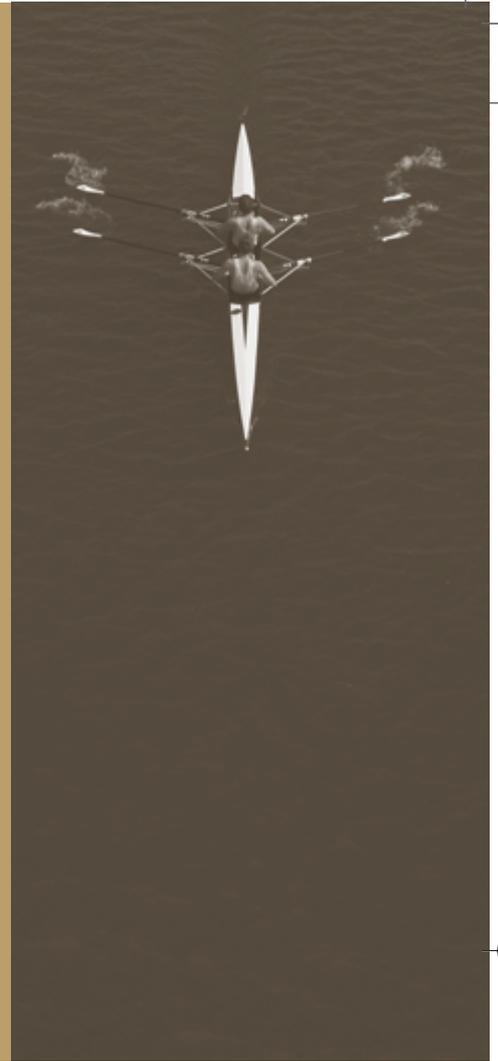


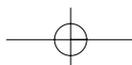


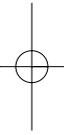
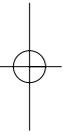
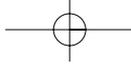
# II

## THE TOOLS OF STRATEGY ANALYSIS



- 2** Goals, Values, and Performance
- 3** Industry Analysis: The Fundamentals
- 4** Further Topics in Industry and Competitive Analysis
- 5** Analyzing Resources and Capabilities
- 6** Organization Structure and Management Systems





## 2

# Goals, Values, and Performance

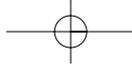


*The strategic aim of a business is to earn a return on capital, and if in any particular case the return in the long run is not satisfactory, then the deficiency should be corrected or the activity abandoned for a more favorable one.*

—ALFRED P. SLOAN JR., MY YEARS WITH GENERAL MOTORS

## OUTLINE

- **Introduction and Objectives**
- **Strategy as a Quest for Value**
  - In Whose Interest? Shareholders vs. Stakeholders
  - What Is Profit?
  - From Accounting Profit to Economic Profit
  - Linking Profit to Enterprise Value
  - Applying DCF Analysis to Valuing Companies, Businesses, and Strategies
- **Strategy and Real Options**
  - Strategy as Options Management
- **Putting Performance Analysis Into Practice**
  - Appraising Current and Past Performance
- **Beyond Profit: Values and Social Responsibility**
  - Performance Diagnosis
  - Evaluating Alternative Strategies
  - Setting Performance Targets
  - The Paradox of Profit Values and Principles
  - The Debate Over Corporate Social Responsibility
- **Summary**
- **Self-Study Questions**
- **Notes**



## Introduction and Objectives

Our framework for strategy analysis (Figure 1.2) comprises four components: the firm's goals and values, its resources and capabilities, its structure and management systems, and its industry environment. The five chapters that form Part II of the book outline these four components of strategy analysis (I devote two chapters to the industry environment). We begin with goals and values, and, by extension, we consider the performance of the firm in attaining its goals.

Firms possess multiple goals. A firm's choice of goals are influenced by its values. However, in this book we make a bold and simple assumption – that the primary goal of the firm is to maximize profit over the long term. Business strategy then becomes a quest for profit. Hence, most of the frameworks and techniques of strategy analysis we will cover are concerned with identifying and exploiting the sources of profitability open to the firm.

Yet, here we face a fundamental dilemma: businesses that have been most successful in generating profits have typically been those driven by ambitions other than profit. Profit is the life-blood of the organization, but it is not a goal that inspires organizational members to outstanding achievement. Linking a sense of mission to the pursuit of profit represents one of the greatest challenges of strategic management.

By the time you have completed this chapter you will be able to:

- Appreciate the main arguments in the debate over shareholder versus stakeholder goals for the firm.
- Recognize how profit maximization relates to shareholder value maximization.
- Diagnose a company's performance problems systematically and strategically.
- Translate the overall goals of long-term profit maximization into meaningful performance targets that can be measured and monitored.
- Understand the linkages between financial analysis and strategic analysis, and how they can be used to complement one another.
- Comprehend the role of values, mission, and vision in formulating and implementing strategy.



## Strategy as a Quest for Value

Business is about creating value. Value, in its broadest sense, refers to the amount of money customers are willing to pay for a good or service. The challenge for business strategy is, first, to create value for customers and, second, to extract some of that value in the form of profit for the firm.

Value can be created in two ways: by production and by commerce. Production creates value by physically transforming products that are less valued by consumers into products that are more valued by consumers – turning clay into coffee mugs, for example. Commerce creates value not by physically transforming products, but by repositioning them in space and time. Trade involves transferring products from individuals and places where they are less valued to individuals and locations where they are more valued. Similarly, speculation involves transferring products from a point in time where the product is valued less to a point in time where it is valued more. Thus, the essence of commerce is creating value through arbitrage across time and space.<sup>1</sup>

The difference between the value of a firm's output and the cost of its material inputs is its *value added*. Value added is equal to the sum of all the income paid to the suppliers of factors of production. Thus:

$$\begin{aligned} \text{Value Added} &= \text{Sales revenue from output} \textit{ less} \textit{ Cost of material inputs} \\ &= \text{Wages/Salaries} + \text{Interest} + \text{Rent} + \text{Royalties/License fees} \\ &\quad + \text{Taxes} + \text{Dividends} + \text{Retained profit} \end{aligned}$$

### *In Whose Interest? Shareholders vs. Stakeholders*

The value added created by firms is distributed among different parties: employees (wages and salaries), lenders (interest), landlords (rent), government (taxes), and owners (profit). In addition, firms also create value for their customers to the extent that the satisfaction customers gain exceeds the price they pay (i.e., they derive *consumer surplus*). It is tempting, therefore, to think of the firm as operating for the benefit of multiple constituencies. This view of the business enterprise as a coalition of interest groups where top management's role to balance these different – often conflicting – interests is referred to as the *stakeholder* approach to the firm.<sup>2</sup>

The notion of the corporation balancing the interests of multiple stakeholders has a long tradition, especially in Asia and continental Europe. By contrast, most English-speaking countries have endorsed *shareholder capitalism*, where companies' overriding duty is to produce profits for owners. These differences are reflected in international differences in companies' legal obligations. In the US, Canada, the UK, and Australia, company boards are required to act in the interests of shareholders. By contrast, French boards are required to pursue the national interest, Dutch boards are required to ensure the continuity of the enterprise, and German supervisory boards are constituted to include representatives of both shareholders and employees.

Whether companies should operate exclusively in the interests of their owners or should also pursue the goals of other stakeholders is an ongoing debate. During the late 1990s, "Anglo-Saxon" shareholder capitalism was in the ascendant – many continental European and Japanese companies changed their strategies and corporate governance to increase their responsiveness to shareholder interests. However, the catastrophic failure of some of the most prominent advocates of shareholder value creation – Enron and WorldCom in particular – and widespread distaste over the

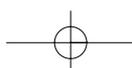


excessive top management remuneration resulting from efforts to align managers' interests with those of shareholders has greatly undermined the case for shareholder capitalism.

The responsibilities of business to employees, customers, society, and the natural environment remain central ethical and social issues. Nevertheless, in order to make progress in developing analytical tools for designing successful strategies, I shall avoid these issues by adopting the simplifying assumption that companies operate in the interests of their owners by seeking to maximize profits over the long term. Why do I make this assumption and how do I justify it? Let me point to four key considerations:

- 1** *Competition.* Competition erodes profitability. As competition increases, the interests of different stakeholders converge around the goal of survival. Survival requires that, over the long term, the firm earns a rate of profit that covers its cost of capital: otherwise it will not be able to replace its assets. Among 2,717 companies included in the Russell 3000 index, Stern Stewart calculated that well over half were earning negative economic profit, i.e. they were not covering their cost of capital.<sup>3</sup> Across many sectors of industry, the heat of international competition is such that few companies have the luxury of pursuing goals that diverge substantially from profit maximization.
- 2** *The market for corporate control.* Management teams that fail to maximize the profits of their companies will be replaced by teams that do. The past 20 years have seen a more active "market for corporate control" in which acquisition provides a mechanism for management change. Underperforming companies may be acquired by other public companies – in 2005 a languishing Sears Roebuck was acquired by a newly revitalized Kmart. Increasingly, private equity groups are the main threat to underperforming public companies. In addition, activist investors, both individuals (Carl Icahn at Time Warner and Kirk Kerkorian at General Motors) and institutions (such as California Public Employees' Retirement System), puts pressure on boards of directors to improve shareholder returns. One result has been increased turnover of chief executives.<sup>4</sup>
- 3** *Convergence of stakeholder interests.* Even beyond a common interest in the survival of the firm, there is likely to be more community of interests than conflict of interests among different stakeholders. Long term profitability is likely to require that a company gains loyalty from its employees, builds trusting relationships with suppliers and customers, and gains support from governments and communities. The evidence from research is that companies that adhere to strong ethical principles, that support sustainable development, and engage in corporate philanthropy are also those that are the most capable in building capabilities, adapting to new external circumstances, and – ultimately – delivering the strongest financial performance.<sup>5</sup>
- 4** *Simplicity.* In terms of analysis, the key problem of a stakeholder approach is the need to consider multiple goals and specify tradeoffs between goals. The result is vastly increased complexity.<sup>6</sup> Virtually all the major tools of business decision making, from pricing rules to discounted cash flow analysis, are rooted in the assumption of profit maximization.

