STRATEGIC PLANNING

DOES YOUR STRATEGY GET THE GREEN LIGHT?

In choosing the best strategy for your organisation, there's more to consider than just the numbers. **Jo Whitehead** explains the additional criteria that FDs might use for evaluating proposed strategies and backing the best.*

Your organisation has spent months analysing markets and researching competitors in order to create or update a strategy. However, all the good work will be wasted if – from all the possible ways forward – you do not the select the best option. As someone in the finance function your inclination may be to cut the strategic analysis and go straight to the numbers. But the numbers often tell the story that their 'cruncher' wants them to tell. You need to have a way of evaluating strategies that does not rely solely on looking at the return on investment (ROI) or net present value calculation.

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Box 1 CHECKLIST FOR AN OPTION'S STRATEGIC FAILURE

1. Does the option position the organisation in large, growing industry segments?
   - ☐ ● Small or declining
   - ☐ ● Average growth and size
   - ☐ ● Very large or high growth

2. Does the option position the organisation in profitable industry segments?
   - ☐ ● Particularly low profitability industry with low returns for even well established players
   - ☐ ● Average industry returns
   - ☐ ● Exceptionally profitable industry or niche

3. Is the option aligned with the broader trends that are shaping the industry?
   - ☐ ● Option will require confronting significant external political, government or regulatory interference
   - ☐ ● Broader trends have limited impact on the outcome of the options
   - ☐ ● Broader trends could provide significant support and upside for the option

4. Does the strategy create significant value for customers and stakeholders?
   - ☐ ● Option will destroy value for customers and stakeholders
   - ☐ ● Limited impact on value creation
   - ☐ ● Option offers opportunities for significant new value generated

5. Is the strategy adaptive and/or resilient to the type of uncertainties that may be faced?
   - ☐ ● Significant uncertainty exists and option will only be successful under a limited range of reasonable future scenarios
   - ☐ ● Some flexibility to respond to known and unknown uncertainties
   - ☐ ● Option will result in a competitive advantage from being more flexible or resilient than others

6. Is the option aligned with the mission, purpose, values and behaviours of the organisation?
   - ☐ ● Significant challenge to deeply held beliefs and behaviours
   - ☐ ● Option is consistent
   - ☐ ● Option is aligned and makes a significant contribution to purpose

7. Is the option aligned with the interests of the most influential stakeholders?
   - ☐ ● Powerful stakeholders will strongly resist
   - ☐ ● Effects will be broadly neutral
   - ☐ ● Option is aligned to the interests of the most powerful stakeholders

8. Will the option provide a competitive advantage, including any additional advantage that comes from linkages across segments?
   - ☐ ● Disadvantaged
   - ☐ ● Me-too player
   - ☐ ● Significant, sustainable advantage

9. Does the strategy allow the organisation the ability to create strategic options for the future?
   - ☐ ● Highly valuable capabilities or options are lost
   - ☐ ● Some future options closed off, but others remain
   - ☐ ● Significant option value from options or capabilities created

10. Is the analysis based on a robust understanding of the evolving external and internal environment, and the full range of options?
    - ☐ ● Suspect data and insights
    - ☐ ● Some critical assumptions with only limited testing
    - ☐ ● Fully confident

Evaluating options

Strategy options can be evaluated using three types of criteria: strategic, feasibility and risk/return, as described below.

1. Strategic criteria

The strategic criteria in the checklist (see box, right) highlight what I believe to be the main strategy concepts. The checklist might be a useful way of structuring your evaluation of strategic options, using a 'traffic light' (red, amber or green) rating system.

When making complex strategic decisions there are frequently a number of important concepts that have be considered. Sometimes these concepts can be folded into the financial analysis. For example, the concept of 'competitive advantage' can be turned into an estimate of the superior profitability that a

‘There are two things to be considered with regard to any scheme. In the first place, ‘Is it good in itself?’ In the second, ‘Can it be easily put into practice?’’ – Jean Jacques Rousseau

successful organisation may enjoy – resulting in superior margins and cashflows. The concept of ‘attractive markets’ can be quantified in terms of the growth rate in cashflows, and the general levels of profitability that might be expected.

However, other important concepts cannot easily be factored into the calculation. For example, the concept of a strategic mission raises the issue of whether or not the option is aligned with the mission, purpose, values and typical behaviours of the organisation. If not then it may not be a viable option even if it has a great financial return. And even concepts such as market attractiveness and competitive advantage can be hard to quantify. For this reason, it is helpful to do a separate, strategic assessment of each option prior to running the numbers.

A first step in using the checklist of questions (previous page) should be to prioritise them according to your situation. For example, the issue of competitive advantage is often the dominant criterion in a competitive industry, but may not be relevant for a defence company that enjoys a quasi monopoly position vis-à-vis the national government. In such a case it may be more important to create value for the primary customer, thus ensuring maintenance of the favoured relationship.

