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Maximizing Corporate Value

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To Paula

for her patience and support in this
and all my endeavors

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I want to express my gratitude to my father, who instilled in me early in life a love and respect for the power and irrefutability of mathematics. I would also like to thank all the coeds with whom I came in contact in college, who convinced me that there were better ways to spend four years than doing engineering homework and that one could enjoy both math and campus life simultaneously. I would like to thank my father again. As manager of the pension fund for one of the big three auto makers for many years, he convinced me that intrinsic company value has little to do with the nuances of market timing or subtle accounting techniques and tricks. Rather, it is the soundness and logic of the organization's business model and the intelligence, experience, and honesty of its management that determines corporate wealth over the long term.

Next, I would like to thank all my clients over the last several decades, who have so willingly and openly embraced the concepts contained herein, especially those whose outspoken comments and suggestions have resulted in a continuing evolution of the framework process into the powerful tool it is today. A special thanks goes to the privately held and not-for-profit clients, whose naturally long-term perspective allowed for many faithful framework executions and implementations without concern for and the distractions of reporting quarterly earnings to the public.

Any list of those to whom a debt of gratitude is owed would not be complete without expressing appreciation to the many software writers and companies who, over the years, have made the use of computer spreadsheets and other analytical tools so simple, complete, and foolproof. These programs allow employees not only to understand and contribute to the maximization of the organization's value, but also to apply easily the same principles to their family situations and to increase their personal wealth and happiness.

Creating the framework is only part of any organization's success story. Making it a reality requires the work of many. Therefore, I wish to thank the many associates, first encountered in my early days at The Wharton School of Finance and Commerce and Booz, Allen and Hamilton. Over the years, their expertise in market research, information technology, executive compensation and recruiting, quality circles, corporation finance, and other areas in which clients have had to seek external assistance in order to execute properly and effectively their framework to obtain corporate value enhancement has been invaluable.

In summary, I would like to thank all the people who helped create this book. I owe a great deal to my family for their support and to all the staff at John Wiley & Sons, especially my editor, Sheck Cho, whose encouragement and patience throughout the process kept the flame alive, and Sujin Hong, whose attention to detail ensured the quality of the final product. The many practitioners of management and finance who over the years so willingly share their findings and techniques should not be forgotten. However, any shortcomings are mine alone.

Finally, I would like to thank, in advance, those of you gracious readers who take the time to contact me with your comments and suggestions after you apply the framework I have provided in this book. I can be reached at georgenorton@cs.com.

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preface

This book is the result of years of experience in assisting middle-market manufacturing and service entities, as well as various not-for-profit organizations, in refining and applying top-management strategy and valuation techniques used by large corporations. Accordingly, it should be of interest to officers, directors, and managers or advisors to all types of organizations. It is especially relevant for people dealing with closely-held firms, autonomous divisions or subsidiaries of publicly-traded companies, county and local governments, and schools and universities as well as other medium-sized entities.

This book shows how, by understanding and using a few, simple concepts, the leaders and members of any type of organization can enhance their daily and long-term satisfaction and that of their key stakeholders while simultaneously reaping substantial financial rewards. It is a "hands on" guide to incorporating sound strategic and valuation principles into decision making throughout the organization. It allows leaders and advisors to create a culture in which people work to achieve their potential and that of the organization by simultaneously improving the well-being of all who come in contact with and have an impact on the organization.

The book is divided into seven chapters. Each chapter explains what to do, why to do it, and how. Examples using the ABC Company facilitate the reader's ability to translate the techniques discussed to unique, real-world situations. In order to maximize the book's usefulness, the organization's leader should put together a management team that can work together throughout the seven major steps presented.

The first three chapters focus on the organization's history, worth, and environment. The management team arrives at a consensus on the organization's current condition and its potential. Chapter 1 focuses on conducting a strategic audit. The exercises enable the participants to develop an understanding of the implicit strategies that have taken the organization to the place where it is today. Chapter 2 presents a methodology to calculate the current value of the organization. The valuation variables involved require five years of financial statements. However, younger or start-up organizations can develop estimates for the variables and also calculate a current value. Chapter 3 helps the management team characterize the organization's strategic landscape. It reviews the fundamentals of planning and conducting research. It introduces the concept of stakeholders as all those various groups that have a current or potential impact on the future of the organization. In addition, it presents exercises aimed at highlighting the key factors for and barriers to the organization's long-term success.

The next three chapters introduce the concept of a strategic framework and how to use it to develop a foundation for future action. Chapter 4 discusses the importance and relevance of a strategic framework. It introduces and defines the major elements of the framework and helps cre-

ate a common language the management team can use throughout the remaining steps. It presents exercises and techniques that enable an organization to define its vision, values, goals, and niches which, in turn, provide a solid foundation for the rest of the steps. Chapter 5 involves the creation of specific objectives and strategies that, when taken collectively, more completely define the organization's vision and long-term goals. It reviews the basic principles of strategy formulation and provides checklists to assist in the process. Chapter 6 discusses techniques to quantify the economic impact on the organization of pursuing various alternative strategies. When followed, these techniques allow for the selection of those strategies better suited to enhancing the organization's overall value.

The last chapter is an action-oriented one. Chapter 7 gets into the specifics of executing the selected strategies. Useful forms and checklists are presented which enable the organization to coordinate implementation of widespread action plans across various elements of the framework. It also addresses methods to deal with changes in the organization and its environment that will inevitably occur over time.

After completing the seven major steps (each represented by a chapter), the organization will have a shared set of values and purposes and a common language to use in discussing future plans. More importantly, it will have an overall sense of urgency to achieve key objectives and take specific actions to change the culture so that each and every employee is focused on cash flow optimization.

CHAPTER 1

Conduct Strategic Audit

If you don't know where you've been, then it's hard to figure out where you are. If you don't know where you are, how can you decide where you want to go? If you don't know where you're going, any road will get you there.

There is great value in reviewing the road your organization has traveled to get it to the place it is today. An understanding of its historical functional emphasis (i.e., marketing, sales, production, finance, or research) helps paint a picture of the expertise resident in its people and systems. An organization achieves higher levels of success more quickly if it focuses on building on its strengths. A clear picture of how your organization's resources have been allocated over the years enables you to see where assets (people, capital, facilities, and equipment) have been deployed. By reviewing the returns associated with these investments, you will be able to make financial decisions with inherently more confidence and a higher expectation of superior results.

Accordingly, the process of identifying where you've been is both a qualitative and quantitative process. The strategic audit encompasses both of these aspects and will assist you in reviewing your organization's past performance. This multistage process results in a strong conceptual understanding of

the strategic building blocks at your disposal and is the first step toward setting sound business goals and maximizing your organization's strategic value in the future.

It is important to remember that it is impossible for the organization's leader to know all aspects of the organization as well as those who deal with them on a daily basis. Accordingly, the most effective way to utilize the material presented in this and the following chapters is to involve all key members of the management team. An outside facilitator is generally retained to conduct the various exercises. However, it is not uncommon for the organization's leader to play this role or to assign another member of the management to do so.

HIGHLIGHT EXISTING STRENGTHS

It is best to start with a qualitative look at your organization. This involves identification of its key processes, historical focus, and environmental positioning. The understanding you develop will enhance your ability to make sense of the numbers when you begin the quantitative phase of the strategic audit. The three procedures used to highlight existing strengths require the involvement of all the key members of the management team.

Key Processes

Requirements You will need a large board on which to draw.

Methodology Diagram each activity in which your organization engages from the time the outside world first makes contact with it until a transaction (such as the delivery of a product or service) is complete. Change the diagram until the

team reaches agreement or a consensus that the activities shown represent the sum total of the value added by the organization during its normal course of business. Then combine and/or eliminate activities to create a diagram highlighting the critical few, key processes in which your organization engages. For an example of what this might look like, see Exhibit 1.1.

Result You have reached an understanding of the important activities your organization performs and all those who participated have a better understanding of the role they play in the overall success of the organization. You also now have a document that can be used to measure how effectively your management information system (manual or electronic) tracks the internal information needs of the organization as transactions flow from one key process to another during the course of a typical business day.

Historical Focus

Requirements You will need scratch paper to develop a questionnaire, blank paper on which to print and make copies of the questionnaire, and graph paper to display the results of the questionnaire.

Methodology—Preparation Select six or seven key areas in which you and your organization have spent a fair amount of time and resources over the last five years. Use the output from the ***Key Processes*** exercise to assist you in creating this list if desired. Write down two or three specific activities which have taken place on a more or less regular basis under each area, starting each with an action verb (e.g., *opening* new outlets, *achieving* low costs, *enhancing* sales training). For an example of what this might look like, see

EXHIBIT 1.1 Key Processes for ABC Company

Key Process	Related Activities/Areas
Create demand	Create and place magazine advertisements Maintain and update web page Distribute marketing brochures Design promotional programs
Process orders	Train and staff 800-number operators Maintain sales force electronic reporting system Coordinate invoicing and inventory control Use common carriers with best rates
Manufacture product	Test competitive products Alter designs as external environment dictates Maintain quality control system Perform required maintenance in a timely way
Maintain work force	Provide employee communication program Ensure benefits appropriate for local area Keep training programs frequent and fun Conduct employee entrance and exit interviews
Increase value	Require sound analysis for new investments Monitor profit contribution of all departments Maintain management information system Comply with tax and other regulatory statutes

Exhibit 1.2. Then arrange the activities in random order with a blank column on either side as a questionnaire as shown in Exhibit 1.3. You are now ready to work with your team.

EXHIBIT 1.2 Key Areas and Activities for ABC Company

Key Area	Specific Activities
Administration	Implementing management information systems
	Dealing with legal problems and solutions
Costs	Negotiating the terms of materials procurement
	Creating and installing cost-control programs
Customers	Ensuring fast project completion; meeting time demands
	Establishing long-term customer relationships
Growth	Opening new outlets and offices
	Developing and introducing new products and services
Employees	Selecting and training sales people, clerks, and engineers
	Sponsoring activities to improve employee motivation
Marketing	Engaging in advertising and promotion campaigns
	Recognizing customer needs; conducting market research
Production	Improving manufacturing processes and policies
	Maintaining and enhancing quality control procedures

Methodology—Team Exercise Pass out the questionnaire to the participants and have them fill it out according to the instructions. Then, one at a time going around the room, sum up the points by area.[1] Once the total points by area are calculated, create a bar graph where the points for the

EXHIBIT 1.3 Past Areas of Emphasis at ABC Company

Over the last five years we have spent time on a variety of activities as highlighted below. Your task now is to identify those in which we invested the most time and resources. That is:

- They were discussed most frequently and intensively in meetings.
- They absorbed the most management time.
- They were allocated most of our financial and manpower resources.

Step 1
In the left-hand column, mark the top five resource-using activities.

Step 2
In the right-hand column, rank *only* those subject areas marked in **Step 1** from most to least resource-using (assign five points to most, four points to second-most, three points to third-most, two points to fourth-most, and one point to fifth-most).

Remember: Select exactly five activities to rank, no more, no less.

Top Resource-Using Activities	Points
1. Implementing management information systems	
2. Dealing with legal problems and solutions	
3. Negotiating the terms of materials procurement	
4. Creating and installing cost-control programs	
5. Ensuring fast project completion; meeting time demands	
6. Establishing long-term customer relationships	
7. Opening new outlets and offices	
8. Developing and introducing new products and services	
9. Selecting and training sales people, clerks, and engineers	
10. Sponsoring activities to improve employee motivation	
11. Engaging in advertising and promotion campaigns	
12. Recognizing customer needs; conducting market research	
13. Improving manufacturing processes and policies	
14. Maintaining and enhancing quality control procedures	

highest scoring area become 100% and each other area's point total becomes a percent of this number (e.g., highest area = 60 points, next area = 45 points, third area = 30 points, so highest area = 60/60 = 100%, next area = 45/60 = 75%, third area = 30/60 = 50%). This graph is usually prepared using presentation software so it can be projected on a screen where the entire team can view the results.[2] For an example of what this might look like see Exhibit 1.4.