Assuming that firm strategy is directed primarily toward making profit doesn't mean that we have to accept that profit is the sole motivation driving business enterprises.



As we noted in the last chapter when discussing strategic intent, the forces driving the architects of some of the world's greatest enterprises – Henry Ford at Ford Motor Company, Bill Gates at Microsoft, and Akio Morita at Sony – are seldom financial. The dominant drivers tend to be the fulfillment of a vision and the desire to make a difference in the world. Nevertheless, even when enterprises and their leaders have motives that transcend mere money making, achieving these goals requires enterprises that are commercially successful – this requires the adoption of profit-oriented strategies. Steve Jobs and Steve Wozniak founded Apple Computer with the goal of changing the world through taking computers to the people. Despite pioneering personal computing, Apple lost out to IBM and Microsoft during the 1980s and 1990s was not because of a faulty vision, but of a faulty strategy. Apple's strategy did not take sufficient account of technological changes and shifting customer requirements in the personal computer industry.

### *What Is Profit?*

Thus far, we have referred to firms' quest for profit in loose terms. It is time to look more carefully at what we mean by profit and how it relates to shareholder value.

Profit is the surplus of revenues over costs available for distribution to the owners of the firm. But, if profit maximization is to be a realistic goal, the firm must know what profit is and how to measure it. Otherwise, instructing managers to maximize profit offers little guidance. What is the firm to maximize: total profit, margin on sales, return on equity, return on invested capital, or what? Over what time period? With what kind of adjustment for risk? And what is profit anyway – accounting profit, cash flow, or economic profit? The ambiguity is apparent once we consider the profit performance of companies. Table 2.1 shows that any ranking of companies by performance depends critically on how profitability is measured. There are several uncertainties that need to be resolved:

- Does profit maximization mean maximizing total profit or rate of profit? If the latter, are we concerned with profit as a percentage of sales (return on sales), total assets (return on assets), or shareholders' equity (return on equity)?
- Over what time period is profitability being maximized? The specification of time period is critical. If management becomes committed to maximizing quarterly earnings, there is a danger that long-term profitability may be undermined through cutting investment in fixed assets and R&D.
- How is profit to be measured? Accounting profit is defined by the accounting principles under which a company's financial statements are drawn up. Not only does a company's profit vary by country, but a company has considerable discretion as to how it applies accounting principles. Accounting scandals at Enron, Ahold, and other companies, and earnings restatements at many blue-chip companies have undermined the credibility of accounting profit as a meaningful performance indicator.

### *From Accounting Profit to Economic Profit*

A major problem of accounting profit is that it combines two types of returns: the *normal return to capital* that rewards investors for the use of their capital; and *economic profit*, which is the pure surplus available after all inputs (including capital)

**TABLE 2.1** Performance of the World's Biggest Companies Using Different Profitability Measures (2006 data)

FT global 500 rank <sup>1</sup>	Company	Market capitalization (\$BN)	Net income (\$BN) <sup>2</sup>	Return on sales (%) <sup>3</sup>	Return on equity (%) <sup>4</sup>	Return on assets (%) <sup>5</sup>	Return to shareholders (%) <sup>6</sup>
1	Exxon Mobil	372	36.1	19.9	34.9	17.8	11.7
2	General Electric	363	16.4	10.7	22.2	14.7	(1.5)
3	Microsoft	281	12.3	40.3	30.0	18.8	(0.9)
4	Citigroup	239	24.6	22.0	21.9	1.5	4.6
5	BP	233	22.3	9.9	27.9	10.7	10.2
6	Bank of America	212	16.5	27.0	14.1	1.2	2.4
7	Royal Dutch Shell	211	25.3	14.7	26.7	11.6	11.8
8	Wal-Mart	197	11.2	5.5	21.4	8.1	(10.3)
9	Toyota Motor	197	12.1	10.7	13.0	4.8	(22.1)
10	Gazprom	196	7.3	28.1	9.8	7.1	n.a.
11	HSBC	190	15.9	23.0	16.3	1.0	(11.8)
12	Procter & Gamble	190	8.7	17.3	13.7	6.4	7.2

**Notes:**

- 1 Ranked by market capitalization. Source: *Financial Times*.
- 2 Source: *Fortune*.
- 3 Pre-tax profit as a percentage of sales revenues. Source: Hoovers.
- 4 Net income as a percentage of (year end) shareholders' equity. Source: Hoovers.
- 5 Net income as a percentage of (year end) total assets. Source: Hoovers.
- 6 Dividend + Share price appreciation. Source: *Fortune*.

have been paid for. One approach to a purer and more reliable measure of profit is to distinguish these two elements and to focus on economic profit as a measure of performance. To distinguish economic profit from accounting profit, economic profit is often referred to as *rent* or *economic rent*.

A widely used measure of economic profit is Economic Value Added (EVA), devised and popularized by the New York consulting company Stern Stewart & Company.<sup>7</sup> EVA is measured as net operating profit after tax (NOPAT) less cost of capital, where cost of capital is calculated as: capital employed *multiplied by* the weighted average cost of capital (WACC).<sup>8</sup>

Economic profit has two main advantages over accounting profit as a performance measure. First, it sets a more demanding performance discipline for managers. As Stern Stewart's calculations show, many major corporations' apparent profitability disappears once cost of capital is taken into account. James Meenan, chief financial officer of AT&T, reported:

*The effect of adopting EVA on AT&T's businesses is staggering. "Good" is no longer a positive operating earnings. It's only when you beat the cost of capital.<sup>9</sup>*

Second, using economic profit improves the allocation of capital between the different businesses of the firm by taking account of the real costs of more capital-intensive businesses.

## STRATEGY CAPSULE 2.1

## Economic Value Added at Diageo plc.

At Guinness-to-Johnny-Walker drinks giant Diageo, EVA provided the basis for a complete management system that transformed the way in which Diageo measured its performance, allocated its capital and advertising expenditures, and evaluated its managers.

For example, taking account of the costs of the capital tied up in slow-maturing, vintage drinks such as Talisker and Lagavulin malt whisky, Hennessy cognac, and Dom Perignon champagne showed that these high-margin drinks were often not as profitable as the company had believed. The result was that Diageo's advertising expenditures were reallocated towards Smirnoff vodka, Gordon's gin, Bailey's, and other drinks that could be sold within weeks of distillation.

More generally, once managers had to report profits after deduction of the cost of the capital tied up in their businesses, they took

measures to reduce their capital bases and make their assets work harder. At Diageo's Pillsbury food business, the economic profit of every product and every major customer was scrutinized. The result was the elimination of many products and renewed efforts to expand sales to unprofitable customers. Ultimately, EVA analysis resulted in Diageo selling Pillsbury to General Foods. This was followed by the sale of Diageo's Burger King chain to Texas Pacific, a private equity group.

Value-based management was extended throughout the organization through making EVA the primary determinant of the incentive pay earned by 1,400 Diageo managers.

**Sources:** John McGrath, "Tracking Down Value," *Financial Times Mastering Management Review*, December 1998; [www.diageo.com](http://www.diageo.com)

*Linking Profit to Enterprise Value*

There is also the problem of time. Once we consider multiple periods of time, then profit maximization means maximizing the net present value of profits over the lifetime of the firm.

Thus, profit maximization translates into maximizing the value of the firm. This means that the value of the firm is calculated in the same way as for any other asset: it is the net present value (NPV) of the returns to that asset. The relevant returns are the cash flows to the firm. Hence, firms are valued using the same discounted cash flow (DCF) methodology that we apply to the valuation of investment projects. Thus, the value of an enterprise ( $V$ ) is the sum of its free cash flows ( $C$ ) in each year  $t$ , discounted at the enterprise's cost of capital ( $r$ ).<sup>10</sup> The relevant cost of capital is the weighted average cost of capital ( $r_{e+d}$ ) that averages the cost of equity ( $r_e$ ) and the cost of debt ( $r_d$ ):

$$V = \sum_t \frac{C_t}{(1 + r_{e+d})^t}$$



where *free cash flow* ( $C$ ) is measured as:

**Net Operating Profit plus Depreciation less Taxes less Investment  
in Fixed and Working Capital.**

To maximize its value, a firm must maximize its future net cash flows (its *free cash flow*) while also managing its finances to minimize its cost of capital.

This value-maximizing approach implies that *cash flow* rather than *accounting profit* is the relevant performance measure. In practice, valuing companies by discounting economic profit gives the same result as by discounting net cash flows. The difference is in the treatment of the capital consumed by the business. The cash flow approach deducts capital at the time when the capital expenditure is made; the EVA approach follows the accounting convention of charging capital as it is consumed (through charging depreciation). In principle, a full DCF approach is the most satisfactory approach to valuing companies. In practice, however, for DCF analysis to be meaningful requires forecasting cash flows several years ahead, since cash flow for a single year is a poor indicator of underlying profitability. Thus, profitable companies are likely to have negative cash flows for the whole of their growth phase. The preference of many financial analysts for cash-based accounting is also based on the fact that cash flows are less easily manipulated by company managers for cosmetic purposes than are accounting profits. For the same reason, operating earnings, EBIT learnings before interest and tax and EBITDA (earnings before interest, tax, depreciation, and amortization) are often preferred to net income as an indicate of profit.

For assessing firm performance in a single year or over a finite number of years, economic profit is usually preferable to free cash flow. Economic profit shows the surplus being generated by the firm in each year, whereas free cash flow depends on management choices over the level of capital expenditure. Thus, a firm can easily boost its free cash flow by slashing its capex budget.

**Enterprise Value and Shareholder Value** How does maximizing enterprise value relate to the much-lauded goal of *maximizing shareholder value*? In the 1950s, Modigliani and Miller laid the foundations of modern financial theory by showing that the value of a company's assets must equal the value of the claims against those assets.<sup>11</sup> Hence, for public companies, the DCF value of the firm is equal to the market value of the firm's securities (plus any other financial claims such as debt and pension fund deficits). Thus, shareholder value is calculated by subtracting the debt (and other non-equity financial claims) from the DCF value of the firm.

