Part I

Getting Started
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The Critical Path—the Meaning of “Dynamics”

Key issues
- Clarifying the issue of “dynamics”—explaining the time-path of strategic performance
- Strategic resources drive performance
- Existing understanding of what determines “performance”

It is important, before setting out to tackle the issues of strategy dynamics, to give some clarity to the critical questions raised in the Preface, namely:

- Why has the historical performance of my business followed the time-path that it has?
- Where will the path of future performance take us if we carry on as we are?
- How can we alter that future for the better?

The first question may not be relevant in every case—a new venture start-up has no history. However, for most firms, their strategic history is highly relevant to the likely trajectory of future performance, at least in the short to medium term. To see why all three questions may be important, and what exactly we mean by each, consider the following three situations, all simplified from real cases:

- **Case A**—A leading retail bank faces the challenge of rationalizing its branch network in the face of customer losses and declining transaction volumes. Like traditional branch-network banks in many countries, this firm is losing business to new banking services offered through the Internet, telephone, and post.
- **Case B**—A pharmaceuticals supplier faces an attack on its major product market by the dominant rival, who is about to launch a near-identical product. The General Manager of this $300m business unit, appointed in early April 1997, was greeted with the news that he had just four weeks to prepare for this competitive onslaught.
- **Case C**—The BBC has one of the best libraries of high-quality TV programming in the world, and wishes to build a strong market for this material.
among cable broadcasters in South America. The programming has been built up over many years, and is known to be popular with high-value viewer segments in many countries. This is attractive to cable companies as it stimulates strong advertising revenues.

All three situations raise deep concerns for the management teams involved: What are the prospects for their firm under current policies, what can they do to improve those prospects, and what lessons and resources can be brought to bear on the problem from their past experience? But the three examples also illustrate why robust tools for understanding and directing the dynamics of competitive strategy are so desperately needed.

In each case, there is a substantial scale of problem or opportunity to be addressed, and the difference between success and failure is considerable. The bank will lose hundreds of thousands of customers and tens of millions of Euros in revenue. The new executive heading the pharmaceuticals business faced losing the majority of his revenues and profits, and with these his market reputation and the commitment of a highly motivated salesforce. If this were to happen, the rest of his business would face collapse. The opportunity facing the BBC is extremely valuable, not only in South America but in burgeoning broadcasting markets throughout the world. Getting this early initiative right will build its confidence and credibility as it seeks to take more such opportunities.

In each case, there is also a timescale over which the strategic issue will evolve, and achieving sufficient speed of progress is vital. The pharmaceuticals firm will win or lose its battle over a few weeks, and the BBC has little time to establish a successful platform for its future in international markets. Even though the bank expects its core business to contract over some 4–5 years, its immediate decisions on branch closures, development of alternative channels and staff redeployment will all have substantial consequences over that timescale.

Finally, each case exhibits a time-path of progress—the firm’s situation will not just start and end at specific points, but evolve at a varying rate as its future unfolds:

- The bank may at first lose few customers, then suffer increasingly rapid losses as its branches are closed and attractive new types of service become available. If it closes branches too slowly, it will be left with un-competitive cost levels. If it closes branches too fast (as it may already have started doing), it will bring about the very problem that is driving it to rationalize in the first place. Similar tricky judgments have to be made about transferring, and reskilling staff, while sustaining adequate, but not excessive service support in the remaining branches.
- The pharmaceuticals firm can expect the rival’s salesforce to target the best customers first and to attack very fast, following which there may be a slower rate of attrition as they find later customers more difficult to capture and have to accept increasingly unattractive business. It will have to choose carefully whether to react on price, and if so by how much and when, and whether to undertake marketing efforts to head off the rival’s attempt to build interest in the new product. Again, when to act, how, and how much
are difficult questions that continue throughout what will be a painful strategic episode.

- The BBC will want to see a positive initial uptake of its high-quality programming, but will soon need to consolidate its growth to avoid a boom-and-bust. If it pushes out its high-quality content too fast, it will win considerable interest from audiences, and enthusiastic support from cable channels and their advertizers. However, it will also raise expectations at the same time as depleting the very resource that is driving the opportunity, so may put itself in a position of having driven up activity to a rate that it cannot sustain. On the other hand, if it is too cautious in releasing content onto the market, audiences, broadcasters, and advertizers may not take sufficient notice to develop continuing demand. In addition, the window of opportunity will be left open for rival program suppliers to take a strong position, leaving the BBC squeezed out.

These verbal descriptions of the strategic issues confronting these firms are succinct and nicely focused on the heart of the issue, whether a problem or opportunity. However, since we are concerned with the scale and timing of performance, they are not enough—we must express them numerically and dynamically if we are truly to understand them and steer performance into the future.