Result The resulting graph shows the relative emphasis placed on the key areas of the business, perhaps highlighting those that received too much attention and those that were overlooked much of the time. Not surprisingly, organizations started by engineers often have an undue focus on production

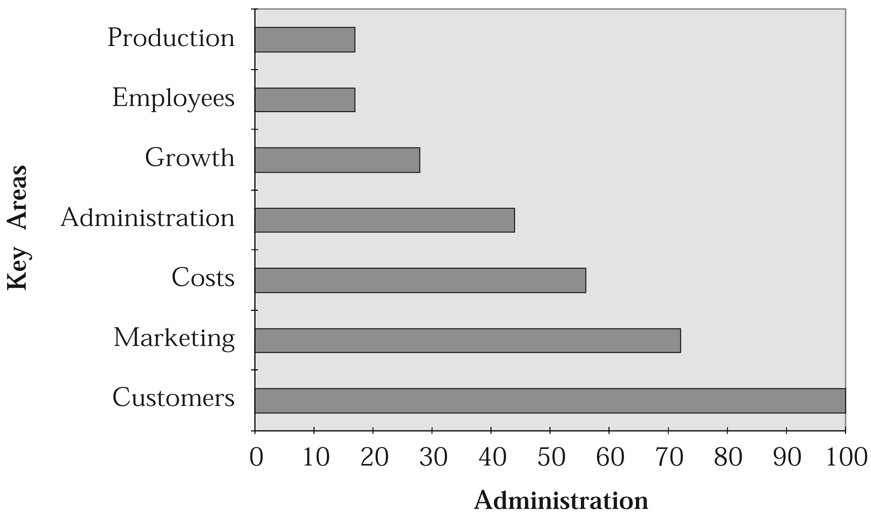

EXHIBIT 1.4 Historical Focus of ABC Company

and cost-cutting activities, while those started by sales people stress activities related to marketing and the customer. In Exhibit 1.4, for example, the founders were a strong sales person as Mr. Outside and a competent accountant as Mr. Inside, resulting in relatively little attention to employees, production, and growth. Regardless, what you have achieved is an unbiased consensus of how resources were allocated over the last five years, without actually performing any financial analysis.

Environmental Positioning

Requirements You will need one can of spray-on artist's adhesive, index cards of four different colors, felt-tipped pens, a package of stick-on red dots, and a blank wall covered with paper.

Methodology—Preparation Spray the paper on the wall completely with the artist's adhesive so that index cards can be placed on and taken off the paper effortlessly. Pass out index cards of each color to every participant.[3] Then pass out felt-tipped pens and ten red dots to each participant.

Methodology—Team Exercise Pick one card color each for strengths, weaknesses, opportunities, and threats. Ask each participant to keep the organization in mind as it exists today and write down on the appropriate color the most important or greatest strength, weakness, opportunity, and threat. Write down other important items in the same categories for each card they have, if they have more than one card. Next, all cards are placed on the paper on the wall grouped by color. After the group discards cards that represent duplication of

ideas, all participants place their ten red dots on the remaining card or cards that are most important to them.[4]

Result In less than one hour, a starting consensus is reached regarding how the organization is positioned in its environment and what strengths it can most readily explore building upon. It also has a pretty good sense for the major issues, challenges, and opportunities it faces in the years ahead.

With a solid qualitative understanding of the major processes, asset allocations, and strengths developed over the last five years in hand, you are now in a position to gain additional insight based on quantitative analyses. By performing some basic financial calculations, you can ascertain what the actual strategies have been over the last five years as well as measure your organization's growth and performance relative to other companies and industries. Often, the results of these efforts suggest that the actual performance of an organization is different from that espoused by its mission and/or leaders. Identifying such disconnects is the first step toward creating an organization capable of strategically adding value over the long term.

IDENTIFY IMPLICIT STRATEGIES

The simple definition of strategy, and the one used throughout the book, is "the allocation or withdrawal of resources." Each organization's resources are different, but they include the *time* of management, staff, and other employees; *tangible assets* such as the real estate and facilities the organization owns or leases and the equipment and tooling used in providing a product or

service; and *intangible items* such as proprietary systems, patents, trademarks and training programs. No organization has unlimited resources, although some tend to act like it in the short run. Accordingly, all resources should be considered precious and scarce.

In order to determine what your organization's implicit strategies in the past have been, you must examine how resources were allocated. Each organization is structured in a unique way, with various components comprising the whole. As a first step, then, you should select the natural parts of your organization for analysis. You will need to have financial records for the last five years that tell you year by year the net assets employed in each selected part of the organization and the related contribution. Net assets are simply total assets less noninterest bearing liabilities, while contribution is merely operating profit times one minus the tax rate (1 – tax rate). It is more important for now that the numbers be calculated the same way for each part rather than worrying about precise definitions for net assets or contribution.

For exemplary purposes, we will look at the past performance of the ABC Company in the two ways management typically thought about the organization:

1. By business unit
2. By geographical area

For ease of understanding we use three years of data. After isolating net assets and contribution by business segment, you then calculate the annual net asset growth rate and the average return on net assets for each segment. For

how this output might appear, see Exhibit 1.5. These results can then be graphed to demonstrate which segments were generating cash (resources) and which segments were using them up. This provides a pictorial representation of the implicit strategy. The ABC Company's implicit business unit strategy is shown in Exhibit 1.6, and its implicit geographical area strategy is shown in Exhibit 1.7.

If you examine ABC Company's implicit business unit strategy you can see that Unit C clearly has the highest returns, yet the company has not invested in (allocated resources to) Unit C at all. Instead, Units A and B, with lower returns, have received all the funds. Note if a unit is right on the diagonal line, its percentage return is exactly the same as its net asset growth, thereby it is self-funding.

EXHIBIT 1.5 Returns and Growth for ABC Company Segments

Business Unit Segmentation	Annual Net Asset Growth (%)	Average Return on Net Assets (%)
Unit A	41.4	15.8
Unit B	33.3	18.3
Unit C	0.3	26.9
Geographical Area Segmentation		
North	23.1	8.1
South	30.6	35.2
East	40.9	26.2
West	6.8	24.9
Canada	28.6	22.1

Also note, for both Exhibits 1.6 and 1.7, the circles representing the segments are proportional to the overall size of the segment.

For ABC Company's geographical area segmentation, it is clear that the North is the largest operation but it is providing the smallest return. In spite of this, its net asset growth rate is over twice its return rate. In fact, note that all areas to the left and above the line are receiving funds at a faster rate than they are earning them.

These two segmentations for the ABC Company made clear to management that they could not continue to allocate resources in the future as they had in the past. These simple calculations and resultant graphical presentation quickly and forcefully got the message across to all involved

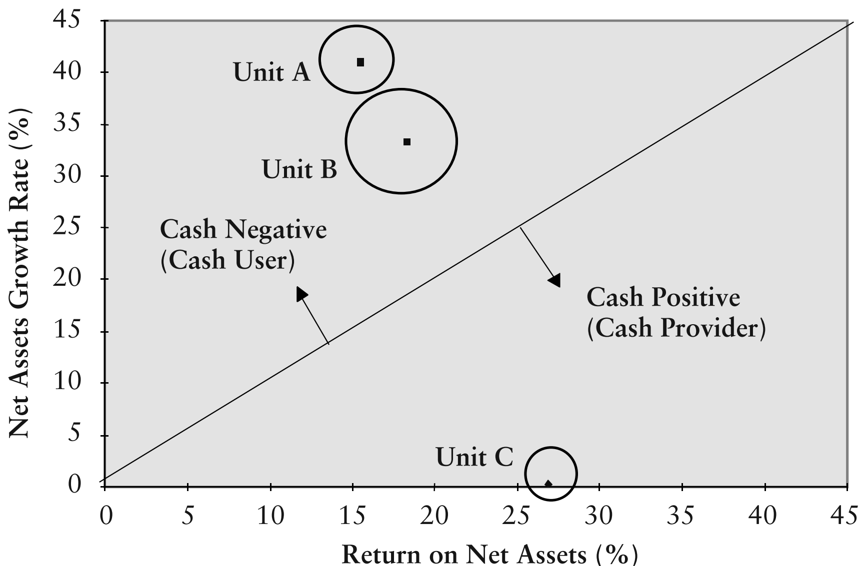

EXHIBIT 1.6 Implicit Business Unit Strategy

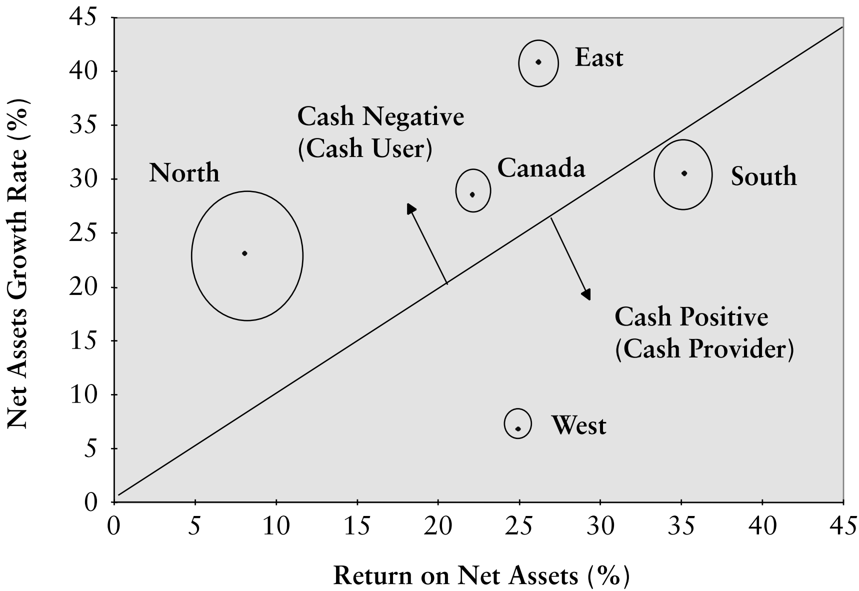

EXHIBIT 1.7 Implicit Geographical Area Strategy

and accelerated the speed and enhanced the teamwork involved in remedying the situation.

PLOT GROWTH PERFORMANCE

At some point, you must step outside the organization and put it into perspective vis-à-vis other similar organizations and the economy as a whole. The larger your organization is or becomes, the more important this is. A good place to start is to compare your organization's growth rate to that of the industry in which it competes. There are many public sources of information available in the reference section of your local library that may provide industry data. Another

EXHIBIT 1.8 Indexing Sales Revenue Data

	Year 1	Year 2	Year 3	Year 4	Year 5
ABC Company $ in MM	70.5	75.8	97.9	122.3	162.2
Industry Composite $ in BB	14.3	16.4	21.5	28.7	37.3
ABC Company Index	100	108	139	173	230
Industry Composite Index	100	115	150	201	261

Note: To convert from dollars to the index, divide yearly data by year one data and multiply by 100. For example, for ABC Company Year 1/Year 1 = 70.5/70.5 = 1 × 100 = 100; Year 2/Year 1 = 75.8/70.5 = 1.08 × 100 = 108, etc.

good source is to go directly to your industry association and review their publications and interview the head librarian at the association's headquarters.

Once you have collected overall sales revenue information for your organization and its industry for five years, you are ready to compare and contrast the two. An effective method for accomplishing this involves converting both sets of numbers to a standard index. This is done for ABC Company and its industry in Exhibit 1.8.

With the data indexed, it is a simple matter to graph the results and determine how your organization is doing versus the industry as a whole. As shown in Exhibit 1.9, ABC Company is not growing as fast as the industry in which it participates.