Does enterprise value less debt really equal the stock market value of a firm's equity? So long as full information about a firm's prospects reaches the stock market and this information is efficiently reflected in stock prices – yes. But isn't the stock market subject to bubbles, fads, and crashes? Yes – but we need to remember that no one knows what a firm's cash flows over its lifetime are likely to be. In the case of the technology internet bubble of the late 1990s, stock prices of technology, media, and telecommunications companies were inflated by over-optimistic expectations of their future earnings.

Our emphasis in this book will be on maximization of enterprise value rather than maximization of shareholder value. This is principally for convenience: distinguishing debt from equity is not always straightforward due to the presence of preference stock and convertible debt, while junk bonds share the characteristics of both equity and debt. Also, focusing on the value of the enterprise as a whole assists



us in identifying the fundamental drivers of firm value. In practice, however, maximization of enterprise value and maximization of shareholder value mean much the same in terms of our strategy analysis.

### *Applying DCF Analysis to Valuing Companies, Businesses and Strategies*

**Applying DCF to Uncertain Future Cash Flows** The biggest difficulty in using DCF analysis to value companies and business units is forecasting cash flows sufficiently far into the future. Given the level of uncertainty affecting most businesses, even one-year forecasts of profits and cash flows may be difficult. To estimate future cash flows we may need to make assumptions. For example in a stable, growth business (the sole dairy in an expanding village) it may be reasonable to assume that the current year's cash flow ( $C_0$ ) will grow at a constant rate ( $g$ ) to infinity. In this case, the above equation becomes:

$$V = \frac{C_0}{(r_{e+d} - g)^t}$$

A slightly more sophisticated approach is to forecast free cash flow over the medium term – say five years – then to calculate a horizon value ( $H$ ) based either on the book value of the firm at that time or on some more arbitrary forecast of cash flows beyond the medium term:

$$V = C_0 + \frac{C_1}{(1+r)^1} + \frac{C_2}{(1+r)^2} + \frac{C_3}{(1+r)^3} + \frac{C_4}{(1+r)^4} + \frac{H_4}{(1+r)^4}$$

**Valuing Strategies** The same approach used to value companies and business units can be applied to evaluating alternative strategies. Thus, different strategy options can be appraised by forecasting the cash flows under each strategy and then selecting the strategy that produces the highest NPV.<sup>12</sup> Since the early 1990s, companies have increasingly integrated value analysis into their strategic planning processes. At PepsiCo, for example, value maximization provides the basis on which strategic plans are formulated, divisional and business unit targets are set, and performance is monitored. A key merit of value maximization is its consistency. The same DCF methodology is used to value individual projects, individual business units, alternative business strategies, and the company as a whole.

Applying enterprise value analysis to appraising business strategies involves several steps:

- Identify strategy alternatives (the simplest approach is to compare the current strategy with the preferred alternative strategy).
- Estimate the cash flows associated with each strategy.
- Estimate the implications of each strategy for the cost of capital – according to the risk characteristics of different strategies and their financing implications, different strategies will be associated with a different cost of capital.
- Select the strategy that generates the highest NPV.

Though in principle simple, applying DCF analysis to strategy selection runs into major practical difficulties. The central problem is forecasting cash flows. A strategy



that is implemented today is likely to influence a company's cash flows over its entire life. Given the volatility and unpredictability of the business conditions facing most companies, making any reasonable forecast of the costs and revenues resulting from a particular strategy is exceedingly difficult. But even if we ignore the problems associated with forecasting an uncertain future, the feasibility of linking a strategy with specific cash flow outcomes is doubtful. As we discussed in the first chapter, a strategy is not a detailed plan, it is a direction and a set of guidelines. As such, a strategy will be consistent with a range of specific outcomes in terms of product introductions, output levels, prices, and investments in new plant. Once we recognize that strategy is about reconciling flexibility with direction in an uncertain environment, there are two key implications as far as strategy analysis is concerned: first, it may be better to view strategy as a portfolio of options rather than a portfolio of investment projects; second, qualitative approaches to strategy analysis may be more useful than quantitative ones. We take up each of these themes in next two sub-sections.

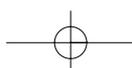
## Strategy and Real Options

The simple idea that there is value to having the option to do something has important implications for how we value firms. In recent years, the principles of option pricing have been extended from financial securities to investment projects and business enterprises. The resulting field of *real option analysis* has emerged as one of the most important developments in financial theory over the past decade, with far-reaching implications for strategy analysis. The technical details of valuing real options are complex. However, the underlying principles are intuitive. Let me outline the basic ideas of real options theory and what they mean for strategy analysis.

In November 2005, BP announced the doubling of capital expenditure at its newly formed BP Alternative Energy division. Yet returns to this investment could not conceivably match those of BP's oil and gas businesses. How could investing in renewable energy – wind and solar power – be consistent with shareholder interests?

The answer lies in the *option value* of alternative energy investments. BP's \$600 million in alternative energy represented only 0.4 percent of overall 2006 capital expenditure. By developing a leading position in solar, wind, and hydrogen energy technologies, BP was buying the option to become a leading player in these energy sources should hydrocarbon use be restricted by Middle East conflict, reserve exhaustion, or environmental concerns.

In a world of uncertainty, where investments, once made, are irreversible, flexibility is valuable. Instead of committing to an entire project, there is virtue in breaking the project into a number of phases, where the decision of whether and how to embark on the next phase can be made in the light of prevailing circumstances and the learning gained from the previous stage of the project. Most large companies have a *phases and gates* approach to product development in which the development process is split into distinct phases, at the end of which the project is reassessed before being allowed through the "gate." Such a phased approach creates option values. Option value arises from the potential to amend the project during the development process or even abandon it. One of the key buzz-words of the e-commerce boom of 1998–2000 was "scalability" – the potential to scale up or replicate a project or business model should the initial version be successful. Again, such scalability is a source of option value.



## STRATEGY CAPSULE 2.2

### Calculating Real Option Value<sup>1</sup>

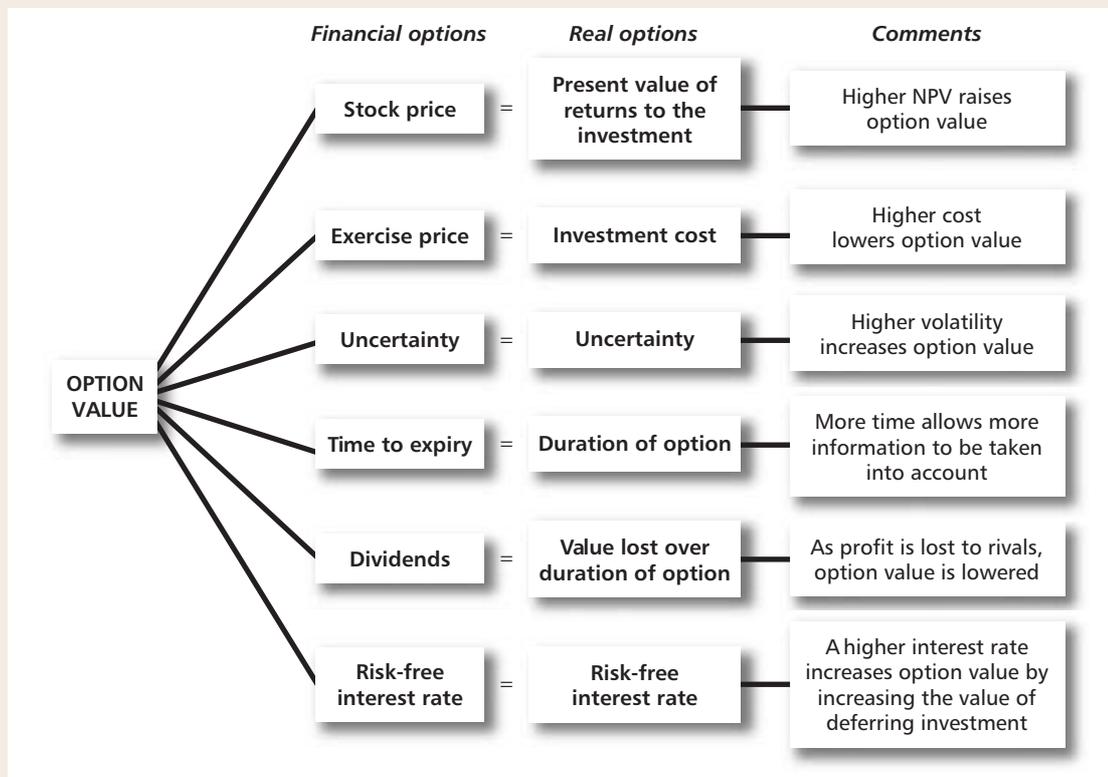
The adoption of real option valuation to value investment projects and strategies has been limited by the complexity of the techniques: modeling uncertainty and taking account of multiple sources of flexibility soon immerses the analyst in complex mathematics.

However, the basic process is logical and straightforward. McKinsey & Company outline a four-stage process for valuing flexibility in a project (the same analysis can be used in valuing a strategy for the business):

- 1 Apply a standard DCF analysis to the project without taking account of any flexibility options.
- 2 Model uncertainty in the project using event trees. This requires identifying the key uncertainties facing the project at each point of time and identifying the cash flows associated with different outcomes.

- 3 Model flexibility using a decision tree. Identify the key managerial decisions with regard to flexibility at each stage of the development of the project in order to convert the event tree into a decision tree. Flexibility may relate to abandonment, deferring investment, or changing the scale of the project.
- 4 Estimate the value of flexibility. For this, the following two approaches can be used.