The challenge facing the bank is depicted in Figure 1.1, which illustrates three critical characteristics of a well-defined dynamic issue:

- a clear numerical scale (customers);
- a timescale over which the dynamic is expected to play out (12 years, from 1999); and
- the time-path (how far and how fast the situation changes over that timescale).

This is a highly simplified summary of the key numbers. For example, it ignores the important issue of the size of customer accounts lost or retained (there is a world of difference between losing a profitable business account and a low-income consumer). Nevertheless, it provides a focus for the problem, and additional considerations can be added at a later stage. The chart also avoids some common problems in management debate about strategic performance. It focuses on the critical resource at stake—customers—rather than on indirect financial
implications (e.g., revenues or profitability). It also focuses on the absolute numbers, rather than ratios like market share. This is important, since the firm’s responses will act upon the resource itself (customers again), not on some derived arithmetical ratio.

This retail bank case also illustrates why it can be vital to understand the time-path of history—firms frequently have inside or around them the conditions that are already driving their trajectory into the future. The branch rationalization has already caused many customers to desert—even many loyal account-holders who had been with this bank, often with a single branch, for decades. Even if the firm immediately ceases its branch closures, customer losses will continue, driven not only by competitors’ new offerings, but by decisions that the bank took some time ago.

It is important to appreciate that such time-paths as Figure 1.1 are not forecasts, and there is little to be gained by devoting analytical effort to getting them “right”. Rather, they are an expression of what might emerge. They come from careful and open debate among the management team, informed by whatever experience they can draw upon—examples from other countries or other industries, consideration of which customers might migrate and how fast, and so on. The two time-paths shown also signal an important idea—that an unattractive future might turn into disaster if the firm doesn’t respond well, and that a better response may make a significant but realistic improvement to that future.

The time-chart description for the pharmaceuticals firm’s rival is shown in Figure 1.2. Once again, both the preferred and feared outcomes are shown. If the new general manager does not react quickly and correctly, the competitor could build up a sales volume and installed base that will create further advantages for them to use against him in future. Note, by the way, that this issue plays out over just a few weeks—no five-year plans here, and no conceptual debate about “Vision” or process! This executive must make the right decisions about the scale and timing of his marketing efforts, salesforce bonus scheme, pricing, and so on. And he must make them quickly against a rapidly evolving situation.

We will not get into semantic debate about the meaning of “Strategy”, but adopt a simple position—strategy is the set of policies that an organization

![Figure 1.2 Rival’s attack on the leading position of a pharmaceuticals supplier.](image-url)
adopts in pursuit of medium to long-term performance objectives (whether those policies are explicit or implicit), and an issue is strategic if it has a significant impact on that likely performance. On this criterion, the pharmaceuticals incident is most certainly of strategic importance. This division provides a substantial share of the corporation’s cash flows, and this one product makes up a substantial share of that contribution. Loss of even a small piece of this market not only impacts those cash flows but threatens the morale and performance of the salesforce, not just on this product but on others in the division. The potential gains to the competitor will enhance its cash flows and salesforce performance, and boost its reputation in the sector, all of which will enable it to build further products, sales, and cash flows. This one event could, in fact, reduce the division’s contribution to shareholder value by over a half.

The BBC’s initiative in South America is illustrated in Figure 1.3. Note again the three critical features—a well-specified scale for the strategic issue (programming content sales), a timescale for the dynamic to play out (4 years), and the time-path (again, both preferred and feared outcomes are shown).

Establishing such a clear specification of the dynamic issue may appear simple, and it is tempting quickly to sketch out a chart that appears to fulfill the need. However, it is rarely so simple in practice. Often, even the history is poorly documented, in which case it is important to collect and test managers’ best recollections of what has happened. This initial step deserves the efforts of the top team and a wide-ranging and open discussion of alternative views.

Strategic resources and performance

So, now that the nature, scale, and time-path of the threat or opportunity is clearly described, what explanations might exist for the eventual outcome, and what might we be able to do to alter it for the better? Industry analysis has traditionally been a popular tool for developing strategy, but it will not help much to address the critical challenges in any of these cases.
The limited relevance of industry conditions to the bank has already been noted, and the disaster waiting to happen in this case will result from internal errors of judgment about the pace of branch closure, product offerings, and service levels offered to remaining customers.

The pharmaceuticals firm will lose customers—the rival already exists, so barriers to entry are irrelevant. We could perhaps use game theory and consider retaliatory options that may be feasible. But this will tell us little about the scale or speed of attrition we will face or how to affect the speed of that process. The rival is going to have to market its competing product, motivate its salesforce, and ensure reliable supply and customer support. It is the time-path of this process that must be understood if there is to be any chance of influencing the future.