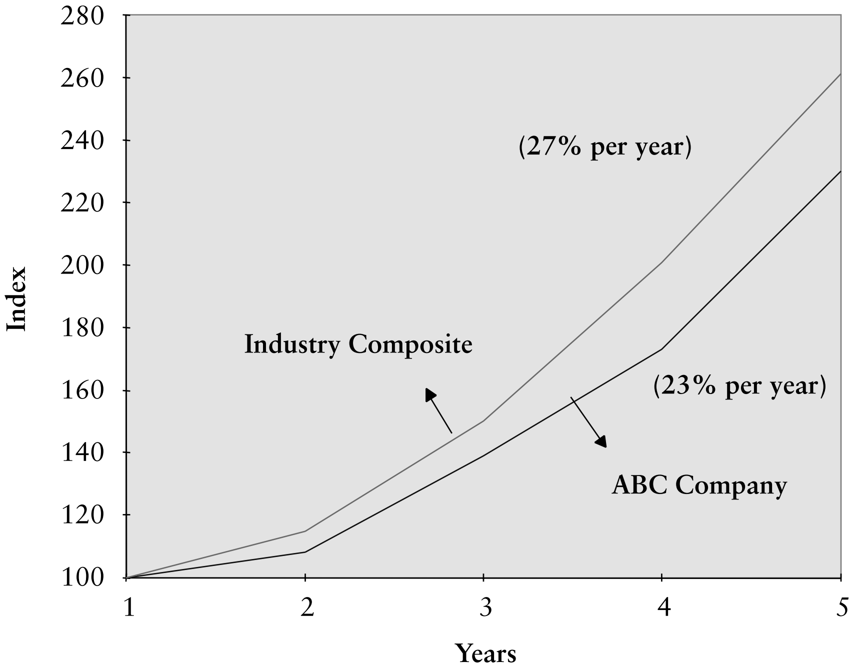

EXHIBIT 1.9 Revenue Growth Years 1 to 5

What this means is that over the last five years, it has been losing market share. If your organization operates in more than one industry or, like ABC Company, has three units operating in different, but measurable segments of a larger industry, it may be desirable to examine the market share dynamics at the next level of detail. By plotting industry segment sales growth versus business unit sales growth, one can quickly see whether the unit is gaining or losing share by noting on which side of the line it appears.

This relationship for ABC Company is shown in Exhibit 1.10, which clearly indicates Unit B is losing share, Unit A

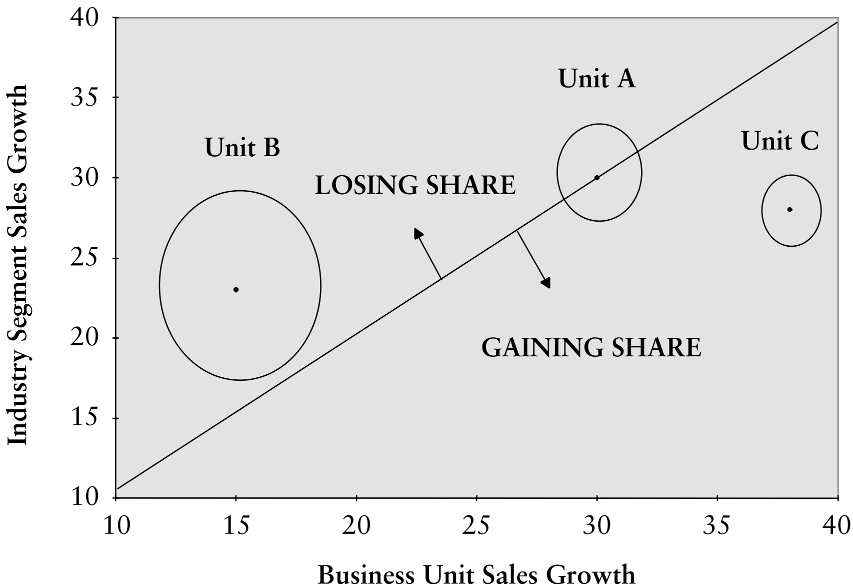

EXHIBIT 1.10 Business Unit Market Share Trends

(right on the line) is holding share and only Unit C is gaining market share. As it turns out, Unit C is operating in a segment where it is able to price its goods and services very competitively and still make a sound return. It is able to and has increased its market penetration and gained market share over the period in question.

ANALYZE PROFITABILITY RATIOS

Profitability ratios are useful in pointing out changes in operating performance over several years. They help you assess whether resources were used effectively in the past and aid in measuring the economic impact of prior manage-

ment decisions. A profitability ratio compares profit to something else, generally by dividing the profit by the "something else." The profit number used here is called operating profit, which is earnings before interest and taxes. Taxes can vary because of events other than the operation of the business. Interest relates to the amount of debt, which can vary based on the stage of growth of the company, the industry in which it operates, or the risk preferences of management. Accordingly, these two items are excluded. Operating profit that has been so filtered can be used to calculate ratios, which can be compared to other companies whose financials have also been so filtered and makes for meaningful comparisons of relative management efficiency.

The rate of return on sales (operating profit/net sales) indicates how much profit was generated by each sales dollar. To tell how well your organization is doing it is necessary to contrast this ratio to that for your industry. In certain industries rates of return below 1% are common, while in others, rates in excess of 20% are the norm. If your rate is below that of your industry, this might suggest your expenses are on the high side or your prices are on the low side.

The rate of return on assets (operating profit/total assets) measures the profit generated by the assets of the business. Again, comparison of your organization to the industry norm is recommended. However, if you have fixed assets that have been heavily depreciated over time, this may raise the ratio and give you a more positive indication than is warranted.

The rate of return on equity (operating profit/net worth) indicates how much profit was derived from the owners'

investment in the organization. If this ratio is on the low side, it suggests the funds might be better invested elsewhere.

Comparing these ratios for your organization with those of other organizations in your industry and the industry averages provides you with another set of external comparisons. This information can assist you in determining how your organization is strategically positioned relative to the competition.

DETERMINE RELATIVE VALUE

The final step in the strategic audit is to determine the relative value of your organization. When taken together with the rest of the above analysis, the calculation of relative value plants a stake in the ground that clearly indicates the size and the nature of the opportunities you have to enhance the value of your organization.

To undertake this analysis you will need to identify those public companies that are most similar to your organization and obtain three numbers for each:

1. Market value
2. Book value
3. Five year average return on equity[5]

Once these are assembled a chart is created. For each company, the market value is divided by the book value and plotted on the *y* or vertical axis, and the return on equity is plotted on the *x* or horizontal axis. A regression line (easily calculated by most spreadsheet software) indicates the aver-

age relationship between these two variables for the industry as a whole. Exhibit 1.11 shows this relationship for ABC Company and ten other public companies.

Note that ABC Company is below the line. This indicates the market value to book value premium which it should receive if it were "average," is well above that it actually is receiving. Accordingly, management has two opportunities to increase the organization's value. First, it can improve the perception of the organization in the public market to the average level, which would increase its value by over 40%.[6] Second, it can improve its return on equity—note how the industry average line slopes up and to the right, indicating an increase in the market value to book

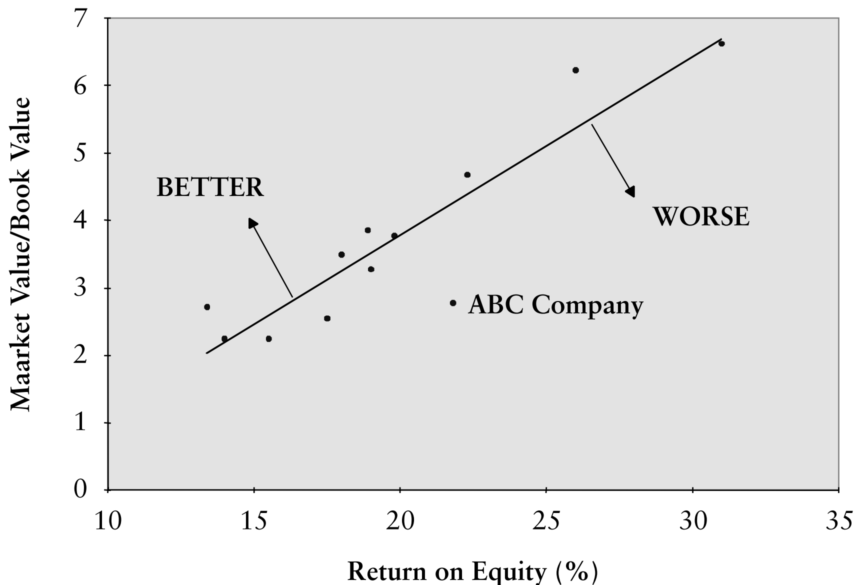

EXHIBIT 1.11 Relative Value

value premium when return on equity increases. This relationship generally holds true regardless of the industry in which an organization competes; however, the line itself may shift up or down depending on the economics and prospects of the particular industry.

For the privately held organization that has no public market for its shares this analysis is still useful. By determining your organization's return on equity and vertically going up until you reach the line, you can, at that point, read the average market value to book value premium indicated for organizations in your industry with your return on equity. To estimate your market value, therefore, simply multiply the premium indicated on the *y* axis times your book value (shareholders' equity account).

SUMMARY

Once you have completed the steps involved in the strategic audit outlined in this chapter, you will have both a qualitative and quantitative review of where your organization has been and what it can build on. This will allow you to determine where you are going and how fast you can get there. When you and your team have this kind of overview, the task of setting sound business goals can begin in earnest.

ENDNOTES

1. If time permits, have participants explain the reasoning behind their selections and weighting, perhaps by citing a specific example or two. This type of discussion often feeds

upon itself as points expressed by one individual spark related ideas in the minds of others. Having a scribe capture these comments for future consideration is a good idea because major issues and opportunities for the organization are generally identified in this type of interchange forum.

2. Alternative methods for presenting results include the use of flip charts, blackboards, or blank acetates written on with colored pens and projected on a screen using an overhead projector.
3. Three cards of each color for five or fewer participants, two cards of each color for six to ten participants, one card of each color for groups over ten participants.
4. Ten dots on one card, one dot each on ten cards, or anything in between is allowed. The only rule is participants must use all their dots.
5. Pick a recent point in time that makes collecting the information relatively easy, for example, at the end of the last calendar year or latest quarter.
6. Moving straight up from the actual ABC Company point to the industry regression line increases the ABC Company market value to book value ratio from about 2.8 to over 4.0.

CHAPTER 2

Calculate Current Value

Valuation knowledge allows an organization to grow and prosper. It empowers everyone in your organization to work together to achieve common goals in a disciplined, compassionate, effective manner. When they understand how value is created and have a clear understanding of their role in the process, they know they are making decisions that enhance the overall worth of their organization. Accordingly, all individuals gain a higher sense of self-esteem and a feeling of worth and freedom.

In Chapter 1's "Determine Relative Value," you were introduced to the concept of relative value—how your organization stacks up to other similar operations. While this is a useful starting point, a more accurate value can be determined by examining additional specific financial characteristics of your organization.

DISCOVER IMPORTANCE OF VALUE

There are three primary reasons why every entrepreneur and executive should understand how organizations are valued and master the process of valuation. They are:

1. Make decisions to optimize company value when you *run* a business
2. Obtain the best price and terms when you *buy* a business
3. Obtain the best price and terms when you *sell* a business

The wealth an organization generates over time is directly related to its ability to create value. Whether you are an individual selling magazines on the corner, an entrepreneur building a fast-growing technology concern, or the director of a not-for-profit organization, the more wealth you create, the better off you will be. The magazine merchant will have more money in the bank at the end of the year to spend on personal or family requirements. The entrepreneur will provide a higher return for investors. The director can provide more and higher quality services for constituents.

Individuals and Organizations

The reason organizations are generally formed is because the potential exists to achieve more as an entity than is possible on the individual level. One person can work only so many hours in a day and, accordingly, even at a very high wage or hourly billing rate, there is an absolute limit to the wealth a single person can create this way. Some people leverage themselves and, hence, their productivity, by hiring others to do specialized tasks that would otherwise detract from their ability to provide the service they can bill out at the highest rate. The streamlining of the modern medical practice, where several nurses, medical assistants, receptionists, bookkeepers, and insurance specialists all provide an

element of the total health care product you and I receive when we visit a doctor or dentist's office, is an example of this type of leverage. Still, the medical practitioner is limited to only so many hours in the day, regardless of the level of efficiency that is achieved.