**Real Option Valuation** applies the principles of financial option valuation developed by Fischer Black, Myron Scholes<sup>2</sup> and Robert Merton<sup>3</sup> to real options. The *Black-Scholes option-pricing formula* comprises six variables, each of which has analogies in the valuation of real options (see the figure below).<sup>4</sup> The key





challenge in using this method is in creating a portfolio of securities that replicates the returns of the project.

**Decision Tree Analysis** values a project through aggregating and discounting all the possible returns to the project at the cost of capital of the project. The key challenge of this approach is in calculating the appropriate cost of capital to the project.

**Notes:**

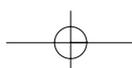
- 1 For more on this topic see T. Koller, M. Goedhart, and D. Wessels, *Valuation: Measuring and Managing the Value of Companies*, 4th edn (Hoboken, NJ: Wiley, 2005), Chapter 20.
- 2 F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy* 81 (1993): 637–54.
- 3 R. C. Merton, "The Theory of Rational Option Pricing," *Bell Journal of Economics and Management Science* 4 (1973): 141–83.
- 4 K. J. Leslie and M. P. Michaels, "The Real Power of Real Options," *McKinsey Quarterly Anthology: On Strategy* (McKinsey & Company, 2000). Also: A. Dixit and R. Pindyck, "The Options Approach to Capital Investment," *Harvard Business Review* (May–June 1995): 105–15.

### *Strategy as Options Management*

From the viewpoint of strategy formulation, our primary interest is not the technicalities of options valuation, but how we can use the principles of option valuation to create shareholder value. The key observation is that creating options, by increasing the strategic flexibility of the firm, increases the value of the firm. For individual projects, this means avoiding commitment to the complete project and introducing decision points at multiple stages, where the main options are to delay, modify, scale up, or abandon the project. Merck, an early adopter of option pricing, noted, "When you make an initial investment in a research project, you are paying an entry fee for a right, but you are not obligated to continue that research at a later stage."<sup>13</sup> In designing projects, options thinking implies comparing the costs of flexibility with the options value that such flexibility creates. New plants that allow different products to be manufactured, permit easy capacity expansion, and can be operated with different types of raw material are more valuable than specialized plants.

For complete strategies, as opposed to individual projects, creating option value means positioning the firm such that a wide array of opportunities become available. Such strategies might include:

- "Platform investments," which are investments that create a stream of additional options.<sup>14</sup> 3M's investment in nanotechnology offers opportunity to create new products across a wide range of its businesses, from dental restoratives and drug-delivery systems to adhesives and protective coatings. Google's creation of its Google China ([www.google.cn](http://www.google.cn)) website and censored Chinese search engine offers the opportunity for Google to become a major player in offering a wide range of internet-based services in China.
- Strategic alliances and joint ventures, which are limited investments that offer options for the creation of whole new strategies.<sup>15</sup> Virgin Group has used joint ventures as the basis for creating a number of new businesses: with Stagecoach to create Virgin Rail, with Norwich Union to create Virgin Direct (financial



services), with Deutsche Telecom to form Virgin Mobile. Joint-venture investments can act as both a call and a put option: in some cases Virgin has bought out its JV partner; in other cases it has sold out to its JV partner. General Motors' network of alliances with other car producers (including Suzuki, Daewoo, and Fiat) has similarly creating a range of options for internationalization and new products.

- Organizational capabilities, which can also be viewed as options offering the potential to create competitive advantage across multiple products and businesses.<sup>16</sup> Sharp's miniaturization capability has provided a gateway to success in calculators, CD screens, solar cells, and PDAs.

## Putting Performance Analysis Into Practice

Our discussion so far has established the following:

- For the purposes of strategy formulation, profit maximization is a convenient and reasonable assumption. Once we look beyond a single period, maximizing profit translates into maximizing enterprise value.
- Profit can be measured in many different ways. In principle, free cash flow is the appropriate measure of profit for calculating the net present value of the firm. In practice, economic profit may be a better indicator of profit performance.
- Discounted cash flow (DCF) valuation of enterprises, projects, and strategies underestimates their value where significant option values are present.
- Using value maximization as a basis for selecting optimal strategy is difficult. DCF approaches to valuing strategy encounter difficulties of estimating cash flows far into the future. Real option approaches to valuing strategy are problematic because of the complexity and information requirements of real option valuation.

Given these challenges, what practical guidance can I offer about using financial analysis to appraise and choose business strategies? Let me deal with four questions. First, how can we best appraise overall firm (or business unit) performance? Second, how can we diagnose the sources of poor performance? Third, how can we select strategies on the basis of their profit prospects? Lastly, how do we set performance targets?

### *Appraising Current and Past Performance*

The first task of any strategy formulation exercise is to assess the current situation. This requires that we identify the current strategy of the firm and assess how well that strategy is doing in terms of the financial performance of the firm. The next stage is diagnosis – identifying the sources of unsatisfactory performance. Thus, good strategic practice emulates good medical practice: the first task is to determine the state of health of the patient, and then to determine the reasons for any sickness.

**Forward-Looking Performance Measures: Stock Market Value** If our goal is maximizing profit over the lifetime of the firm, then to evaluate the performance of a firm we need to look at its stream of profit (or cash flows) over the rest of its life.



The problem, of course, is that we don't know what these will be. However, for public companies we do have a good indicator: stock market valuation, which represents the best available estimate of expected cash flows into the future. Thus, to evaluate the effectiveness of the firm's top management team or of the strategies they have implemented, growth in the market value of the firm over the relevant time period is a good indicator. However, there are two main problems of using stock market valuation as a performance indicator. First, the information upon which the stock market values companies is imperfect. Second, expectations about a firm's future earnings tend to be volatile and strongly influenced by expectations about the economy in general and individual sectors.

**Backward-Looking Performance Measures: Accounting Ratios** Given the volatility and imperfections of stock market values, evaluation of firm performance for the purposes of assessing the current strategy or evaluating management effectiveness tends to concentrate on current indicators of financial performance. All of these are inevitably historical – financial reports appear, at minimum, three weeks after the quarter to which they relate.

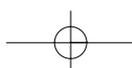
In the light of our discussion over accounting profit vs. economic profit vs. cash flow, which are the best indicators to use? McKinsey & Company argue that, for practical purposes, the DCF value of the firm may be viewed as a function of three variables: the return on the firm's invested capital (ROIC), its weighted average cost of capital, and the rate at which it grows its operating profit.<sup>17</sup> Hence, return on invested capital, or its close relatives return on capital employed (ROCE), return on assets (ROA), and return on equity (ROE), are useful indicators of the effectiveness of the firm in generating profits from its assets. However, evaluating this return requires that it is compared with cost of capital, and also takes account of growth – one easy means of boosting a firm's return on capital is by reducing its capital base through disposing of less profitable businesses.

While the debate over different profitability measures emphasizes the advantages of some measures over others, in practice they are all related. Moreover, the longer the time period under consideration, the greater their convergence.<sup>18</sup> Over shorter periods, the key issues are, first, to be aware of the limitations and biases inherent in any particular profitability measure and, second, to utilize multiple measures of profitability so that their consistency can be judged. Table 2.2 outlines some commonly used performance indicators.

Interpreting profitability ratios requires benchmarks. Longitudinal comparisons examine whether a profitability ratio is improving or deteriorating. Interfirm comparisons tell us how a firm is performing relative to a competitor, relative to its industry average, or relative to firms in general (e.g. the average for the Fortune 500 or FT 500). Another key benchmark is cost of capital. To determine whether a firm is earning economic profit, ROIC and ROCE should be compared with WACC, and ROE compared with the cost of equity capital.

### *Performance Diagnosis*

If profit performance is unsatisfactory, we need to identify the sources of poor performance so that management can take corrective action. Diagnosis primarily involves disaggregation of return on capital in order to identify the fundamental "value drivers." A useful approach is to use the *Du Pont Formula* to disaggregate return on



**TABLE 2.2** Profitability Ratios

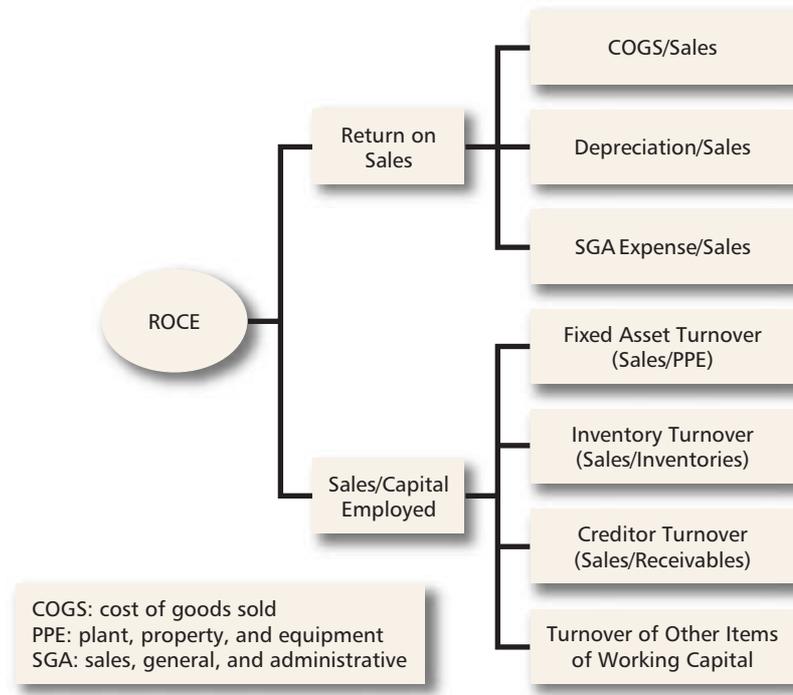
Ratio	Formula	Comments
Return on Invested Capital (ROIC)	$\frac{\text{Operating profit before interest after tax}}{\text{Fixed assets} + \text{Net current assets}}$	ROIC measures the return on the capital invested in the business. ROIC is also referred to as return on capital employed (ROCE). ROCE is sometimes calculated pre-tax and sometimes post-tax.
Return on Equity (ROE)	$\frac{\text{Net income}}{\text{Shareholders' equity}}$	ROE measures the success of the company in using shareholders' capital to generate profits that are available for remunerating investors. Net income should ideally be measured net of dividends on preferred stock. Net income is often measured net of income from discontinued operations and before any special items.
Return on Assets (ROA)	$\frac{\text{Operating profit}}{\text{Total assets}}$	Different measures of the numerator are common. Ideally the numerator should be a broad-based measure of profit: operating profit, EBITDA (earnings before interest, tax, depreciation, and amortization), or EBIT (earnings before interest and tax).
Gross margin	$\frac{\text{Sales} - \text{Cost of bought-in goods and services}}{\text{Sales}}$	Gross margin measures the extent to which a firm adds value to the goods and services it buys in.
Operating margin	$\frac{\text{Operating profit}}{\text{Sales}}$	Operating margin and net margin measure of a firm's ability to extract profit from its sales, but for comparing firm's performance, these ratios reveal little because margins vary so much between different sectors (see Table 2.1).
Net margin	$\frac{\text{Net income}}{\text{Sales}}$	

