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Formulating & Evaluating Strategy

Part 2

Chartered Accountancy
Strategic Level

Strategic Management & Leadership (SML)

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STRATEGIC MANAGEMENT

&

LEADERSHIP

CA - STRATEGIC LEVEL

Formulating & Evaluating Strategy (02)

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Formulating & Evaluating Strategy – (10%)

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INTRODUCTION

This chapter covers the broad areas of identifying alternative strategies and making strategic choices, and the evaluation of strategies. It also introduces the topic of game theory as a possible approach to strategy selection taking competitive strategy into consideration.

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1.0 Product – Market Strategy

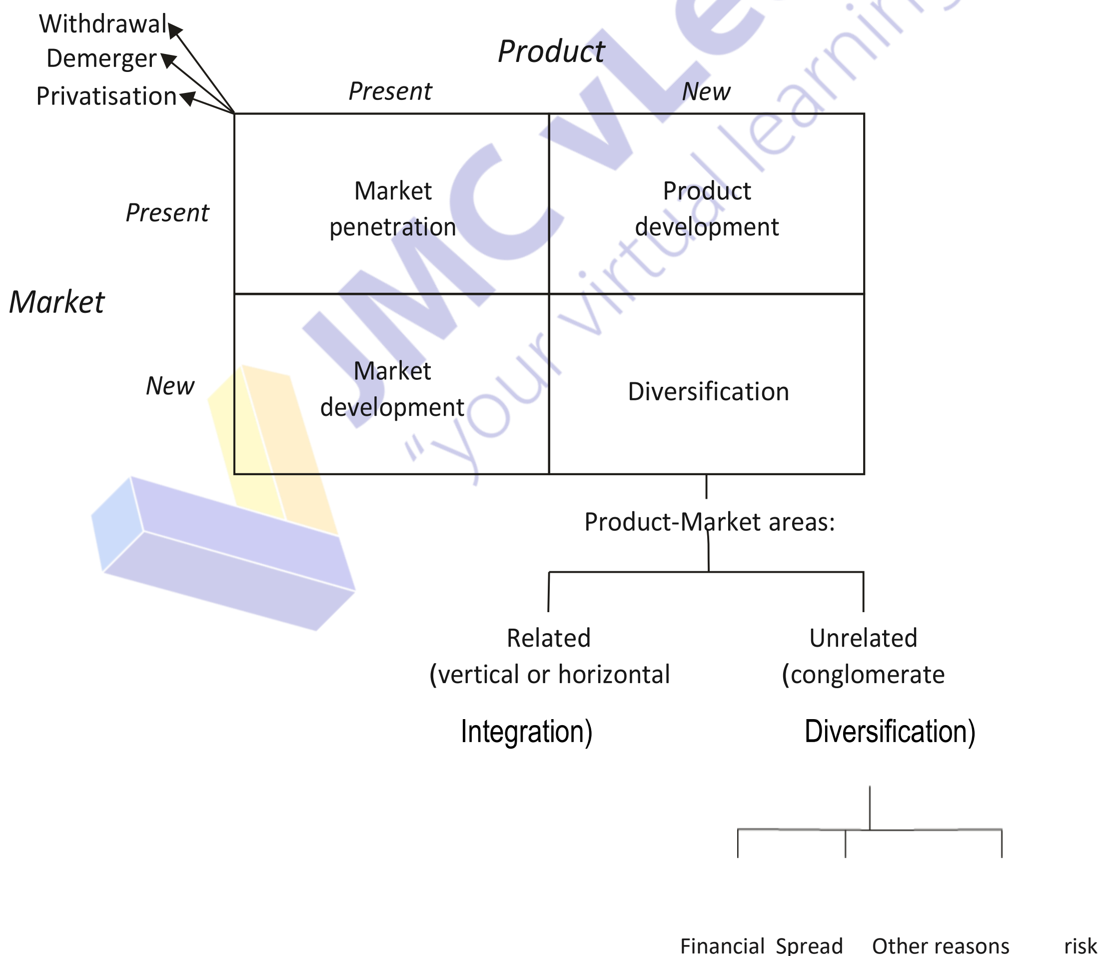
Product-market strategies involve determining which products should be sold in which markets, by market penetration, market development, product development and diversification. Diversification is assumed to be risky, especially diversification that is entirely unrelated to current products and markets.

1.1 Importance of Market Share

There is a definite, observable correlation between market share and return on investment. This is probably the result of lower costs resulting from economies of scale. Economies of scale due to increasing market share are particularly evident in purchasing and the utilization of non-current assets.