More wealth can be created by the individual when the collection of skills and practices and procedures used to achieve initial success are institutionalized. That is, instead of just providing as much service as one can fit into a day, the entrepreneur, in effect, creates clones that can duplicate the services provided over and over again. To be effective, the institutionalization process requires not only appropriate training in product/service delivery and support procedures and policies, but also that the overall entity is monitored and managed effectively.

Some economic opportunities and social services require size to compete effectively or deliver a service correctly and at reasonable cost. Certainly, you and I could spend time with the classifieds and on the internet to identify enough parts to put a car together and ultimately sell it. However, in the automobile business, as in many traditional economic ventures involving a product, there is a world-class scale of operations that requires both labor and capital in order to achieve the economies required to provide useful goods at a competitive and reasonable cost. In the service business and not-for-profit organizations, training, regulatory, fund raising, and recruitment/retention expertise are just some of the elements of providing services that require this type of large scale focus to operate efficiently. Capital funding for computers and other equipment to manage many aspects of operations is also important in service-oriented organizations.

Financial Relationships

In every organization, there are internal financial relationships between departments and functions and operating entities. There are also external financial relationships between the organization and its various stakeholders, such as customers, employees, suppliers, lenders and investors. Decisions made within these relationships generally result in movements of cash that take place immediately, over time and/or in the future. That is, each decision results in one or more actions which have financial or economic consequences and, hence, impact the organization's cash flow. Examples of such actions and the financial results are contained in Exhibit 2.1.

The management that can make consistent, high-quality decisions that maximize cash flow over time is doing the best job for its constituents. Just like children, the more money in the bank at the end of the year, the happier they are.

Economic Elements

Despite the wide diversity in types of organizations and management priorities, the decisions which affect cash flows are generally one of three types or elements, which, together, form an integrated economic framework. These, in the order in which they initially occur, are:

1. Funding
2. Investing
3. Operating

EXHIBIT 2.1 Financial Actions and Economic Results

Financial Action	Economic Result
Sell a product on credit	Items released from inventory; obligation by customer to pay in the future
Hire a new controller	Incur a future series of wage payments and benefit expenses for services to be provided
Construct a new plant	Increase fixed asset base; incur typically complex set of future financial obligations
Install sales incentive program	Incur a possible increase in cost of sales which may be offset by fixed cost coverage
Use a line of credit	Obtain an inflow of cash to settle current needs which must be repaid in later periods

First, one must raise money to *fund* the organization. Then, one must *invest* the money raised in people and equipment to provide the product or service. Finally, one must *operate* the organization in such a way that adequate money is generated to compensate all the stakeholders in the organization.

The first element, funding decisions, initially deals with the types of debt and/or equity to use for early financing of the organization. However, once it is up and running, the organization continues to face funding issues as a matter of course. For example, given the industry in which the organization operates and its unique cash flow patterns, what should the targeted debt-to-equity ratio be? Or, considering

the prospects for growth, how much profit should be paid out in dividends and how much should be kept for future investment?

Investing decisions, the second element, initially deal with trying to obtain the correct combination of labor and capital to allow the organization to run as efficiently as possible. Over time, decisions as to credit, inventory, and payment policies that affect the level of working capital become additional investing decisions that must be addressed. Regularly assessing the plant and equipment base as to whether continued investment makes sense and considering acquiring other operations or selling some already owned are other types of investing decisions which organizations face.

Initial operating decisions, such as at what price to sell the product, which market to target, and what level of service to provide, allow the organization to plant a stake in the ground against which to measure subsequent financial performance. Ongoing adjustments in pricing, markets, and service and other related and supporting areas, comprise the third element of the organization's integrated economic framework—operating decisions.

Cash Generation

Decisions in all of the three elements affect the organization's overall cash flow. Some decisions have a positive effect, increasing the cash available to the organization, some have a negative effect, decreasing the cash available to the organization. When the organization generates net positive cash flows over time, it is creating value. Furthermore,

the more cash flow that can be generated and the smaller the investment required, the greater the value created.

Numerous studies of public companies which measure the correlation of various alternative financial measures to value bear this out. Growth in earnings has very little positive correlation with company value (accounting conventions used to arrive at reported earnings and a lack of any consideration of the size of investment required to achieve the growth are the key reasons). Return on equity (earnings/equity) has a small positive correlation with company value (lack of consideration of how much debt is used and differences in depreciation methods resulting in similar assets at differing book values are the key reasons). Return on capital employed (earnings/(equity + debt)) has a slightly higher correlation with company value, but still retains accounting-convention flaws associated with reported earnings and depreciation and also does not consider leased property. However, when the cash flow return on investment (cash flow/investment) is calculated, the correlation with company value is two to three times as high as the previous two methods.

The message is clear. As an owner and/or manager of an organization, focus on maximizing cash flow[1] to obtain the benefits of high value for your organization.

Summary

The key management challenge today, regardless of the nature of the organization, is to create value. Accordingly, the basic purpose of the organization from a value perspective is cash flow production. The more members of the

organization who realize this, and consider the consequences of their daily decisions[2] in cash flow terms, the greater chance the organization has to maximize its cash flows over time and survive and prosper in a rapidly changing world.

MASTER DISCOUNTED CASH FLOW

One of the key differences between individuals and organizations is that, unlike an individual, the life of an organization is not necessarily limited by biological factors. Provided it is well managed (i.e., continues to generate adequate amounts of cash for its purposes), an organization can last as long as it is fulfilling an economic need. Accordingly, it is useful to consider, from a valuation point of view, that each organization is a going concern, regardless of the unique economic dynamics it might possess. The discounted cash flow methodology considers the net cash flows expected from the organization for a reasonable time in the future, and discounts these to present worth at an appropriate rate.

Future Benefits

Cash flows from a going concern can be considered a stream of benefits, much the same as if you placed a sum of money in a savings account and you received a stream of annual interest payments as benefits from your action. The value of an organization today is dependent on the future benefits that will accrue to its stakeholders, with the value of the future benefits discounted back to the present at some appropriate discount rate. Therefore, the approach to determining today's value is simply to project the future benefits

(generally cash flows) and to discount the projected stream back to a present value. The more organization-specific such projections are, and the more they are based on its financial capabilities and marketplace realities, the higher confidence it is possible to put into the calculated valuation.

Financial Inputs

Several specific financial characteristics of the organization should be identified and examined in order to arrive at cash flows (*CF*). The main components include:

R	revenues
OPM	operating profit margins
T	taxes (where appropriate)
FCI	fixed capital investment
WCI	working capital investment

In simple terms, the formula for cash generated from operations during a year and available for distribution or reinvestment at the end of the year is:

$$CF = R \times OPM - (T + FCI + WCI)$$

A set of sample data showing how annual cash flow is calculated is contained in Exhibit 2.2.

Revenues typically come from items such as the sale of products and services, dues, fees, and contributions. Operating profit is what is left over after the cost of providing goods and services and covering sales and administrative expenses are subtracted from revenues. If the amount is positive, then taxes are payable to the government. Finally, if the organization is growing its revenues, additional funds are usually required to cover the larger investments in current

assets (such as inventory) and fixed assets (such as plant or equipment) needed to sustain such growth. All of these financial items are related to the cash flow available from the normal operations of the organization as a going concern.

Discount Rate

The discount rate used reflects the time value of money and the risk associated with the operation of the organization.[3] The stream of cash flows provides a return on, and reflects the value of, the aggregate investment in the organization.

EXHIBIT 2.2 Yearly Cash Flows for ABC Company

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	1060.00	1123.60	1191.02	1262.48	1338.23
Operating Profit Margin %	10.00	10.00	10.00	10.00	10.00
Operating Profit	106.00	112.36	119.10	126.25	133.82
Less:					
Taxes	42.40	44.94	47.64	50.50	53.53
Incremental Fixed Capital Inventory	2.40	2.54	2.70	2.86	3.03
Incremental Working Capital Inventory	1.80	1.91	2.02	2.14	2.27
Cash Flow from Operations	59.40	62.96	66.74	70.75	74.99

At the end of the growth period, the organization still has worth, which is called its ending value.

As seen in Exhibit 2.2, operating cash flows are derived by subtracting taxes from operating profit as well as allowances for incremental investments to fund increasing levels of organizational activity and anticipated fixed asset expenditures. At the end of the cash flow projections forward for a reasonable time into the future, cash flows are generally assumed to stabilize (grow no more). This allows an ending value for the organization to be calculated and then discounted to present worth and added to the present worth of the interim cash flows.

To find the present worth of a future cash flow or value, one simply multiplies the cash flow by a discount factor appropriate for that time period and the chosen discount rate. The factor is calculated as follows:

$$1/(1 \times \text{Discount Rate})^n$$

where *n* represents the year in which the cash flow occurs.

A set of sample data with a 14% discount rate, showing how cash flows are discounted, is contained in Exhibit 2.3.

Operations Value

To the cumulative value of the present worth of the cash flows of $226.44 (as shown in Exhibit 2.3) is then added the present worth of the ending value of the organization. The assumption that the organization will grow no more at the end of the growth period (in the ABC Company example this is five years), means that no additional investment of working or fixed capital is required due to no incremental growth in revenues requiring same. Instead, the assumption is made

that whatever depreciation is being taken is just the right amount to fund the upkeep of the existing fixed asset base and that the relationships between the main components of working capital (accounts receivable, inventory, and accounts payable) will remain intact. Accordingly, the cash flow for each year after the last growth year (Year 5 in the ABC Company example) will remain constant and can be calculated simply as operating profit minus taxes.

In the ABC Company example, this amount is $133.82 – $53.53 or $80.29. This represents an annuity or constant payment of this amount in perpetuity or forever, starting at

EXHIBIT 2.3 Discounted Cash Flows for ABC Company

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	1060.0	1123.6	1191.0	1262.5	1338.2
Operating Profit	106.0	112.4	119.1	126.3	133.8
Cash Flow from Operations	59.4	63.0	66.7	70.8	75.0
Discount Factor	0.8772	0.7695	0.6750	0.5921	0.5194
Present Worth of Cash Flow	52.1	48.5	45.1	41.9	39.0
Cumulative PW of Cash Flow	52.11	100.6	145.6	187.5	226.4

Note: Dollar values rounded to the nearest tenth for ease of presentation.

the end of Year 5. To calculate the worth of this type of payment, the payment itself is divided by the discount rate. This works out to be a value of $573.50 at the end of Year 5 ($80.29 / 14%). Finally, to obtain the worth of this annuity today, this value must be multiplied by the discount rate factor for Year 5, which results in an ending value for ABC Company today of $297.87.

When today's ending value for the organization is added to the cumulative value of the cash flows, a total valuation of the operating cash flow potential of the organization can be calculated. In the ABC Company example, this total value is equal to $524.31 ($297.87 + $226.44).[4]

Summary

The operations value is independent of and does not consider how the organization has been financed and whether or not there is any debt. As you may recall, there is no consideration of interest expense in any of the calculations above. This is because it is important to always separate out the investment decision (what is the organization as a collection of labor and capital capable of doing), versus how you might fund the investment required to put such an organization in place or to buy one which already exists.

UNDERSTAND VALUE DRIVERS

Each of the major financial inputs used to determine the value of an organization's operations is, in turn, itself impacted by other variables. These variables determine or drive the value of the financial inputs used. This section highlights the key drivers of value for each of the major financial inputs discussed in this chapter's "Financial Inputs."

Revenue

Revenues are generally the first item on an organization's profit and loss or income statement. It represents the primary source of money received from customers or members for goods sold or services rendered. It usually is a net number representing the amount received after taking into consideration any product returns and allowances for price reductions.