**Notes:**

- 1 Few accounting ratios have agreed definitions. Hence, it is always advisable to be explicit about how you have calculated the ratio you are using.
- 2 A general guideline for rate of return ratios is that the numerator should be the profits that are available to remunerate the owners of the assets in the denominator.
- 3 Profits are measured over a period of time (typically over a year). Assets are valued at a point of time. Hence, in rate of return calculations, assets and capital employed need to be averaged between the end of the period and the end of the previous period.

invested capital into sales margin and capital turnover. But we can go further: as Figure 2.1 shows, sales margin and capital productivity can be further disaggregated into their constituent items. This analysis allows us to identify the sources of poor performance in terms of specific activities.

Strategy Capsule 2.3 investigates the performance of Ford's automotive operations compared with those of the industry's top performer, Toyota. By disaggregating

**FIGURE 2.1** Disaggregating return on capital employed

**Note:** For further discussion, see T. Koller, M. Goedhart, and D. Wessels, *Valuation*, 4th edn (New York: Wiley, 2005): Chapter 7.

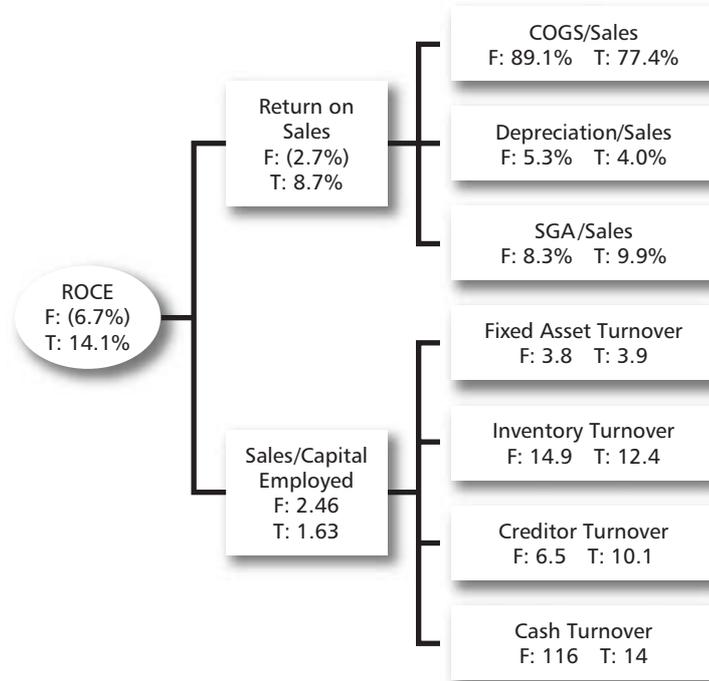
### STRATEGY CAPSULE 2.3

## Diagnosing Performance: What Ails Ford?

During the early years of the twenty-first century, Ford Motor Company continued the declining trend that had begun during the 1980s. During the five-year period 2001–5, return on equity averaged a negative 0.9% while operating losses in its automotive business totaled over \$14 billion. Ford's share of the US car and truck market declined from 22.8% to 18.2%. The ousting of CEO Jacques Nasser by Bill Ford (great-grandson of founder Henry Ford) had brought about a change of strategy and

significant cost cutting, but no major upturn in profitability.

To understand the sources of Ford's poor financial performance, it is useful to compare Ford's automotive operations with those of the company that had displaced it as the world's second largest auto manufacturer (by volume) – Toyota. We can disaggregate Ford and Toyota's return on capital employed into sales margin and capital turnover, then disaggregate further into individual cost and asset productivity ratios:



**Note:** These ratios relate to the automotive businesses only; financial services are excluded.

The analysis reveals the following:

- Ford’s lower ROCE is wholly the result of a lower margin on sales than Toyota. This lower margin results from a substantially higher ratio of cost of goods sold to sales. This could be the result of higher costs (e.g. of labor and parts), or lower unit prices, or both. Additional analysis suggests that Ford’s higher COGS/sales ratio is the result of lower productivity of labor – Ford produced 23.8 vehicles per employee compared with 31.9 for Toyota. Also, Toyota with just 17 manufacturing plants worldwide is likely to exploit scale economies more effectively than Ford with its 113 plants. Although Ford received more revenue per vehicle than Toyota (\$22,514 vs. \$20,642), the difference seems to be accounted for by Toyota’s greater emphasis on small cars. For comparable models, it appears that Toyota’s prices are higher than Ford’s – possibly the result of higher quality and better features.
- Ford’s capital productivity is higher than Toyota’s. Yet, when we review the disaggregated asset productivity ratios, it is difficult to find the source of this higher capital turnover. Certainly Ford is leaner in terms of cash and inventory, but not in turning over plant and equipment and creditors. The real explanation for Ford’s apparent efficiency in capital utilization derives from its higher current liabilities – especially short-term debt – which reduce its capital employed.



overall return on assets we can begin to pinpoint the sources of Ford's dismal profitability. We can also disaggregate performance by business and geographical segments. If we then combine the financial data with qualitative data on Ford's business strategy, its operations, its product strategy, the organizational issues it has faced, and the conditions in the world market for motor vehicles, we can begin to formulate hypotheses as to why Ford has performed so poorly. This can then provide the basis for identifying corrective measures.

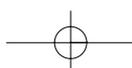
### *Evaluating Alternative Strategies*

A probing diagnosis of a firm's current performance – as outlined above – provides a useful starting point for strategy formulation. If a firm is making losses or is performing worse than its major competitors, then the main priority for strategy is to address sources of deficient performance. If current performance is so bad that the survival of the enterprise is in question, then strategy must adopt a short-term orientation and focus, at least initially, on staunching cash flow drain.

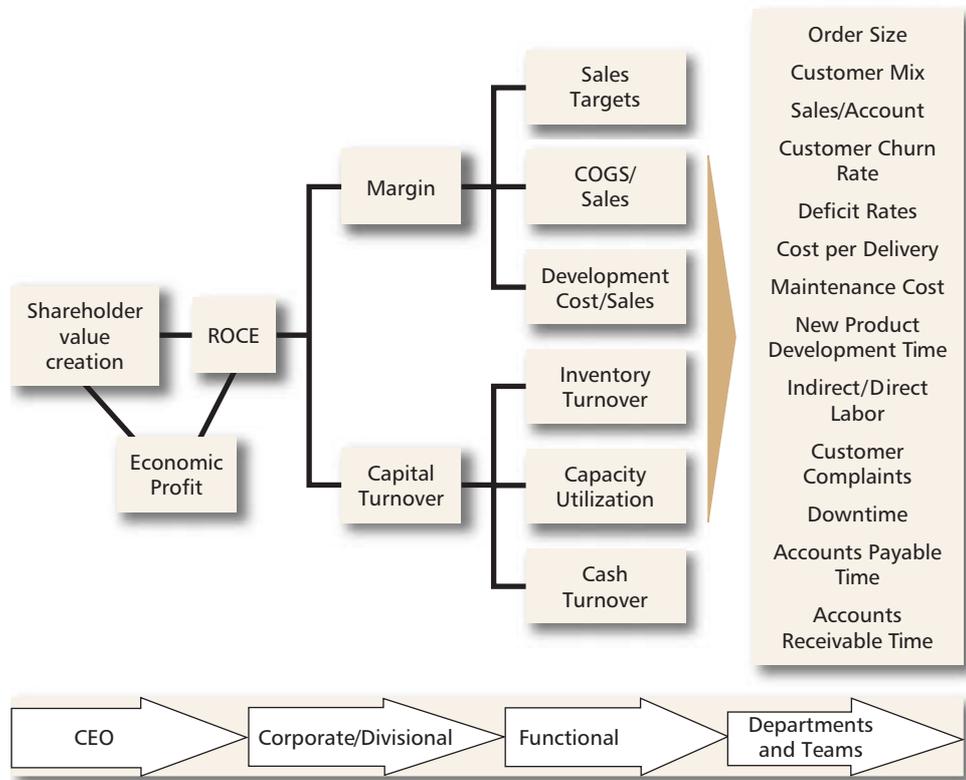
Even if a firm is performing well, it is not enough to conclude that the present strategy is working well and should therefore be continued. The world of business is one of constant change, and the role of strategy is to assist the firm to adapt to changing market and competitive conditions. The sustained, outstanding success of companies such as Wal-Mart, Dell, Nokia, Canon, HSBC, and Toyota has been achieved by their continual strategic adaptation rather than sticking with previous winning formulae. But, as we have already noted, we cannot simply test out alternative strategies by calculating which one will yield the greatest net present value of the firm. The problems of estimating future cash flows are simply too daunting. In practice, therefore, strategy formulation requires more qualitative tools of strategic analysis. We may not be able to forecast the profits that might result from Ford consolidating its plants, shifting production to lower cost countries, or introducing more fuel-efficient cars, but we can analyze the industry trends, product market conditions, and sources of competitive advantage that are likely to determine Ford's future profit streams and then make soundly based judgments about which strategy offers the best prospects.