It may also be necessary to add some particularly important criteria. For example, the defence company may feel that the degree of local production is particularly important in the eyes of the government, and so needs to be added as a criterion.

It’s impossible to be precise about what constitutes an acceptable mix of reds, ambers and greens: it will be different for every situation. However, a rule of thumb is that even a single red should prompt serious concerns about a strategy; at a minimum, a plan to tackle the issue would be required. One or two greens, in important categories, would be required for the strategy to be attractive.

2. Evaluating feasibility

Even if the traffic lights help establish whether an option is a good one in principle, it is also important to double check whether it is feasible and can be put into practice. Criteria for establishing feasibility might include questions such as:

- are the required resources and capabilities available?
- is the management team up to the job?
- is there strong sponsorship by senior management?
- is the option likely to have significant negative side effects and thus face resistance from other parts of the organisation? and
- are there suitable suppliers and partners to allow us to operate?

There may also be criteria specific to the context. For example, in acquiring a new business, a critical question would be ‘Can we manage the post-merger integration?’ In entering a new country, there may be issues such as ‘Can we get the required permits to operate?’

Consideration of feasibility criteria – although better late than never – should not be regarded as just part of the final checks and balances on a proposed strategy: it should be an inherent part of the strategy process. Otherwise you are in danger of committing one of the cardinal sins of strategy: devising an un-implementable strategy.

After all, as Jean-Jacques Rousseau so pithily observed, ‘there are two things to be considered with regard to any scheme. In the first place, ‘Is it good in itself?’ In the second, ‘Can it be easily put into practice?’’

3. Evaluating risk/return

When both strategy and feasibility criteria have been applied, there will be a mix of options that might be acceptable, each with a different combination of risk and return.

Measures of return are often set partly by the financial policies of the organisation and will include metrics such as profitability, payback or discounted payback, net present value and return on investment. You are likely to reject strategic options that have lower return for the same amount of risk. The most common ways of assessing the risk/return ratio include, in rising order of sophistication:

- listing the main risks. By simply describing the risks it is possible to get a better gut feel about the level and nature of the risks involved in different options;
- sensitivity analysis. This involves measuring the potential impact of the risks on operating and financial metrics, such as time to market, investment cost, margins and payback;
- base, upside and downside cases. This uses the results from the sensitivity analysis, to build a set of possible scenarios for how the strategy may turn out, and the resulting financial returns;
- probability trees. This involves assigning probabilities to the base, upside and downside cases to get a more precise measure of the impact of risk on the expected returns from the strategy; and
- more detailed analysis of specific risks. For complex and major risks, special modelling might be required – for example, the impact of foreign exchange rate fluctuations on an investment in a manufacturing plant that imports and exports components, or the impact of changes in fuel prices and demand on the prices for power enjoyed by a new gas-fired power station.

> 'While the numbers can be vital for prioritising which risks to worry about and their potential impact, don't assume that they convey the full picture'

One of the challenges in evaluating strategies is how to measure risk. As finance professionals you will be fully familiar with how to generate numbers that measure the financial returns of an option and evaluate its risks. However, while the numbers can be vital for prioritising which risks to worry about and their potential impact, don't assume that they convey the full picture.

Bringing it all together

Once you have assessed the options on these three types of criteria it is time to sit back and make the decision. One effective discipline, when weighing the pros and cons surrounding different options, is to create a simple table of the most attractive options arrayed against the most important strategic, implementation and risk/return criteria. Not only is this a useful check on your logic, it provides a great basis for discussion. Figure 1 (below) illustrates this – showing three options for an airline ranked against some of the most important criteria (in this case with a bias towards the strategic criteria).

While it is true that strategic decisions are typically helped by the development of some well-grounded facts and numbers, it is also true that options are rarely successfully selected on the basis of these alone. There are likely to be some issues which cannot be quantified in the mechanical risk/return analysis. Taking the approach suggested can help bring appropriate structure and breadth to even the most complex, messy strategic decision.

Don't miss our forthcoming feature on segmentation in business strategy formulation, due to be published in the September issue of *Finance & Management*.

Figure 1 GLOBAL ORGANISATION OPTIONS – AIRLINE

OPTION / CRITERIA	**Drop all non-profitable routes**	**Defend European routes**	**Grow intercontinental routes**
Size	Low	Low	Moderate
Growth	Low	Moderate	High
Segment profitability	Moderate	Low	High
Competitive advantage	High	Low	Moderate
Feasibility	High	Moderate	Moderate
Return	Moderate	Low	Moderate
Risk	Low	Moderate	Moderate
Conclusion	Safe but limited growth potential	Avoid due to low competitiveness	Attractive growth option