The first key driver of revenue is price. If your organization engages primarily in providing products, then the prices involved would be on a per unit basis. If, however, it provides services, the prices involved would more likely be related to the hourly billing rate of the people providing the services. An upper limit on price is often perceived to be set by demand, the competition, or the marketplace. In reality, any product or service provided is a combination of not only the basic product or service, but also the quality, features, and longevity of what is being sold and the delivery schedule, payment terms, and other characteristics of the sales transaction. The real measure of price is the value perceived by and delivered to the consumer.

For example, if a personal tax preparation service offered to review your taxes and save you $3,000 on your tax bill legally, all for $1,000, you would likely take them up on their offer. Logically, you should not care whether the billing rate (price) of the preparer is $1,000 per hour (representing one hour of work) or $100 per hour (representing 10 hours of work). Conversely, some people who do not want a product at any price (e.g., you may not be able to give a free candy bar to some people), will not be swayed by an otherwise low price. Therefore, in the area of the price

driver, there is often more flexibility than meets the eye in making decisions to increase price and cash flow and organization value.

The other key driver of revenue is volume. The more goods you provide at a given price, the higher the revenues are going to be. The more hours your staff is billable in a service business, the higher the revenues will be. Decisions which add a second sale per sales call or result in a service provider selling additional work to the same customer represent examples of how to improve revenues and value using the volume driver.

Operating Profit Margin

The operating profit margin is the percentage of revenues remaining after operating costs for the organization have been accounted for. The major elements of operating costs in most organizations consist of the cost of goods sold or services provided, depreciation expense, and selling and general expenses.

For a typical manufacturing organization, the cost of goods sold represents all the costs incurred in the factory and is usually the largest cost item. Its key drivers generally include raw material, labor, energy, and factory overhead. The key driver for service organizations is generally labor (i.e., the assets go home at night).

The importance of depreciation expense depends on the size and acquisition time frame of the fixed assets employed by the organization. For the purpose of organization valuation, the amount set aside for depreciation is assumed to be spent replacing the assets in question and, accordingly, does not drive cash flow or value at all.

The key drivers of selling expenses include sales force salaries/commissions, advertising/promotion, and travel/entertainment. For some organizations, the decisions made regarding product/service distribution and logistics can be a major area in which to improve cash flows and value as well.

The key driver for general expenses is administrative efficiency. However, organizations with large research and development staffs have opportunities for value-enhancing decisions in this area. The main point to remember is that, in cost-centered operations, the organization can only reduce negative cash flow so much without hampering the overall performance of the organization. Accordingly, a global view is important here. Also, some creative organizations, when thinking wisely about cash flow, have actually turned cost centers into profit centers by selling services they otherwise normally perform for their own organization to other organizations as well.

Taxes

When taxes are considered, it is the cash impact of taxes which is important to organization value. Certain decisions regarding depreciation and accounting for acquisitions tend to overstate reported earnings but adversely affect true cash flow. It generally is a smarter move to maximize the cash flow from tax decisions rather than be overly concerned with what is reported to the public, banks, investors, or other lenders.[5]

Fixed Capital Investment

The key drivers of fixed capital investment, again, depend to a great extent on the nature of the organization. For low

fixed capital organizations, this item is often considered a secondary driver. However, when safety requirements, machinery additions and replacements, environmental restrictions, and capacity expansion options loom large relative to available cash flow, some or all of these items might be considered key drivers of value.

Working Capital Investment

The three key components of working capital are accounts receivable, inventory, and accounts payable. Each of these, for all organizations, is a key driver. Decisions relating to how much credit to extend to customers, when to pay receivables, how quickly to turn or mark down inventory, and how much interest to charge on delinquent accounts are all factors that affect the level of working capital investment required for a given level of operations and, in turn, affect the overall cash flow and value of the organization.

Summary

Once you have incorporated the key drivers into a simple spreadsheet economic model of your organization, you can easily ascertain which ones are most important to cash flow. By changing a key driver assumption, you can test the sensitivity of the result to the degree of change in the key driver. Becoming familiar with which key drivers have the largest impact on cash flow is the first step in focusing your decision making on those operations of the organization which are the most important to enhancing its value.

DETERMINE COST OF CAPITAL

The discount rate used to determine organization value is the weighted cost of capital. This number is different for each organization and reflects the nature or riskiness of the organization's operations and its financial structure (which, in turn, is a result of the financing decisions made in the past and/or to be made in the near future). The three steps involved in determining the weighted cost of capital are:

1. calculating the cost of equity
2. calculating the cost of debt
3. combining the costs of equity and debt appropriately

Cost of Equity

The components of the cost of equity (Ce) are:

- Rf risk-free rate of return
- Rm rate of return on the overall stock market
- B beta or riskiness of the organization or the industry in which it operates

The formula for calculating the cost of equity is:

$$Ce = Rf + B \times (Rm - Rf)$$

Assuming you trust the full force and power of the U.S. Government to pay back its financial obligations, the risk-free rate of return at any point in time can be closely approximated by the interest rate being paid on U.S. Treasury Bills. Considering that organizations tend to have a long/indefinite life, it is prudent to select the rate on Treasury Bills expiring at least five years in the future. These rates can be obtained from most any daily financial publication.

The rate of return on the overall stock market is higher than the risk-free rate, as one would expect given the higher element of risk (i.e., the chance your investment might lose value or disappear altogether). Academic studies of the stock market for periods as long as 50 years indicate the premium required by investors in the stock market above the return available from risk-free investments ranges between 5 and 7%. That is, if the risk-free rate is 8%, then the rate of return required by stock investors (or *Rm*) would be between 13 and 15% (8% + 5% and 8% + 7%).

The beta (*B*) measures the riskiness of a company or industry relative to the overall stock market. If it is just as risky as the market (has about the same level of volatility in terms of frequency and size of price swing), then the beta is exactly 1.0 (one). If it is more risky than the market, it is greater than one, if it is less risky, it is less than one. Several financial research firms calculate this number (based on historical performance) for both individual companies and industries. It can be found in stock and industry guides available at the research desks of most libraries.

Cost of Debt

The cost of debt has two components:

1. Interest rate paid on the debt
2. Marginal tax rate paid by the organization

Because it is possible to have a number (*n*) of debt instruments (amounts = *DI*), and each might have a different interest rate (*IR*), it is generally advisable to use an average interest rate (*AIR*) paid on the debt which reflects

proportionally the amounts and rates of the different instruments. This is calculated as follows:

$$AIR = \left(\sum_{n=1}^{n} DI\,n \;\times\; IRn \right) / \sum_{n=1}^{n} DIn$$

Because interest expense is generally a tax-deductible item, the government is actually subsidizing the cost of debt. This is true because the interest expense can be subtracted from the operating earnings before taxes are calculated. Accordingly, the true cash flow cost of debt (Cd) is only equal to one minus the tax rate (TR) times the average interest rate or:

$$Cd - (1 - TR) \times AIR$$

In practice, when you are attempting to place a value on an organization, you are interested in the fair market value, that amount a willing buyer and seller would arrive at, neither being under any compunction to act. Accordingly, the cost of debt you would be most interested in would be that of the likely buyer of the organization. The cost of debt of the industry in which the organization operates is a good proxy for this number and is readily available in guides at your local library.

Weighted Cost Of Capital

The only new variable one needs to calculate the weighted cost of capital is the debt to equity ratio. For the individual organization the debt (D) to equity (E) ratio (D/E) is simply the total long-term debt divided by the total equity. This can be the one of the organization today, or the one it targets over the long term, recognizing it will go up and down due

to the typically large size of major investments and the financing decisions involved. For organizations with no debt, a glance at the industry average might be appropriate in order to arrive at a weighted cost of capital which reflects the economics a willing buyer might encounter when placing a value on the organization.

The weighted cost of capital (*Cw*), which reflects the proportional required returns and interest rates, is calculated as follows:

$$Cw = (1/(1 + (D/E) \times Ce) + ((D/E)/(1 = (D/E)) \times Cd)$$

Summary

The rate used, therefore, in discounting the future value of cash flows into a lower equivalent present value of the organization is *Cw*, the weighted cost of capital. To apply this rate simply convert it to a series of discount factors as described in this chapter's "Discount Rate."

CALCULATE CURRENT ORGANIZATION VALUE

To establish a starting point for examining your organization's value it is useful to consider a scenario in which nothing in the future changes. That is, the value derived represents the value of the organization today, assuming it is run and performs as it has in the past. This methodology allows you to see what the organization is worth today if you chose to continue operating in the same world as in the past with the same policies and procedures and financial interactions.

A value calculated in this way can be viewed as planting a stake in the ground and creating a base case against which to consider alternative decisions and their impact on value, as described later in Chapter 6, "Evaluate Alternative Approaches." Calculating this base case current organization value involves three straightforward steps:

1. Analyze historical financial data
2. Create financial inputs and project cash flows, based on historical analysis
3. Calculate the cost of capital to use as the discount rate

Once these are completed, it is a simple matter to discount the cash flows and ending value to the present, and calculate the current organization value.

There are obviously many ways to analyze financial data. The ones used in the example below for ABC Company are simple to understand and implement and provide a reasonable approximation of how the future cash flows might look, all other things being equal. The important point at this stage is to understand how a base case is created and value calculated. Subsequent iterations and alternative scenarios are limited only by the imagination and time available to perform them. How to use the organizational value model as an important planning tool is discussed in Chapter 6.

Historical Data

For ease of presentation, five years of prior historical data will be considered. The financial data of particular interest are highlighted in Exhibit 2.4. The five most recent years are considered. *Year 0* represents the most recent fiscal year,

EXHIBIT 2.4 Selected Historical Data for ABC Company

	Year –5	Year –4	Year –3	Year –2	Year –1	Year 0	Mean
Revenue	750	800	850	900	950	1000	
% Change		6.7	6.3	5.9	5.6	5.3	6
Operating Profit		64	77	90	105	120	
Operating Profit Margin		8.0	9.1	10.0	11.1	12.0	10
Taxes		26	28	40	44	46	
Tax Rate[a]		40.6	36.3	44.4	41.9	38.3	40
Net Working Capital[b]	40	41	43	45	46	48	
Increase		1	2	2	1	2	
Increase as % of Sales Increase		2	4	4	2	4	3
Net Fixed Capital	80	81	83	86	87	90	
Increase		1	2	3	1	3	
Increase as % of Sales Increase		2	4	6	2	6	4

[a] Taxes as a percent of Operating Profit

[b] Accounts Receivable + Inventories – Accounts Payable

Year –1 the year before that, *Year –2* the year before that, and so on. Note that in order to calculate five year-to-year changes for some items, six years of data are required.

The analysis shows the relevant historical data and also calculates an average value or mean for several key percentages. Some analysts might weight performance closer to the most recent year higher, others might use compounding, as is done in bank accounts. Knowledge that a major account was just won or lost might suggest additional modifications to or treatment of the data. However, the purpose here is to simply demonstrate a starting point for value, based on actual data, not on anyone's hopes or fears.

Financial Inputs and Projections

All of the inputs needed to compute five years of future cash flows for ABC Company are contained in the historical numbers and analysis thereof appearing in Exhibit 2.4. Specifically, these inputs are the most recent fiscal year's revenues and the five-year annual averages for:

- Percentage increase in revenues (6%)
- Operating profit margin as a percent of sales (10%)
- Tax rate as a percent of operating profit margin (40%)
- Increase in net working capital investment as a percent of the increase in revenues (3%)
- Increase in net fixed capital investment as a percent of the increase in revenues (4%)

When the percentage increase in revenues is applied to the *Year 0* revenue number (1000 increasing by 6% = 1060), the *Year 1* projected revenue is generated. By increasing this number again by 6%, the *Year 2* projected revenue is generated. The result of using all the average annual percentages above creates five-year cash flow projections. Exhibit 2.2

contains the results of the cash flow projections using these percentages. The fact that the projections have the same incremental increase each year is not meant to suggest this level of precision. However, over a five-year period, if the future does follow the past trends, as measured financially in "Historical Data" earlier, the overall five-year financial performance should approximate the totality of the projected cash flows.