### *Setting Performance Targets*

As discussed in Chapter 1, an important role for strategic planning systems is to drive corporate performance through setting performance aspirations then monitoring and assessing results against targets. To be effective, performance management needs to be consistent with long-term goals, closely linked to strategy, and address individuals throughout the organization. While the overall corporate performance goal is to increase long-run profits with a view to maximizing the value of the firm, such a goal is meaningless outside the top echelon of management. Corporate targets need to be translated into more specific goals that are meaningful for managers further down the organization. The key is to match performance targets to the variables over which different managers exert some control. Thus, for the CEO, it may make sense to set the overall goal of maximizing enterprise value. For the chief operating officer and divisional heads, it makes more sense to set more specific financial goals (such as maximizing ROCE on existing assets and investing in projects whose rate of return



**FIGURE 2.2** Linking value drivers to performance



exceeds the cost of capital). For functional, departmental, and unit managers, more specific operating targets are preferable. Thus, in a retailing company, store managers might be given targets with regard to sales per square foot and gross margins. Warehouse managers might be required to achieve target levels of inventory turns. Purchasing managers might be required to reduce the cost of goods purchased as a percentage of sales revenue. The chief financial officer might be required to minimize average cost of capital and reduce cash balances.

The same procedure that we used to disaggregate return on capital for appraising past performance can be used to set performance targets appropriate to different levels and functions within the organization. Figure 2.2 uses the same breakout of the drivers of return on capital as Figure 2.1. The difference is that Figure 2.2 provides a basis for identifying the financial and operating ratios appropriate to managers at the different levels and in the different functions of the company.

**Balanced Scorecards** The problem with any system of performance management is that the performance goals are long term (e.g. maximizing profits over the lifetime of the company) but to act as an effective control system, performance targets need to be monitored over the short term. The problem with the above financially based

**FIGURE 2.3** Balanced scorecard for Mobil North American Marketing and Refining

		Strategic Objectives	Strategic Measures
<b>Financially Strong</b>	Financial	F1 Return on Capital Employed	<ul style="list-style-type: none"> <li>● ROCE</li> <li>● Cash Flow</li> <li>● Net Margin</li> <li>● Full cost per gallon delivered to customer</li> <li>● Volume growth rate vs. industry</li> <li>● Risk index</li> </ul>
		F2 Cash Flow	
		F3 Profitability	
		F4 Lowest Cost	
		F5 Profitable Growth	
		F6 Manage Risk	
<b>Delight the Consumer</b>	Customer	C1 Continually delight the targeted consumer	<ul style="list-style-type: none"> <li>● Share of segment in key markets</li> <li>● Mystery shopper rating</li> </ul>
		C2 Improve dealer/distributor profitability	
<b>Win-Win Relationship</b>			
<b>Safe and Reliable</b>	Internal	I1 Marketing	<ul style="list-style-type: none"> <li>● Non-gasoline revenue and margin per square foot</li> <li>● Dealer/distributor acceptance rate of new programs</li> <li>● Dealer/distributor quality ratings</li> <li>● ROCE on refinery</li> <li>● Total expenses (per gallon) vs. competition</li> <li>● Profitability index</li> <li>● Yield index</li> <li>● Delivered cost per gallon vs. competitors</li> <li>● Trading margin</li> <li>● Inventory level compared to plan and to output rate</li> <li>● Number of incidents</li> <li>● Days away from work</li> <li>● Quality index</li> </ul>
		1. Innovative products and services	
		2. Dealer/distributor quality	
		I2 Manufacturing	
		1. Lower manufacturing costs	
2. Improve hardware and performance			
<b>Competitive Supplier</b>			
<b>Good Neighbor On Spec On time</b>		I3 Supply, Trading, Logistics	
		1. Reducing delivered cost	
		2. Trading organization	
		3. Inventory management	
		I4 Improve health, safety, and environmental performance	
		I5 Quality	
<b>Motivated and Prepared</b>	Learning and growth	L1 Organization involvement	<ul style="list-style-type: none"> <li>● Employee survey</li> <li>● Strategic competitive availability</li> <li>● Strategic information availability</li> </ul>
		L2 Core competencies and skills	
		L3 Access to strategic information	

approach of disaggregating profitability into its constituent ratios is that the short-term pursuit of financial targets is unlikely to result in long-term profit maximization. One solution to this dilemma is to link the overall corporate goal of value maximization to strategic and operational targets to ensure that the pursuit of financial goals is not at the expense of the longer term strategic position of the company. The most widely used method for doing this is the *balanced scorecard* developed by Robert Kaplan and David Norton.<sup>19</sup> The balanced scorecard methodology provides an integrated framework for balancing financial and strategic goals, and extending these balanced performance measures down the organization to individual business units and departments. The performance measures combine the answers to four questions:

- 1 *How do we look to shareholders?* The financial perspective is composed of measures such as cash flow, sales and income growth, and return on equity.
- 2 *How do customers see us?* The customer perspective comprises measures such as goals for new products, on-time delivery, and defect and failure levels.
- 3 *What must we excel at?* The internal business perspective relates to internal business processes such as productivity, employee skills, cycle time, yield rates, and quality and cost measures.
- 4 *Can we continue to improve and create value?* The innovation and learning perspective includes measures related to new product development cycle times, technological leadership, and rates of improvement.

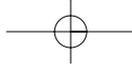
By balancing a set of strategic and financial goals, the scorecard methodology allows the strategy of the business to be linked with the creation of shareholder value while providing a set of measurable targets to guide this process. Thus, at machinery and chemicals conglomerate FMC, Kaplan and Norton report:

*Strategists came up with five- and ten-year plans, controllers with one-year budgets and near-term forecasts. Little interplay occurred between the two groups. But the scorecard now bridges the two. The financial perspective builds on the traditional function performed by controllers. The other three perspectives make the division's long-term strategic objectives measurable.*<sup>20</sup>

Mobil Corporation's North American Marketing and Refining business (NAM&R) was a pioneer of the balanced scorecard during the 1990s. Faced with pressures of unsatisfactory profit performance, the business adopted the scorecard methodology as a means of linking strategy with financial performance goals and translating these into operating objectives tailored to the specific performance requirements of individual business units and functional departments. The scorecard provided a mechanism for "cascading down" divisional strategy into specific operating goals. The result was an integrated system where scorecards provided the measurements by which the performance of each unit and department was appraised and against which performance-related pay bonuses were determined.<sup>21</sup> Figure 2.3 shows NAM&R's scorecard.

## **Beyond Profit: Values and Social Responsibility**

It is time to look more deeply and more realistically at the goals of the firm. In Chapter 1 we introduced the simplifying assumption that the primary goal of the firm is long-run profitability. In this chapter we have developed techniques of performance



appraisal and analysis based on this assumption. Yet, lurking in the shadows is the recognition that, in reality, firms are motivated by goals other than maximizing profit. Even more worrying, such alternative goals may be better, both for society and maybe even for the firm itself. Let us address these issues directly.

### *The Paradox of Profit*

There is more to business than making money. Profit maximization (enterprise value maximization, to be more precise) provides a convenient foundation for building our tools of strategy analysis, yet it is not the goal that inspired Henry Ford to build a business that precipitated a social revolution. Ford Motor Company was the outcome of Henry's mission and vision:

*I will build a motor car for the great multitude . . . It will be so low in price than no man making good wages will be unable to own one and to enjoy with his family the blessing of hours of pleasure in God's great open spaces . . . When I'm through, everyone will be able to afford one, and everyone will have one.<sup>22</sup>*

Similar remarks can be made about most of the great entrepreneurs that have shaped the world of business. It seems unlikely that it is the quest to make more money that causes the world's richest person, Bill Gates, to show up for work most days at Microsoft.

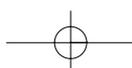
As we recognized in Chapter 1 (see Strategy as Target), the world's most consistently successful companies in terms of profits and shareholder value tend to be those that are motivated by factors other than profit. A succession of studies have pointed to the role of strategic intent, vision, and "big, hairy, ambitious goals" in driving sustained corporate success.<sup>23</sup> Indeed, the converse may also be true – the companies that are most focused on profitability and the creation of shareholder value are often remarkably unsuccessful at achieving those goals. The case of Boeing during the 1990s is instructive (see Strategy Capsule 2.4).

Why is it that the pursuit of profit so often fails to generate adequate returns? First, profit will only be an effective guide to management action if managers know what determines profit. Obsession with profitability can blinker managers' perception of the real drivers of superior performance. Conversely, a strategic goal "to build a motor car for the great multitude that everyone will be able to afford" (Ford), or to "build great planes" (Boeing), or to "become the company most known for changing the worldwide poor quality image associated with Japanese products" (Sony, 1950s) may lead a company to direct its efforts towards the sources of competitive advantage within its industry – ultimately leading to superior long-term profitability.

The second factor concerns motivation. Success is the result of coordinated effort. The goal of maximizing the return to stockholders is unlikely to inspire employees and other company stakeholders and it's unlikely to be especially effective in inducing cooperation and unity between them. Dennis Bakke, founder of the international power company AES, offers the following analogy:

*Profits are to business as breathing is to life. Breathing is essential to life, but it not the purpose for living. Similarly, profits are essential for the existence of the corporation, but they are not the reason for its existence.*

To consider these issues more specifically, let us look more generally at values, ideals and principles.



## STRATEGY CAPSULE 2.4

### The Pitfalls of Pursuing Shareholder Value: Boeing

Boeing was one of the most financially successful members of the Dow Jones Industrial Index between 1960 and 1990. Yet, financial goals or financial controls had little role in Boeing's management over this period. CEO Bill Allen was interested in building great planes and leading the world market with them: "Boeing is always reaching out for tomorrow. This can only be accomplished by people who live, breathe, eat and sleep what they are doing." Allen bet the company on the 747, yet when asked by non-executive director Crawford Greenwalt for financial projections on the project, Allen was utterly vague. "My God," muttered Greenwalt, "these guys don't even know what the return on investment will be on this thing."