The BBC, too, will learn little from industry analysis. The customers and cable channels already exist and are continuing to develop. The BBC itself is already involved and may wish to erect barriers to entry against new rivals, but, in practice, competitors can easily make the same thrust, and the end-market and broadcasting channels for reaching it are already understood and available to many firms. Assessing the drivers of cost and value in the industry may help somewhat, and certainly gives a clear picture of break-even revenues and economies of scale that may help determine the company’s pricing flexibility. But this is going to help little to explain the time-path in Figure 1.2. Typically, such considerations would focus around questions like: “How many hours of programming do we think we could sell at a price of $x if rivals’ prices are $y?” But this question already makes many assumptions; for example, that awareness of the BBC brand is high, that its reputation among potential viewers is strong, and that cable channels are both taking the programming and managing well its place in the broadcast schedule.

These discussions of the three mini-cases hint at a possible start-point for attacking the problem—a consideration of the strategic resources involved, either for the firm itself or for its rivals. Table 1.1 lists some of the resources relevant to each case.

Note that the lists in Table 1.1, as well as including many simple, tangible items (staff, customers, capacity) also feature several intangible factors—items that are tricky to define, let alone measure or touch. Such “soft” issues often arouse

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<td>Branch network</td>
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skepticism among those devoted to fact-based analysis, but managers know that their product’s functionality, their service reputation, investor support, and staff morale make a substantial difference to performance. So, to dismiss these items as unobservable and unmanageable is unhelpful. Furthermore, firms increasingly take the trouble to research and track exactly such soft issues, so the second criticism—that even if they matter, they are not practically observable—is also inaccurate.

We’ll get into a deeper consideration of strategic resources shortly, but, first, we need to clarify the very direct link between these items and firm performance. This link has long been clear to strategy writers, but if we are not careful, it risks becoming a somewhat banal observation. Given that we know what resources the firm has right now, our accountants can tell us the firm’s performance with almost total precision. Indeed, they have performed exactly that task for hundreds of years! This direct link between firm resources and profitability is illustrated in Figure 1.4.

But here’s a puzzle. This simple picture explains firm performance precisely, even though it includes only a few of the resources, mostly tangible, discussed thus far. We know that intangibles are important, but they don’t appear to be needed. Indeed, we don’t need anything else at all. This implies that attempts to correlate firm performance at a moment in time with any other observations is pointless—you can’t improve on a complete explanation!

The solution to this puzzle lies in the fact that this is merely a snapshot at a moment in time. Sure, these few tangible resources today explain precisely our profitability today. Similarly, the state of those same items tomorrow will explain
precisely our profitability at that time too. But what we cannot yet do is explain how those resources get to change from today’s level to tomorrow’s (Figure 1.5). That explanation lies at the heart of the framework for strategic performance that follows in later chapters.

**Doing it right!**

“Word-and-arrow” diagrams like Figure 1.4 feature widely in contemporary management writing, but the items and connections used convey a wide variety of meanings. In contrast, each element in the figures in this book has a specific meaning. The boxes simply denote resources, which will be defined more precisely in the next chapter. The curved arrows do not mean merely that there is some vague relationship between two items, they state that one item can be immediately calculated or estimated from another, just like a formula in a spreadsheet cell.

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The problem of valuing businesses and their strategies

The valuation of firms starts from understanding the motives of investors, who are primarily interested in the likely future stream of earnings. Strictly, the best
indicator is free cash flow—the cash that will be generated, after reinvesting what is needed to deliver that growth. Current free cash flow, therefore, is:

\[
\text{Operating income} + \text{Depreciation} - \text{Tax payments} + \text{Non-operating income} - \text{Net investment in current assets} - \text{Net investments in fixed assets}
\]

Since we will devote our attention throughout this book to the time-path of cash flows, newcomers to the issue are well advised to familiarize themselves with the essentials of valuation. Copeland et al. (2000) is one example of many sound texts, the early chapters of which provide an accessible introduction to the topic. The principles of valuation have been further extended to provide the foundation for “value based management”—a means for setting performance and rewarding managers and other staff (Martin and Petty, 2000). Note that the purely financial view implied by this approach to valuing firms can be entirely consistent with other objectives, and with concerns for wider issues like social responsibility. Later chapters will make clear that lack of respect for such interests will likely lead to losses of key resources, notably staff and customers, which ultimately damage long-term sales and earnings.

Having computed today’s free cash flow, valuation requires a forecast of future free cash flows. These will be discounted by the firm’s cost of capital, to arrive at a value for the firm. This task is typically built on some variation of the following approach (Martin and Petty [2000, chapter 4]; Copeland et al. [2000, chapter 11]):

- estimate growth in sales turnover;
- project operating profit margins (operating profit divided by sales);
- forecast the ratio of operating assets to sales (net working capital, and fixed assets divided by sales);
- project the rate of tax;

... from which the free cash flow calculation is repeated for each year of the forecast period.