1.2 Product – Market Mix

Ansoff (1987) drew up a growth vector matrix, describing how a combination of a firm's activities in current and new markets, with existing and new products can lead to growth. Ansoff's (1987) original model was a four cell matrix based on product and market, shown as the heart of the diagram below. Lynch (2006) has produced an enhanced model that he calls the market options matrix. This adds the external options shown in the diagram.



Integration) Diversification)

Financial Spread Other reasons risk

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Market Penetration

Product Development

Market Development

Diversification

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Product & Market Diversification

Johnson et al (2005) suggest three reasons why diversification may be advantageous.

1. **Economies of scope** (as opposed to economies of scale) may result from the **greater use of under-utilized resources**. These benefits are often referred to as **synergy** and can take several forms:

Marketing Synergy	
Operating Synergy	
Investment Synergy	
Management Synergy	

2. **Corporate management skills** may be extendible across a range of unrelated businesses. In a way this is also a kind of synergy, in which the corporate parent represents the resource that can be more intensively utilized.

3. Diversification can increase **market power** via cross-subsidization. A high margin business can subsidize a low margin one, enabling it to create a price advantage over its rivals and building market share.

Johnson et al (2005) also discuss **three questionable reasons** that may be advanced to justify a policy of diversification.

1. **Response to environmental change** can be justified as a reason to diversify if it is undertaken in order to protect existing shareholder value by, for example, responding to the emergence of new and threatening technology developments.

2. **Risk spreading** can be a valid reason for an owner-managed business to diversify.

3. The **expectations of powerful stakeholders** can lead to inappropriate strategies generally.

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Related Diversification

(a) Horizontal Integration

(b) Vertical Integration

(b.1) Backward Vertical Integration

(b.2) Forward Vertical Integration

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Advantages of vertical integration

- A **secure supply of components** or **materials,** hence lower supplier bargaining power
- **Stronger relationships** with the final consumer of the product
- A share of the **profits** at all stages of the value network
- More effective pursuit of a **differentiation strategy**
- Creation of **barriers to entry**

Disadvantages of vertical integration

(a) **Overconcentration.**

(b) The firm **fails to benefit from any economies of scale or technical advances** in the industry.

Unrelated Diversification (Conglomerate Diversification)

Potential advantages of conglomerate diversification

(a) **Risk-spreading.** Entering new products into new markets can compensate for the failure of current products and markets.

(b) **Improved profit opportunities**. An improvement of the **overall profitability and flexibility** of the firm may arise through acquisition in industries with better prospects than those of the acquiring firms.

(c) **Escape** from a declining market.

(d) **Use a company's image and reputation** in one market to develop into another where corporate image and reputation could be vital ingredients for success.

Potential disadvantages of conglomerate diversification

(a) The **dilution of shareholders' earnings** if diversification is into growth industries with high P/E ratios.

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(b) **Lack of a common identity and purpose** in a conglomerate organisation. A conglomerate will only be successful if it has a high quality of management and financial ability at central headquarters, where the diverse operations are brought together.

(c) **Failure in one of the businesses will drag down the rest**, as it will eat up resources.

(d) **Lack of management experience in diverse business areas**. Japanese steel companies have diversified into areas completely unrelated to steel such as personal computers, with limited success.

2.0 Competitive Strategies Based on Market Position

In developing alternative strategies for separate businesses (or product categories) within the organization, the strategist needs to pay explicit attention to a variety of factors, including:

- the organization's objectives and resources
- managerial attitudes to risk
- the structure of the market
- competitors' strategies and, very importantly,
- the position of each business or product category within its market.

Accordingly, organisations attempt to develop separate competitive strategies based on the market positions of each of its respective businesses. These businesses can be categorized in four ways with respect to their market positions:

Market leader

In the majority of industries there is one firm that is generally recognized to be the leader. It typically has the largest market share.

Market challenger

A market challenger is a current non-market leader which is actively trying to move up within its industry. Market challengers therefore hold smaller market share than the market leader, and develop competitive strategies to attract more customers.

Market followers

Market followers are smaller firms which are maintaining lower levels of market share than the leader or its challengers. They may adopt a less aggressive stance in order to maintain the status quo.

Market Nichers

Virtually every industry has a series of small firms that survive, and indeed often prosper, by choosing to specialize in the parts of the market that are too limited in size and potential to be of real interest to larger firms.

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Accordingly Wilson and Gilligan suggested some strategic alternatives for market leaders, market challengers and market followers separately.