The change came in the mid-1990s when Boeing acquired McDonnell Douglas and a new

management team of Harry Stonecipher and Phil Condit took over. Mr. Condit proudly talked of taking the company into "a value-based environment where unit cost, return on investment, shareholder return are the measures by which you'll be judged."

The result was lack of investment in major new civil aviation projects and diversification into defense and satellites. Under Condit, Boeing relinquished market leadership in passenger aircraft to Airbus, while faltering as a defense contractor due partly to ethical lapses by key executives. When Condit resigned on December 1, 2003, Boeing's stock price was 20 percent lower than when he was appointed.

*Source:* Adapted from John Kay, "Forget how the Crow Flies," *Financial Times Magazine* (January 17, 2004): 17–27.

### *Values and Principles*

Even when a company recognizes profit or the creation of shareholder value as its primary goal, its pursuit of that goal is likely to be constrained by values, ideals, and principles to which the members of the company subscribe. It has become popular for public companies – and some private companies too – to be explicit about the values and principles that guide their business conduct. This may even be formulated into specific rules or a code of conduct. Strategy Capsule 2.5 summarizes Shell's values and business principles.

At one level, statements of values and principles may be regarded as instruments of companies' external image management. Yet, to the extent that companies are consistent and sincere in their commitments, values and principles can be integral to an organization's sense of what it is, what it represents, what it wants to achieve, and how it intends to achieve it. Values and principles not only condition, constrain, and even transcend the pursuit of profit, they influence employees' motivation, propensity to collaborate, and their own sense of identity. To the extent that values are shared among organizational members, they form a central component of organizational culture.

## STRATEGY CAPSULE 2.5

### Shell's Values and Principles

#### Our Values

Shell employees share a set of core values – honesty, integrity, and respect for people. We also firmly believe in the fundamental importance of trust, openness, teamwork and professionalism, and pride in what we do.

#### Principles

- 1 *Economic*. Long-term profitability is essential to achieving our business goals and to our continued growth. It is a measure both of efficiency and of the value that customers place on Shell products and services.
  - 2 *Competition*. Shell companies support free enterprise. We seek to compete fairly and ethically and within the framework of applicable competition laws; we will not prevent others from competing freely with us.
  - 3 *Business Integrity*. Shell companies insist on honesty, integrity, and fairness in all aspects of our business and expect the same in our relationships with all those with whom we do business. The direct or indirect offer, payment, soliciting or acceptance of bribes in any form is unacceptable.
  - 4 *Political Activities*. Shell companies act in a socially responsible manner within the laws
- of the countries in which we operate in pursuit of our legitimate commercial objectives. Shell companies do not make payments to political parties, organizations or their representatives.
- 5 *Health, Safety, Security, and the Environment*. Shell companies have a systematic approach to health, safety, security, and environmental management in order to achieve continuous performance improvement.
  - 6 *Local Communities*. Shell companies aim to be good neighbors by continuously improving the ways in which we contribute directly or indirectly to the general wellbeing of the communities within which we work.
  - 7 *Communication and Engagement*. Shell companies recognize that regular dialog and engagement with our stakeholders is essential. We are committed to reporting of our performance by providing full relevant information to legitimately interested parties, subject to any overriding considerations of business confidentiality.
  - 8 *Compliance*. We comply with all applicable laws and regulations of the countries in which we operate.
- Source:** Extracted from Royal Dutch Shell plc, *General Business Principles*, 2005 ([www.shell.com/static/royal-en/downloads/sGBP/sGBP\\_300805.pdf](http://www.shell.com/static/royal-en/downloads/sGBP/sGBP_300805.pdf))

In terms of providing the basis for firm strategy, a company's values complement its vision. Thus, Jim Collins and Jerry Porras argue that "core values" and "core purpose" – the organization's most fundamental reason for being – unite to form an organization's "core ideology" which "defines an organization's timeless character"

and is “the glue that holds the organization together.”<sup>24</sup> When core ideology is put together with an “envisioned future” for the enterprise, the result is a powerful sense of strategic direction.

### *The Debate Over Corporate Social Responsibility*

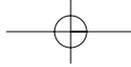
Values and principles can enhance a sense of identity and self-worth, but what values and principles should companies adopt? The risk is that, rather than focus and enhance a firm’s sense of identity and purpose, commitment to values may conflict with the commercial interests of the company. At cosmetics and toiletries retailer Body Shop, faltering performance during the 1990s could be traced to the excessive commitment of top management to environmental and social activism. Founder and CEO Anita Roddick became increasingly involved in campaigns against globalization and threats to biodiversity and the rights of indigenous peoples. The head of finance was detailed to help set up windmills in Wales to ecologically balance the electricity used by the corporate head office.<sup>25</sup> The danger is that a company’s purpose becomes manipulated to serve the values and beliefs of a powerful leader. Silvio Berlusconi is the most recent in a long line of media barons who have used their companies as vehicles for their political aspirations. The history of Hughes Aircraft under the leadership of aviator and playboy Howard Hughes is an even more salutary example of the risks of business strategy becoming dominated by the personal interests of the CEO.

The debate over corporate social responsibility provides a particularly interesting arena for the discussion of goals, values, and principles. Like many free-market economists, Milton Friedman was suspicious of any influences that cause a firm to deviate from profit maximization:

*There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*<sup>26</sup>

Socially responsible acts by a CEO – whether it is improving the natural environment, hiring disadvantaged individuals rather than better qualified workers, or holding down prices in the interest of supporting inflation goals – involve management spending owners’ money for a general social interest. According to Friedman, this is an unjustified abuse of executive power.

Conflicting views of the responsibilities of the firm reflect different concepts of the nature and role of the public corporation. William Allen identifies two different concepts of the public corporation: “the property conception,” which views the firm as a collection of assets owned by the stockholders, and the “social entity conception,” which views the firm as the community of individuals that is sustained and supported by its relationships with its social, political, economic, and natural environment.<sup>27</sup> While the “firm as property” view implies a narrow focus by management on maximizing shareholder value, the “firm as social entity” implies the fundamental requirements for the survival and prosperity of the firm are the maintenance of the firm’s social relationships, which, in turn, requires coexistence with the external environment. Thus, Charles Handy argues that the property view is a legal hangover from the nineteenth century, when shareholders really did own and run their companies. In the twenty-first century, shareholders invest in companies; they are not “owners” in



any meaningful sense. Certainly it is important to reward shareholders, but to regard profit as the purpose for which companies exist is a tragic confusion, argues Handy – companies exist to do something that is better or different than anyone else.<sup>28</sup>

While Charles Handy, Sumantra Ghoshal, and other critics of the shareholder value maximization view seek to emphasize the conflicts between shareholder interests and the interests of other stakeholders, in practice it would appear that their interests converge, especially over the longer term. If a firm is to maximize profitability over its lifetime, it is helpful if it lives a long time. Former Shell strategist, Arie De Geus, argues that long-living companies are ones that build strong communities, have a strong sense of identity, commit to learning, and are sensitive to the world around them. In short, the company is a living organization whose lifespan depends on recognizing its organic nature and ensuring its effective adaptation to its changing environment.<sup>29</sup> Adaptation to a changing environment is enhanced by close interactions and supportive relations between the firm and customers, employees, governments, local communities, and the natural environment. Beyond these broad generalizations that social responsibility is typically compatible with business survival and prosperity, Strategy Capsule 2.6 examines BP's approach to social and environmental responsibilities, while Strategy Capsule 2.7 summarizes the views of leading strategy gurus on the convergence of profitability and corporate social responsibility.

## STRATEGY CAPSULE 2.6

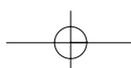
### Social and Environmental Responsibility at BP

In a 1997 speech at Stanford University, John Browne, BP's CEO, committed the company to an active role in the quest for solutions to the problem of global warming. Since then, sustainability has become a central theme of BP's corporate strategy. Given BP's position as one of the world's leading extractors of fossil fuels, this has inevitably meant a focus on the natural environment – climate change in particular. In response, BP has pursued aggressive targets for emissions reduction, pioneered R&D into environmentally friendly technologies (including reformulated fuels), and invested in alternative energy (notably solar). However, BP's sustainability initiatives also extend to other aspects of human development – in the countries where it does business, BP supports

education, poverty relief, and the “development of human talent.”

At the same time, in a 2006 bulletin to shareholders, “Maintaining our Strategy, Maximizing our Returns,” Lord Browne emphasized that: “Our core objective is to grow sustainable free cash flow and to distribute it so as to grow shareholder returns.” With a 28% return on equity in 2005 and a five-year growth in earnings per share of 26%, BP has done well for its shareholders. Future returns look even better: at its 2006 AGM, Lord Browne outlined the potential for BP to return \$65 billion to shareholders during 2006–8.

So, how does BP reconcile its quest for social and environmental responsibility with its focus on shareholder returns? Some cynics claim that



BP's program of sustainable development is simply a front to deflect criticism from governments and environmental and antiglobalization activists, to sustain the feel-good factor among corporate executives while allowing BP to continue feeding the flow of greenhouse gases and earning outrageous profits. Certainly BP puts its eco-friendly image at the forefront of its external communications. It spent \$7 million to develop its new "sunburst" corporate logo and over \$100 million annually integrating the new logo into its marketing efforts. Associating BP with "Beyond Petroleum" rather than British Petroleum was another major marketing initiative.

