historical costs that are not recoverable when considering future courses of action
  - How to counter?
    - Full rigor investment analysis to *incremental* investments, only looking at incremental prospective costs and revenues.
    - Be prepared to kill strategic experiments early
    - Use "gated funding" for strategic investments

- **Network**
  - Who has the 'real power' to get things done?
    - Arrows: Who do you go to for advice?
  - Formal network vs. Informal network





Extension competitive dynamics: Stackelberg & kartels

- Elements of a "Game"
  - Players
    - Those playing the game
  - Strategies
    - What the players can do; plan of action
  - Payoffs
    - 'Outcomes' as functions of players' strategies
  - Rules
    - How the game is played

- Solve a sequential game (Stackelberg)

- Backward induction: look forward and reason back
  - Look at best response of second mover and on that curve you find your highest contribution margin
- Do you prefer to be the leader of the follower?
  - Stackelberg (pricing games): best to be the follower → Strategic complements
  - Cournot (quantity games): best to be the leader → Strategic substitutes

- Collusion
  - Maximize industry profits
    - LAL does all the production → lower costs
    - KL would not agree + monopoly
  - Agree on high prices
    - Transparency increases collusion (→ illusion of not cheating)

- Soften price competition
  - Differentiation
  - Advertising → more loyal customers

- **Conclusions**
  - Running your competitor out of business is not necessarily the best option
  - Understand how your competitors' actions affect your payoffs and how your actions affect your competitors' reactions.
  - Do the best you can with what you predict your competitor will be doing (**Best Response**)
  - Predict where these interactions will lead you. Do the best you can with what you predict your competitor will be doing and your competitor should do the same (**Nash Equilibrium**)
  - Change the fundamentals that affect the responsiveness of your competitor. Make the reactions of your competitor softer.
  - Collusion is difficult to sustain as incentives to deviate are strong.