Discount Rate

The discount rate used to arrive at the present value of the organization is the weighted cost of capital, as described in this chapter's "Determine the Cost of Capital." The formulae involved are clearly spelled out in that section and, as mentioned, the inputs are readily available. A set of sample inputs required to calculate the weighted cost of capital for ABC Company is contained in Exhibit 2.5.

EXHIBIT 2.5 Weighted Cost of Capital Inputs for ABC Company

Input	Value
Risk-Free Rate of Return (*Rf*)	8%
Market Rate of Return (*Rm*)	14%
Beta of Equity (*B*)	1.2
Average Interest Rate (*AIR*)	16.5%
Tax Rate (*TR*)	40%
Debt to Equity Ratio (*D/E*)	30%

When the appropriate formulae are applied to these numbers, the weighted cost of capital, or discount rate to use is 14%. The results of applying this rate to the ABC Company are contained in Exhibit 2.3, which appears earlier in this chapter.

SUMMARY

The present values of the cash flows for this set of projections for ABC Company, along with the present value of the ending value of the company, are contained in this chapter's "Master Discounted Cash Flow." Taken together, these present values result in a current worth of ABC Company of $524. The knowledge gained by the management team when this worth is calculated for the organization provides an understanding of its cash-generating capabilities and value on the open market. This, in turn, will reap benefits as the management team builds a strategic framework which enhances cash flow awareness and generates positive cash flow actions across the entire organization.

ENDNOTES

1. In numerical terms, there are two parts to the cash flow/investment calculation. The result can be higher if one increases cash flow while keeping investment constant or by reducing investment while keeping cash flow constant. However, the best way to maximize this result is to consider the cash flow implications involved in decisions made in all three economic elements of the organization (see "Economic Elements" in this chapter).

2. In most organizations, only a few large decisions with cash flow consequences are made each year. The cumulative effect of small, daily decisions over the course of a year can outweigh these large decisions by a factor of two to four. Accordingly, one of management's greatest opportunities to enhance value is through the inculcation in all organization members of the importance of and techniques for sound cash flow enhancement. Specifics regarding these items are addressed later in the book.

3. The discount rate depends not only on the nature of the investments made, but also on decisions made in the funding area relative to financial leverage used. These issues will be addressed in greater detail in the "Cost of Capital" section in this chapter.

4. All the calculations involved in these and similar calculations can easily be accommodated by any standard spreadsheet software.

5. Many commercial loans have provisions relating to accounting ratios and reported figures. It is not suggested that these be ignored or slighted, but rather that cash flow implications be given a high priority when the tax code allows alternative approaches to calculating taxes due.

CHAPTER 3

Assess Strategic Landscape

Fail to plan, plan to fail. Whether it is the family vacation or the annual top management retreat, the more effort that goes into creating a credible picture of what the desired outcome is, the better the result. The more clearly and precisely the plan is put together, the easier it is to communicate to all those involved and the fewer the surprises. The more thought given to various alternative approaches and uncontrollable contingencies, the more likely the event is to be a success.

The same thing holds true for organizations. This chapter examines some of the difficulties and rewards of planning. It explores how to develop a consensus view of the strategic landscape in which your organization is likely to operate in the years ahead, including identifying special interest groups that might aid or hinder its progress. Techniques for discovering and prioritizing the key factors for and major barriers to the success of your organization are also covered.

REVIEW PLANNING FUNDAMENTALS

One of the keys to enhancing the value of your organization as it moves forward is to be aware of the likely impact of today's decisions on future cash flows. You can choose to create financial statements representing the cash flows desired five years hence, and then identify various actions which might allow you to achieve such results. Conversely, you can identify nonfinancial objectives and the actions that might lead to their achievement, and then back into the cash flows generated and/or required by such actions. In either case, the shift to a forward-thinking or planning approach is required. This section deals with several aspects of planning to facilitate this shift in focus.

Background

In the mid-twentieth century, after living through the shortages of World War II, the American people had developed a tremendous demand for many products. The key to success for organizations operating in such an environment was simply to get as much product into the marketplace as soon as possible. The management response was budgeting or *short-term planning*, which allowed resources to be accumulated and meted out as necessary for a year or so into the future, ensuring a continual flow of product into the voracious market and a nice profit in the process.

As demand continued unabated, labor came to be in short supply. To meet this challenge, managers began designing larger machines requiring less labor per unit of output. Such larger machines required increasing amounts of capital and had physical lives of several years. However,

over the several year period required to recoup the investment in such machines, labor might go out on strike, or new, faster machines might technologically obsolete the older machines. The management response to this increasing uncertainty going further out into the future than one year was *long-range planning*.

As demand began to level off later in the twentieth century, organizations were facing an environment in which the rising tide of continual growth lifting all players was changing to more of a zero sum game in which growth for one organization frequently came at the expense of another. Management discovered that there was a learning curve effect which meant the more product built, the cheaper each succeeding product was to produce. A premium, therefore, was placed on having the leading market share. This way the leader built more product than any other, had the cheapest unit cost, the highest operating margin, and was better able to survive over time. Organizations also discovered that products had a definite life cycle, with different growth characteristics for each stage. They began to plot the S Curve, an aid to the timing and impact of innovation. Putting into practice these ideas and techniques, as well as other related ones, was management's response to flattening demand, and collectively was known as *strategic planning*.

Today, all three types of planning—*short-term, long-range, and strategic*—are practiced by organizations at different times and in varying situations. Yet, much like the printed telephone directories still popular across the country, no sooner are they off the presses than they become out of date. Accordingly, the accelerating pace of change facing all organizations has fostered another tool to assist organizations in managing for the

future—*the strategic framework*. This concept is addressed in Chapter 4, "Build Framework Foundation."

Focus

Chapter 2, "Calculate Current Value," dealt with current organizational value from a historical perspective—financial and management performance that was a direct result of past decisions regarding financing, investing, and operating the organization. Planning, with an emphasis on a forward look, encompasses forecasting likely future conditions, a fairly important requirement for managing any organization.

Planning can be done for any time frame, as indicated in the last section. It can also be performed at any level of the organization or at any level of detail desired. However, to be most useful to the management of an organization, it should be approached with a global perspective, keeping the entire organization in mind at all times. The reason for this becomes obvious when you realize the dynamic nature of organizations—you cannot change one part without affecting another. This holds true, of course, for cash flows which, at any point in time, can be generated by one part of the organization and used by another. Unless one's cash flow view is global, taking into account these financial interactions, the checkbook can become overdrawn, and/or bankers, suppliers, and investors may come knocking at your door.

Beyond the financial considerations, however, planning also deals with positioning the organization in a desired future landscape. Expectations regarding the future technical, social, economic, and competitive environment should be considered. The ability to think outside the parameters

management normally considers in day-to-day operations is often difficult to achieve. It can be enhanced when a different setting, such as an off-site retreat center,[1] and different personnel, such as a team of facilitators, create an environment and structure more conducive to reflection regarding the future. This holds true whether the focus is on short-term, long-range, or strategic planning.

Techniques

Short-term budgeting and long-range planning are primarily financial in nature. They focus on projecting operating performance and the financial requirements required to support future operations. They encompass assumptions made by organization management regarding a variety of future conditions. Initial forecasts created generally take the form of standard accounting statements—income statements and balance sheets—as well as cash flow projections. Time periods covered can range from week-to-week to several years into the future, depending on the type of planning and the purposes involved.

The ease with which computer spreadsheets can be set up and altered allows initial forecasts to be refined with additional information and insights, and the planning/budgeting process is usually an iterative one. However, this computational power needs to be balanced with sound judgment and a highly consistent approach in order to make the planning exercise most useful. Determining which component or components of the financial statements have the greatest impact on cash flow is fairly easy to accomplish with computer spreadsheet power. This testing of the sensitivity of the initial

and subsequent assumptions is also a critical factor in successful planning.

Strategic planning has gained widespread acceptance and use across a wide variety of organizations since it was first introduced and promulgated by high-priced consultants and consulting firms in the 1970s. The techniques involved, some of which were covered in Chapter 1 (see Exhibits 1.6 and 1.7), were often based on empirical observations and sophisticated calculations and were closely guarded secrets. Now these techniques and their appropriate application are taught as a matter of course in most business schools and are available to all in any number of textbooks and reference books.

Pros and Cons

Planning professionals have concerns regarding how planning is actually carried out. These are in the areas of *consistency*, *efficiency*, and *culture*. The first two relate to problems with computer-generated spreadsheets. Because different parts of the organization have specialized approaches to solving their individual problems, the seams where one department interfaces with another are potential sources of problems.

For example, long-range plans created cannot always easily incorporate special situations such as acquisitions or major capital expenditures. The top-level annual budget, incorporating all the lower-level budgets, does not always coincide with, and therefore, cannot be linked to, the first year of the long-range plan. This lack of *consistency* (remember the importance of global thinking) can negatively impact *efficiency* and cause difficulty in the consolida-

tion and revision process and in the ability to conduct varying scenario analysis and what-if and sensitivity analysis. This, in turn, can cause a lack of confidence in the numbers and much rebuilding year after year.

Shortcomings in these two areas can also adversely affect the organization's *culture*. When it comes to planning, there can be a lack of ownership, a lack of accountability, and much gamesmanship. The process often becomes more political and, accordingly, less realistic and useful.

These difficulties are not inherent in planning. They tend to evidence themselves when there is a lack of strong, consistent leadership from the top. However, when no such lack exists, and a strong planning system is in place, the benefits are numerous. Management and staff can spend time analyzing investment opportunities for their cash flow potential, rather than wrestling with inefficient spreadsheets. The longer a solid working system is in place, the more confident everyone who uses it becomes, and the more use it gets as the environment continually changes. Decisions can be made more quickly and alternatives assessed with greater flexibility. Just one cautionary note—the installation of a top-to-bottom, comprehensive planning system endorsed by all members of the organization and practiced by people well-educated in its use is a process that usually takes three to five years.

IDENTIFY STAKEHOLDERS

Each organization interfaces with a number of different groups. Each of these groups has its own agenda which is,

generally, more important to it than to the organization with which it interfaces. These groups can be outside of or within the organization. The groups might stand to gain from the success of your organization or to lose from it, or they may be indifferent. Actions which they take knowingly or otherwise may aid or hinder the progress of the organization.

Such groups, which have a stake in the success or failure of your organization, are called stakeholders. They can be broadly classified as competitors, external partners, or internal partners. This section introduces the typical key organizational stakeholders and describes a method for identifying and characterizing them for your organization.

Competitors

Every organization has competitors. Universities compete for students and talented faculty. Local governments compete for new businesses and federal funds. Businesses compete for market control and customer loyalty. Industry associations compete for the time and votes of the members of congress.

Stakeholders who are competitors have an interest in the demise of your organization. This could be a conscious interest where explicit actions and/or statements are made which reflect negatively on your organization. Alternatively, such interest might be unstated and just felt intuitively as a general desire for the failure of those organizations making survival more difficult through competitive tactics. In rare cases, for political or other reasons, it might be in the best interest of a competitor to act in such a way that another competitor (or competitors) stay afloat (e.g., to avoid the possibility of antitrust litigation).

External Partners

Those stakeholder groups who are not directly competing against your organization are partners. Those that exist outside of your organization are external partners. These partners generally stand to gain from the success of your organization. However, as in any partnership, they can also take actions which might be harmful to your organization. Accordingly, to the extent various stakeholders can have an impact on your organization, it is important to ensure they are handled with an appropriate amount of care.

Certain external stakeholders are desired by organizations in order to further their ends. These would include stakeholders where, generally, the organization has options as to which specific company or institution with which to associate. For example, organizations usually have choices when it comes to suppliers, lenders, insurers, attorneys, and accountants.