Lord Browne is resolute in his argument that the theme of sustainability applies equally to the planet, human society, and to BP's own profit stream. In his 2000 BBC Reith Lecture, Browne outlined his concept of "enlightened self interest":

*The simple fact is that business needs sustainable societies in order to protect its own sustainability . . . And I say this because very few businesses are short-term activities. Most want to do business again and again over many decades. And this is especially true of the businesses which are most often criticized – those, like mine, which are in the business of extracting and developing the world's natural resources. We are by definition – whether we like it or not – long-term*

*players. We have to live with the consequences of what we do for decades. We can't pack up and go home when the going gets tough. But in order to sustain what we value, we have to be prepared to change. And the sort of change which business promotes is the application of technical advances to meet human needs.*

By pioneering the quest for eco-friendly technologies and ambitious environmental targets, BP has discovered a number of commercial benefits – many of them unexpected. Its aggressive program of reducing emissions from its refineries resulted in wider improvements in refinery processes that generated cost savings that exceeded the investment costs of the refinery upgrades. In pioneering reformulated fuels, BP has gained early-mover advantages over competitors. In gaining access to exploration licenses and joint ventures with national oil companies, BP has established itself as a preferred partner of producer countries.

By mid-2006, BP's reputation as the petroleum sector's pioneer of social responsibility was tarnished by its inability to match its actions to its words. In 2005, an explosion at its Texas refinery killed 15 employees and during summer 2006, BP was rocked by an oil spill in Alaska and allegations of price fixing in its natural gas liquids business.

**Sources:** www.bp.com; Craig Smith, "BP's failure of execution, not strategy," *Financial Times* (August 9, 2006): 11.

**STRATEGY CAPSULE 2.7****Strategic Philanthropy and Serving the Bottom of the Pyramid**

In contrast to Milton Friedman's denunciation of corporate social responsibility, strategy gurus Michael Porter and C. K. Prahalad point to the strategic use of social responsibility as a means of furthering the long-term profit goals of the firm.

**Strategic Philanthropy**

Michael Porter and Mark Fuller argue that: "There is no inherent contradiction between improving competitive context and making a sincere commitment to bettering society." Yet, all too often corporate philanthropy fails to look beyond public relations and employee moral. Charity and social responsibility efforts need to align with the firm's strategy to improve its competitive environment or enhance competitive advantage. Companies often make available both finance and employees' time to support collaborative initiatives with local schools. Improvements in the education and training of the local labor force are clearly in companies' own interests. Aardman Productions, creators of animated films such as the *Wallace and Gromit*, collaborated with the University of the West of England to establish the Bristol School of Animation – a rich source of future employees. Apple's computers-for-schools program helped build it a strong position in the educational sector during the 1980s. To be effective, many of these initiatives must be collaborative. Multinational companies throughout the world are

major sources of funding for Transparency International.

**Serving the World's Poor**

C. K. Prahalad and Allen Hammond argue that multinational companies tend to overlook the world's poor. This is shortsighted on two counts. First, although poor, the lowest economic tier of world society – "the bottom of the pyramid" – can offer attractive market opportunities. The shanty towns of Rio de Janeiro, Johannesburg, and Mumbai house millions of people, vibrant economies, and substantial collective purchasing power. On a smaller scale, Grameen Telecom's payphones sited in Bangladeshi villages generate strong profit margins. Second, looking long term, it is through engaging with the world's poor that they will grow their way out of poverty and be the growth markets of the future. The challenges of serving the "bottom of the pyramid" market can stimulate innovations with more general applicability. The wind-up, batteryless radio was developed by British inventor Trevor Bayliss to give poor, Third-World communities access to radio broadcasts. Wind-up radios have been one of the most successful audio products of the past decade.

**Sources:** M. E. Porter and M. Fuller, "The Competitive Advantage of Corporate Philanthropy," *Harvard Business Review* (September 2002): 57–68. C. K. Prahalad and A. Hammond, "Serving the World's Poor, Profitably," *Harvard Business Review* (September 2002).

## Summary

Chapter 1 established that strategy is about success and provided a framework for viewing strategy as a link between the firm and its industry environment. This chapter has explored the first component of that framework – the goals, values, and performance of the firm. The key assumption in this chapter is that the firm operates in the interests of its owners through maximizing their returns (profits), which implies maximizing the net present value of the firm. At the same time, we must recognize that profit, while essential, is not the *raison d'être* for most business enterprises. Strategy is also about creating purpose and unifying the energy and creativity of organizational members in pursuing that purpose.

While every business venture has a unique purpose and vision, common to all is the need to generate profit for that vision to be realized. Hence, the challenge we address in this book is to develop strategies that can help the firm generate profit over the long term.

Financial analysis can help us understand how return on capital, cost of capital, growth, and option values determine the value of the firm. But, ultimately, creating value depends on identifying and exploiting the fundamental drivers of firm value. That is the challenge we address in the next three chapters of the book. We begin with the industry environment of the firm.

## Self-Study Questions

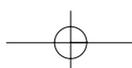
- 1 Table 2.1 compares companies according to different profitability measures:
  - a) Which two of the six performance measures do you think are the most useful indicators of how well a company is being managed?
  - b) Is return on sales or return on equity a better basis on which to compare the performance of the companies listed?
  - c) Several companies are highly profitable, yet have delivered negative returns to their shareholders. How is this possible?
- 2 Nike, supplier of sports footwear and apparel, is interested in actions it might take to increase its option value. What advice would you give to its top management?
- 3 Some of the most prominent adopters of EVA (and other measures of economic profit) for the purposes of setting targets, monitoring performance, and allocating capital expenditure have been in capital-intensive industries (automobiles, energy, engineering, hotels). Why might companies in capital-intensive industries find EVA a more useful tool than companies in sectors with low capital intensity?
- 4 With regard to Strategy Capsule 2.3, what additional data would you seek and additional cost and productivity ratios would you calculate to shed further light on the reasons for Ford's inferior ROCE relative to Toyota?



- 5 A listed public company is considering developing a program of corporate social responsibility (CSR). One group of board directors believes that the company should embrace CSR as part of a “stakeholder” orientation in which the company explicitly pursues the interests of investors, customers, employees, and the community. Another group believes that the company should develop a program of CSR initiatives as a means by which the company pursues investor interests through the long-term maximization of profitability. Which group would you support and why?

## Notes

- In this chapter, I use the term “value” in two distinct senses. Here I am referring to *economic value*, which is worth as measured in monetary units. We shall also be discussing *values* as moral principles or standards of behavior.
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- S. L. Hart and M. B. Milstein, “Global Sustainability and the Creative Destruction of Industries,” *Sloan Management Review* 41 (Fall 1999): 23–33. M. Orlitzky, F. L. Schmidt and S. L. Rynes, “Corporate Social and Financial Performance: A Meta-Analysis,” *Organization Studies* 24 (Summer 2003): 403–41.
- See K. R. MacCrimmon, “An Overview of Multiple Objective Decision Making,” in J. L. Cochrane and M. Zeleny (eds), *Multiple Criteria Decision Making* (Columbia, SC: University of South Carolina Press, 1973).
- Go to [www.sternstewart.com](http://www.sternstewart.com). See also: G. Bennett Stewart III and A. Ehrbar, *EVA: The Real Key to Creating Wealth* (New York: Wiley, 1999).
- EVA is one of several measures of economic profit. A similar measure is *value added*, proposed by J. Kay in *Foundations of Corporate Success: How Corporate Strategies Add Value* (Oxford: Oxford University Press, 1993).
- S. Tully, “EVA: The Real Key to Creating Wealth,” *Fortune* (September 20, 1993): 42.
- The cost of equity capital is calculated using the Capital Asset Pricing Model: Firm X’s cost of equity = the risk-free rate of interest + a risk premium. The risk premium is the excess of the stock market rate of return over the risk-free rate multiplied by Firm X’s beta coefficient (its measure of *systematic risk*). See T. Koller, M. Goedhart, and D. Wessels, *Valuation: Measuring and Managing the Value of Companies*, 4th edn (New York: Wiley, 2005): Chapter 10.
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- This “shareholder value” approach to strategy appraisal is outlined by A. Rappaport in *Creating Shareholder Value: The New Standard for Business Performance* (New York: Free Press, 1986); and “CFOs and Strategists: Forging a Common Framework,” *Harvard Business Review* (May–June 1992): 84–91.
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- B. Kogut and N. Kulatilaka, “Options Thinking and Platform Investments: Investing in Opportunity,” *California Management Review* (Winter 1994): 52–69.
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- Koller, Goedhart, and Wessels, *Valuation* op. cit.: Chapter 13.
- J. A. Kay and C. Meyer, “On the Application of Accounting Rates of Return,” *Economic Journal* 96 (1986): 199–207; J. A. Kay, *Foundations of Corporate Success: How Business Strategies Create Value* (Oxford: Oxford University Press, 1993): 207.
- The approach is in a stream of publications by R. S. Kaplan and D. P. Norton. See “The Balanced Scorecard: Measures That Drive Performance,” *Harvard Business Review* (January–February 1992); *Balanced Scorecard: Translating Strategy into Action* (Boston: Harvard Business School Press, 1996); “Using the Balanced Scorecard as a Strategic Management System,” *Harvard Business Review* (January–February 1996).
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- R. S. Kaplan and D. P. Norton, *The Strategy-focused Organization* (Boston: Harvard Business School Press,



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- 22 [www.abelard.org/ford](http://www.abelard.org/ford)
- 23 T. Peters and R. Waterman identified “shared values” as a key ingredient in corporate excellence (*In Search of Excellence*, HarperCollins, 1982); G. Hamel and C. K. Prahalad introduced “Strategic Intent” (*Harvard Business Review*, May–June 1989: 63–76); J. Collins and J. Porras, “Building Your Company’s Vision,” *Harvard Business Review* (September–October 1996): 65–77.
- 24 Collins and Porras, “Building Your Company’s Vision,” op. cit.
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- 26 M. Friedman, *Capitalism and Freedom* (University of Chicago Press, Chicago, 1963). See also: M. Friedman, “The Social Responsibility of Business is to Increase its Profits,” *New York Times Magazine* (September 13, 1970).
- 27 W. T. Allen, “Our Schizophrenic Conception of the Business Corporation,” *Cardozo Law Review* 14 (1992): 261–81.
- 28 C. Handy, “What’s a Business For?” *Harvard Business Review* (December 2002): 133–43.
- 29 A. De Geus, “The Living Company,” *Harvard Business Review* (March–April 1997): 51–59.