But this forecast is precisely the step where financial evaluations typically lose connection with the firm’s strategy. These ratios and projections are made on the basis of estimating the impact of competitive conditions the firm will face, and efficiencies that management can be expected to make in its operating ratios. These forecasts, in turn, are developed by estimating future market size, market share, prices, staffing, wage rates, inventory, and so on.

The problem is that, while we have detailed and rigorous analytical methods for computing value from estimates of future free cash flows, the firm’s cost of capital, and the resulting shareholder value, this model is then populated with
highly speculative estimates for sales, costs, and margins. The exactitude of the value calculation thus becomes largely spurious.

Industry factors and firm performance

Analysis of industry-level competitive conditions has dominated fact-based efforts to understand and forecast firm performance for the last 20 years. This dominance arises from the centrality of the Structure–Conduct–Performance paradigm (SCP) within industrial economics (Figure 1.6). This view asserts that managerial conduct of firm strategy (entry, differentiation, pricing, etc.) is heavily constrained by industry conditions, and therefore limits any firm’s ability to perform significantly differently than the average for its sector. The industry conditions in question relate largely to the barriers that obstruct firms who wish to enter or leave the industry, or switch between rival suppliers and substitute products. These barriers may be financial (e.g., the cost of constructing capacity, gaining market access, developing competitive products) or strategic (fear of retaliation by rivals, customers’ reluctance to switch from trusted suppliers).

The implications of the SCP view for strategic management are somewhat depressing. If industry conditions dominate your likely performance, then all you can do is pick an “attractive industry” and your destiny is determined, at least as regards profitability. There is no further role for management. This view is supported by the fact that firms fail to outperform the industry average for any sustained time—excess profitability gets competed away.

However, two observations provide more optimism that management does have a role to play in determining the strategic performance of their firms. First, the strategy field itself acknowledges that industry conditions are a poor predictor of performance. McGahan and Porter (1997), responding to analysis by Rumelt (1991) that suggested that industry conditions only explained 15% of the variance in profitability among a large sample of firms, discovered that this was
indeed an underestimate (Figure 1.7)—they could account for 19% of profitability variance by industry conditions! This analysis offers three observations:

- industry factors provide a desperately poor explanation for business performance;
- management does, indeed, matter—since business unit factors and corporate parent effects both cover issues under managerial control;
- taken together, these factors still give us a pretty poor understanding, overall, of why some firms are more profitable than others.

Furthermore, the failure of firms sustainably to outperform their industry does not prove that industry conditions dominate. These conditions are not the only factors that change through time—management changes too—so it is likely that business unit factors also feature in the failure of firms to sustain an advantage.

The second reason to be more optimistic about the opportunity for strategic management to make a difference is the wide variance that exists among the performances achieved by firms within any given sector. Firms differ widely in both the revenue growth and return on capital that they achieve. Indeed, such differences must exist if underperformers are to drag themselves up from the bottom and leaders are to fall from their pinnacle, thereby causing the low rate of sustained outperformance noted above.

The failure of industry factors to explain firm performance calls into question the value of the SCP paradigm as a basis for identifying strategic opportunities or advising management on how best to take those opportunities. In fairness, developments of that view, which are beyond the scope of this book, have recognized the influence of management, not just in determining the firm’s own performance but also, thereby, changing the very industry conditions that were thought to dominate.
The key, for our purpose, is to recognize that the world is the way it is today because Bill Gates, Rupert Murdoch, Jack Welch, and a host of others have made it like this! All of us contribute in some degree, be it large or small, to shaping the future, and the challenge we will address is how to design that path for your enterprise to stand the best chance of bringing about your preferred future.

### Summary

The challenge and responsibility facing strategic managers is to understand and direct the time-path of performance for their enterprise (whether stated in terms of financial or other objectives). It is vital to understand that time-path, not just qualitatively but including the specifics of scale and timing as well.

Dynamic issues of strategic importance to the firm may consist of either opportunities to be exploited or damage to be limited. They may be largely driven by forces internal to the firm, or by rivalry and other external pressures. Many such challenges will concern the business at large, but others may be largely centered upon particular functions within the organization. The timescale over which the issue will play out may range from many years down to just a few weeks or months in especially fast-moving sectors.

It has long been understood that current performance is a direct function of the strategic resources that the enterprise either owns or has reasonably reliable access to, at this moment in time. The same is true at all times in the past, and will be true in the future, so if the time-path of performance is to be understood and managed, the management team needs the means to understand how resource levels change through time and how that process can be controlled.