However, other external groups are partners with the organization, yet seldom are these types of stakeholders sought out. For example, in each significant acquisition there are generally at least three parties:

1. Buyer
2. Seller
3. Uncle Sam[2]

The point is, when doing business in the United States and most western countries, the government and its various agencies become stakeholders in your organization, whether you like it or not. For example, depending on the nature of your operation, the IRS (Internal

Revenue Service), SEC (Securities and Exchange Commission), OSHA (Occupational Safety and Health Administration), and/or EEOC (Equal Employment Opportunity Commission) can have a major impact on your organization. Besides the government, other unwanted but necessary external stakeholders with the potential to affect your organization's health might include unions and common carriers.

Internal Partners

Those stakeholder groups which exist within your organization are internal partners. Depending on the nature and size of the organization, all those people on the payroll would be considered stakeholders. They might all fit into one group. If, however, their identified needs are sufficiently different, it may make sense to segregate them into separate stakeholder groups such as engineers, management, the research and development team, customer service representatives, and sales personnel. Some of these groups might also be classified as external partners, for example, founders (investors) who still work for the company, and employees who own stock.

The nature of internal partners is that the survival and well-being of the organization is generally considered to be of primary importance to them. For this reason, major customers and significant clients are sometimes included with this group. Some managements include these important contributors to the organization's success in the internal partner world and seek their views and value their input in making important decisions.

Profile Exercise

After reviewing the definition of stakeholders and the various generic types with your management team, hold a brief brainstorming session and collectively list all the possible stakeholder categories you can. Sort the results into related groups. Then ask the following question, "Which categories could have a major impact on the success or failure of our organization?" Once this list of categories is constructed and agreed on, place the name of each category on the left side of a two-column flip chart entitled "Stakeholders." The title of the right column should be "Needs To Be Met." The last stage of the process is to discuss and identify the key need or needs for each selected stakeholder and record them in the right column. An example of what this might look like is contained in Exhibit 3.1.

If the stakeholders identified truly do have the capability to have a major impact on your organization, then it is important you do everything within your power to meet and exceed the expectations of these groups.

GATHER ADDITIONAL INFORMATION

In many cases, organizations can develop a list of stakeholders and their needs in one sitting, using just the knowledge of the management team assembled for that purpose. Often, notes taken during the various strategic audit stages (see Chapter 1) provide an adequate information base for the organization to feel comfortable that it has a collective view of the environment into which it is headed.

Sometimes, however, there may be some aspects of the external world or some issues or conflicts internal to the

EXHIBIT 3.1 Stakeholders and Their Needs for ABC Company

Stakeholders	Needs
Air Force	High-energy, low-weight engines
Aircraft Manufacturers	Low-cost products
Airline Companies	Creative financing packages
Airplane Maintenance Crews	Reliable parts, timely delivery
Banks	Predictable cash flow
Component Suppliers	Secure market
Engineers	Cutting-edge design challenges
Investors	Superior capital appreciation
Top Management	Financially sound project plans
Union Members	Steady work

organization for which insufficient data exists within the team for them to arrive at a consensus regarding key stakeholders and their needs. After all, to ensure a stakeholder can have a significant impact on your organization requires a fairly good working knowledge of its attributes and capabilities. To ascertain a stakeholder's key needs demands a sound understanding of its values and goals.

Accordingly, obtaining reliable data beyond that generated in internal team meetings may be necessary in order to answer important questions raised by meeting participants. Additional information can also provide an unbiased, factual basis from which to develop a joint understanding of the internal and external environments in which the organization must operate in the future.

This section highlights secondary and primary sources available to the organization from which to glean such supporting data. It also discusses the use of surveys and concludes with some general research suggestions.

Secondary Sources

The best starting point for gathering additional material on competing organizations and other prospective stakeholders is data that has already been prepared and organized by others, often referred to as secondary source information. Printed material created by organizations themselves, such as annual reports and other required financial disclosures, promotional brochures, product descriptions, and press releases are publicly available. Industry and trade publications as well as Wall Street analysts' reports on public companies can be found at local and industry association libraries as well as over the Internet. The government publishes a great deal of information every day including industrial reports, demographic and labor rate information, and traffic patterns and can also be an excellent source. Furthermore, conversations with your accountants, bankers, and attorneys can often put you in touch with their libraries and knowledgeable staff members who may be able to provide additional information on organizations not readily available elsewhere, as well as simply expedite the data collection process.

Primary Sources

Once a review of secondary sources is complete, it is possible more questions may arise and new hypotheses about the

environment and potential stakeholders may need to be tested. Going to primary sources and obtaining additional information is generally the approach taken, one where the results are much more customized.

Observation and questioning are the two basic methods of collecting this type of data. In observation, one asks no questions but just notes how people behave and interact. For our purposes, this approach is too slow and expensive. The more direct route of asking questions of people believed to have the desired information is generally preferred. Depending on where the information shortfalls may lie, the list of potential primary sources might include employees, customers, vendors, distributors, dealers, competitors, and former executives of related organizations.

Once a list of primary sources is developed, there are at least four ways to approach them. The most useful is the personal interview. It allows for a direct, private interchange of ideas and gives the interviewer a chance to probe for additional information in areas of special interest. If you own a restaurant, you can wander out onto the floor, buy a dessert and coffee for an elderly couple, and ask a few pertinent questions, such as, “Why do you eat here?” and “Where do you live?” which may help you profile what and how to advertise to that age group. If you are at a trade show, you can pass the time of day by asking a few questions concerning name recognition and product reputation regarding your organization and the competition. Formal interviews, where the interviewer has requested some time of the interviewee, are more common, but also more expensive.

Another approach to primary sources is by telephone. If a broad base of coverage is desired and the questions are

fairly brief and straightforward, a series of interviews by telephone may be in order. Marketplace issues such as relative ranking of your organization versus competition regarding quality and service lend themselves well to the telephone interview. A large-enough base of prospect and customer sources should exist to account for the inevitable early call termination syndrome—the interviewee hangs up!

In certain situations, when more in-depth information is desired and candor in responses is called for, the focus group approach is useful. Gather six to ten related primary sources (e.g., East Coast buyers of your product) and convene a session led by a skilled facilitator who guides the group through a series of open-ended questions. As the discussion feeds on itself, creative suggestions and wish lists often emerge along with possible areas for improvement—the kind of information useful to those responsible for identifying and agreeing on the key needs of critical stakeholders.

The fourth way to approach primary sources is by conducting a mail survey. Even if they are short and direct, the response rates are often low and there is usually a large portion of the target audience underrepresented. Nonetheless, this method is cost-effective and often the only one feasible when large groups are involved. Also, statistical sampling techniques can reduce the uncertainty associated with this approach. If an employee survey is involved, then it is much easier to ensure a high level of participation. To ensure honesty in answers in such situations, it is usually a good idea to have filled-out forms sent to an independent third party with anonymity assured.

Survey Guidelines

Surveys have become so commonplace in today's world that the average manager seldom questions the idea that useful information can be obtained in this manner. The questionnaires which comprise surveys, however, can make or break any individual data-gathering effort. To be successful, they should translate the data requirements or hypothesis to be tested into specific, easily answered questions and also motivate the respondent to furnish the correct information and completely finish the survey. The type of questionnaire should match the method used, be it a personal, group, or telephone interview or a direct mail piece.

The content of the questions in the first draft of any questionnaire is a good place to begin checking its logic. Seasoned survey editors evaluate several items:

- Is the question interesting but not necessary?
- Is more than one question really required to get at the answer?
- Does the respondent have access to the data necessary to answer correctly?
- Will the respondent have to do some work to get the required information?
- Will the respondent, in fact, be willing to share the desired information?
- Does the form of the question (e.g., multiple choice) fit the situation?
- Are there any leading questions?
- Might the placement of a question bias the potential response?

EXHIBIT 3.2 Topics for Customer and Employee Survey for ABC Company

Customer Survey Topics	Employee Survey Topics
Individual demographic profile	Job responsibilities and duties
Position and time with the company	Personal background and experience
Purchase decision-making process	Organization structure
Competitor awareness	Department functions and operations
Buying patterns	Subordinate relationships
Internal bottlenecks and problems	Superior authority interactions
Service requirements	Problem areas
Quality versus price trade-offs	Suggestions for improvement
Suggestions for improvement	Rumors

Each organization is unique and will likely want to probe different primary sources in assimilating information to use in developing a consensus view of its strategic landscape. However, the two groups most likely to receive surveys are customers and employees. Exhibit 3.2 highlights some of the areas it is possible to probe in this regard.

Once the surveys are completed, the results should be tabulated and pulled together. The results themselves should suggest the most compelling ways in which to present the

findings. Share them with your team and watch the confidence level rise.

Research Suggestions

If poor data is collected, poor conclusions will be the result. It is necessary, therefore, to collect accurate data to achieve useful results. Practice the "sufficiency of information" rule—once you believe you have enough information, stop the research, and move on with other tasks—because research efforts take time and money and reduce cash flow.

In personal interview situations, always ask the easy questions first. That way, if you aggravate an interviewee with a hard question and are thrown out, you have at least received some answers for your effort (note the "easy to controversial" order of the employee survey topics in Exhibit 3.2). To improve participation, offer to share the results (disguised or in group summary format) with the participants. This might mean sending a report to customers or vendors involved after the completion of the survey processing or holding a companywide meeting with all employee participants to present the survey results.

If the type of data you are seeking involves external stakeholders' views of your organization, it is probably best to have an outside firm conduct the research to encourage frankness in the responses. Customers or vendors, for example, who know it is your organization asking the questions may be reluctant to be totally honest because they do not want to offend. This does not have to be an expensive process. Often, a call to the marketing professor at the local community college will result in a plethora of students willing to conduct the survey as well as assist in the question-

naire design and subsequent tabulation and analysis of the results.

If your organization chooses the telephone survey, remember to have a script of the entire interface, not just the questions. This ensures consistency in delivery and improved responses and results. Tell the respondent the reason for the call immediately and about how long it will take. Do not be discouraged if some potential respondents refuse to cooperate. It is amazing how many people are willing to speak freely and frankly over the telephone with absolute strangers.

The more research you and your team members perform and get involved in, the more comfortable you will be with who the key stakeholders are and what their key needs are. Hopefully, you will discover other information along the way which will help you, along with the organization's internal expertise and self-knowledge, to perform the exercises which complete the strategic landscape picture in the next two sections.

DEFINE FACTORS FOR SUCCESS

The next step in defining the strategic landscape for your organization is to define the key factors necessary for its success. This exercise pulls together all the information gathered and discussions held up to this point. This is a team effort that requires the involvement of all the members of your management team. It takes only a small hole to sink a ship; likewise, if a critical success factor is overlooked, it could mean disaster for the organization. In addition, by working together, a joint sense of urgency and commitment

is more likely to emerge and aid in moving the organization forward through the next stage—designing the strategic framework. As in past exercises, you can be the team leader, or appoint another member of the team, or hire an outside facilitator to conduct the exercises.

Requirements You will need five to ten blank acetates (for use with an overhead projector) on which to make copies of two forms. You will also need presentation software and a projector to share the results.

Methodology Create groups with at least three people in each one (seek balance, but uneven numbers are okay). Distribute the Key Factors for Success worksheet as shown in Exhibit 3.3.

Make sure the worksheets are copied onto blank acetates, and there is space on the form for the team to list ten factors critical to the organization's success over the next five years. Have each group present their results using the overhead projector and discuss the rationale behind their selections. Combine the results of the groups using presentation software and create a single, weighted average ranking list of the top ten factors. Then plot the answers in the appropriate boxes on the action grid. For an example of what this might look like, see Exhibit 3.4.