Defensive Strategies for Market Leaders

- To expand the total market for their product by binding new users, creating new uses, and encouraging more usage
- To protect its current market share by adopting defensive strategies
- To increase its market share and profitability

Defensive Strategies for Market Challengers

- Attack the market leader
- Attack other firms of the same size
- Attack smaller firms

Strategies for Market Followers

- **Counterfeiter** (which is illegal) – the counterfeiter duplicates the leader's product and packaging and sells it on the black market or through disreputable dealers.

- **Cloner** – the cloner imitates leaders' products, name and packaging, with slight variations.

- **Imitator** – the imitator copies some attributes of the leader's offering to the market, but maintains differentiation in terms of packaging, advertising, pricing, or location. The leader does not mind the imitator as long as the imitator does not aggressively attack the leader.

- **Adapter** – the adapter takes the leader's products and adapts or improves them. The adapter may choose to sell in different markets, but often the adapter grows into being the future challenger, as many Japanese firms have done after adapting and improving products developed elsewhere by market leaders.

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3.0 Strategic Behaviour & Competitive Markets : Game Theory

The key challenge faced by the organizations in selecting a business strategy is that the competitor behavior and reaction cannot be pitched with a 100% accuracy. What really happens is either the future competitor behavior is predicted or is ignored.
In real business, based on the strategic moves made by the organizations competitors tend to change their own way forwards.

"Game Theory" can be used when making a choice between alternative strategies by the organization while trying to establish what competitors might probably do in response. Simply Game Theory is the approach to the study of optimal decisions by taking in to the account of competitors who are also in the game.

Dominant & Dominated Strategies

Dominant Strategy

Dominated Strategy

"Intransitivity" occurs when one strategy seems to be better or worse for an organization depending on the strategies selected by competitors.

Under the assumption that there are only two strategic alternatives available for the company (Strategy A / Strategy B) and if only one competitor is available in the market, the outcome of the analysis of Game Theory can be as follows;

Strategy B dominates Strategy A	
Strategy B strictly dominates strategy A	
Strategy B weakly dominates strategy A	

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Strategy A & Strategy B are intransitive	
Strategy B is dominated by strategy A	

Nash Equilibrium

4.0 Evaluation & Recommendation of strategies for SBU's

Out of all possible strategic alternatives available for the business, a strategic business call to be taken with regards to evaluation of those alternatives, selection and implementation.
Strategy evaluation should primarily take in to account the;

1.0 Business Objectives

2.0 Business Risk

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Accordingly following two approaches can be used;

- McKinsey's 7 S Model
- Assessment of Suitability, Acceptability & Feasibility (SAF Analysis)

McKinsey's 7S Model

There are seven interrelated elements that should all be considered when planning for major changes. This model represents the organization as a set of interconnected and interdependent sub systems where some of these elements are quantifiable and easily defines (Hard Elements) where as some of these elements are more subjective and less likely to be defined (Soft Elements).

Hard Elements

Structure	
Strategy	
Systems	

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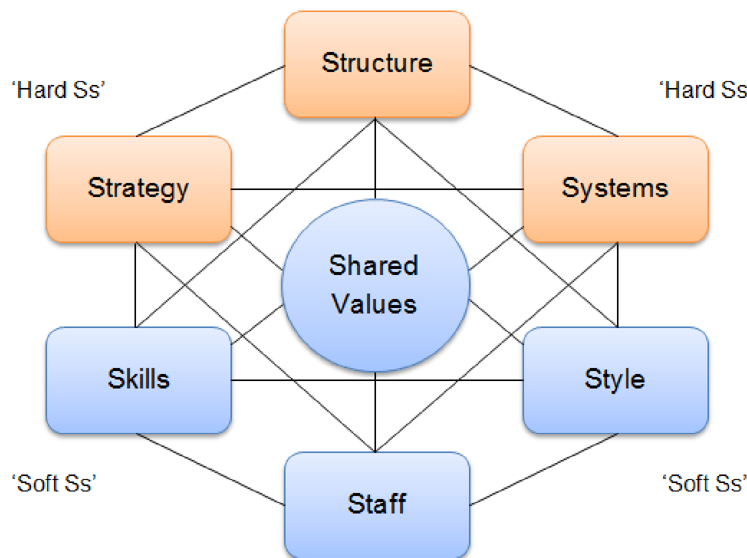
Soft Elements

Staff	
Skills	
Style	

Shared Values	



5.0 Suitability, Acceptability, Feasibility (SAF Study)

All proposed strategies can be assessed according to three factors;

1. Suitability
2. Acceptability
3. Feasibility

Suitability

Acceptability

Feasibility