Results By reviewing the location of each factor on the priority grid, you and your management team can quickly see where the organization stands relative to its ability to succeed. For example, for the ABC Company, a strong sales force is an important factor for success, but it is an area in which they rank their organization strong today, so immediate attention is not indicated. However, regarding the factor

EXHIBIT 3.3 Key Factors for Success for ABC Company

Looking forward into the future for the next five years, considering both our internal and external environments, reflect on those characteristics and capabilities organizations such as ours will need to possess in order to succeed. Your task now is to identify the top ten factors for success and rank them in two ways.

Step 1
In the left-hand column, list 10 factors critical to our success over the next five years.

Step 2
In the center column, answer the question, "How critical is this factor to our success?" for each factor by ranking it high (very important), medium (moderately important), or low (not very important). Refine and rethink your answers until you have ranked at least three factors high and three factors low.

Step 3
In the right-hand column, answer the question, "What is our capability right now to perform regarding this factor?" for each factor by ranking it high (very strong), medium (moderately strong), or low (not very strong). Refine and rethink your answers until you have ranked at least three factors high and three factors low.

Remember: At least three highs and three lows for the last two columns.

Success Factor	How Critical	Our Capability Today
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		

IMPORTANCE \ CAPABILITY	High	Medium	Low
High	Strong Sales Force		Air Frame Patents
Medium			
Low			

EXHIBIT 3.4 Success Factor Action Priority Grid for ABC Company

air frame patents, the company sees them as very important, yet low in its current capability. Accordingly, some licensing or swapping action will likely need to be taken to shore up their capability in this area.

After reviewing the placement of all factors for your organization and reaching agreement that the placements are fairly correct relative to one another, your team should be eager to start taking actions to improve the organization's capabilities in the areas with the greatest impact on its growth and survival.

IDENTIFY BARRIERS TO SUCCESS

Examining your organization from the point of view of what is required for success, as in the preceding section, is important. However, it is also useful to look at the organization from the opposite direction. That is, identify the hurdles your team will need to clear, the blockades they will have to surmount, and the bottlenecks they must eliminate to increase revenues and cash flows over the next five years.

The exercise with which to accomplish this is basically the same as that described in the section prior, with only minor differences in the forms. For listing and ranking the major barriers to success, use a form similar to Exhibit 3.3 but change the column headings from left to right to:

- Success barrier
- How large
- Capability to overcome today

For Exhibit 3.4, simply change the titles for the *x* and *y* axes to "Capability to Overcome" and "Size of Barrier," respectively. The ranking, consolidation, and grid-displaying steps remain the same. The desire to shore up weaknesses and build capabilities to overcome barriers and the ability to prioritize the action required to accomplish these tasks should assist in preparing your organization to withstand the uncertainties of the future.

SUMMARY

After accomplishing the tasks discussed in this chapter, you and your team should be well on the road to achieving a

consensus view of the strategic landscape. You will have an understanding of other organizations with whom you must deal, those groups who, by their very nature and relationship with you, will have to be considered in your decision-making processes. Also, your knowledge of the relative importance of the key factors for and barriers to your organization's success will form the basis for current actions outside the scope of normal operations. The sense of global thinking and better understanding of the role and techniques of planning place you in a position to take the next step and create the strategic framework described in the next chapter.

ENDNOTES

1. Holding planning meetings off-site also has the added advantage of physically freeing the participants from the possibility of work-related interruptions or psychological reminders of the normal routine.

2. Often, there are other parties which might be more or less desired, including investment bankers, business brokers, and finance companies.

CHAPTER 4

Build Framework Foundation

A place for everything and everything in its place. A nice concept to enhance efficiency around the office, reduce stress on the home front, or save your life in an emergency, such as when your yacht starts taking on water in the middle of that trans-Atlantic crossing you have always dreamed about completing. It is also a pretty valuable approach when it comes to coordinating and communicating all those goals, objectives, and strategies your organization must deal with on a regular basis. The tool that allows you to put this approach into practice is called the strategic framework.

The strategic framework presented here encompasses all the strategic issues facing an organization. The key to its success in practice is its logical format, simplicity, and thoroughness.

This chapter explores the background and major components of the strategic framework and the key steps an organization typically takes in developing its own. It goes through the steps required to build a strong foundation for continuing the process and highlights some of the benefits likely to accrue to those organizations that embrace it.

REVIEW FRAMEWORK RELEVANCE

Until the advent of the information age, a healthy, growing economy provided ample space for many organizations to prosper alongside each other. Clever, proprietary techniques developed by organizations to give them a competitive edge were sustainable over some reasonable period of time. However, with the explosion of available information, and a workforce more willing and more able to shift from one company to the next, sustaining such competitive positions has become much harder to do. Coupled with a leveling off of the population and the resultant flattening of demand, many organizations are faced with the challenge of surviving in this new world order.

Accordingly, organization leaders are facing several key issues:

- How to deal with ever-increasing competition
- How to cope with accelerating change
- How to motivate their work force to accomplish the desired tasks

Traditional plans developed exclusively by top management and/or outside consultants have fallen short in this environment. These types of plans fail because they:

- Lack clarity and specificity
- Do not deal explicitly with risk
- Delegate key strategic tasks to the wrong people

Such results can be avoided if plan formulation is interactive. The development of a workable strategic framework

by the team of managers responsible for carrying it out addresses these issues and shortcomings head on. The overall process for accomplishing this is discussed in the next section.

DISCOVER THE PROCESS

Strategic framework development is a highly structured process that assists leaders and managers in taking a hard look at the future of their organization. Working through various elements step-by-step, a six-level structure is created that can be used to guide the organization in the direction necessary to achieve its agreed-upon goals. The six levels from top to bottom, in the general order in which they are created, are:

1. Mission
2. Niches
3. Goals
4. Objectives
5. Strategies
6. Actions

The mission provides a single focus for all of the organization's activities. It acts as a filter to exclude ideas and diversions not related to achieving objectives critical to success. It appears at the top of the output schematic shown in Exhibit 4.1.

There are five levels below mission. Each level supports the one above it. (In practice, levels two and three are often combined into one level called Strategic Goals). When taken

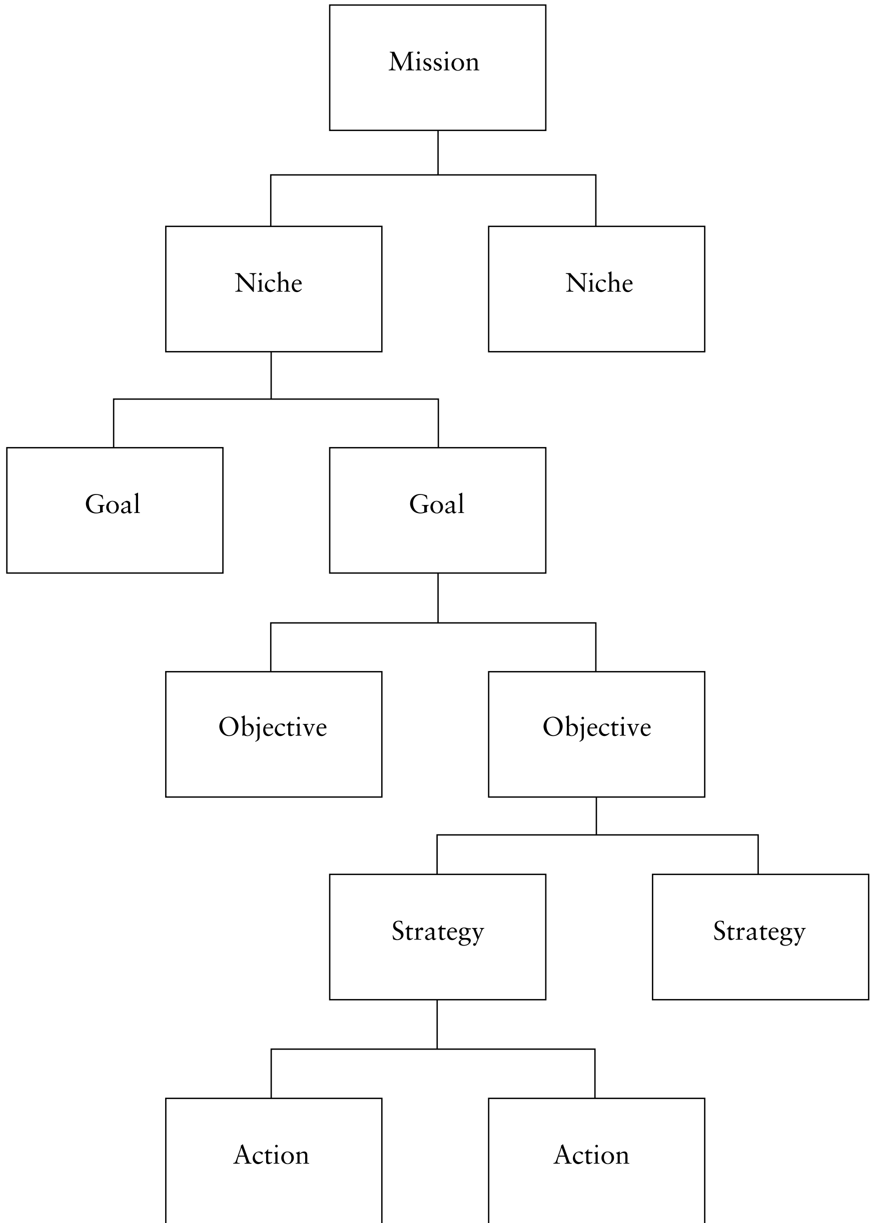

EXHIBIT 4.1 Strategic Framework: Output Schematic

collectively, all of the elements (boxes) in a given level should clearly and precisely describe what is meant by the achievement of the level above it. More specifically, each group of elements tied together by lines and to a specific element above it defines success for this upper element. This is an important strategic and logical point to grasp, for in framework development, if at the end of the day you do not know whether or not you have won or lost (i.e., you are unable to clearly measure success or failure), then you have not described the element in adequate detail (i.e., insufficient clarity and specificity).

Typically, the creation of a framework for an organization is a three- to six-month process. It generally involves five distinct steps[1]:

1. *Planning meeting*. Information collection, process scheduling
2. *Fundamentals workshop*. Mission, niches, goals
3. *Economic model creation*. How cash flows impact organization value
4. *Development workshop*. Objective and strategy creation and selection
5. *Execution workshop*. Action plan design and participant commitments

This structure acts as a feasibility check once the process is completed. It provides a simple framework whereby, in the naturally iterative process of strategy development, each goal, objective, strategy, and so on (i.e., the contents of a box) can be seen in its relationship to the whole. It describes how all of an organization's resources are combined and

focused on achieving the single mission at the top of the schematic.

As you become more familiar with each level of the framework, the terms used and their applicability to your organization will tend to become standardized. You and your team will develop a common vocabulary to use in discussing strategic and valuation issues. However, by way of introduction, a brief description/definition of each level/element is included in Exhibit 4.2.

The strategic framework, when created in a workshop environment, with all the key members of the management

EXHIBIT 4.2 Strategic Framework Definitions

Term	Definition
Mission	Statement of the organization's vision for the future, its core values, and its primary purposes.
Niche	Distinctive position that the organization occupies that allows it to earn higher and more stable returns than similar organizations.
Goal	Broadly based, longer-term, desired state that contributes to achieving and maintaining one or more niches.
Objective	Quantifiable, measurable, time-related achievement critical to goal attainment.
Strategy	Creative allocation or withdrawal of resources consistent with traditional principles.
Action	Plan identifying the who, when, and how much required to execute one or more strategies.

team participating, results in a shared vision for the organization and creates joint commitment to the purposes and values developed. It provides a working knowledge of strategic principles and allows for creative, cost-effective, powerful solutions using newly discovered/developed skills. This, in turn, is the key to building sustainable advantage in the arena in which the organization operates.

LAY THE FOUNDATION

With a basic understanding of the benefits and key elements of the framework in hand, you are now ready to begin the process. Just as a foundation is important to the long-term viability of a building, so it is to your strategic framework. It begins with the initial planning meeting and is strengthened as the mission is developed.

Planning Meeting

Perhaps the most important part of the process is the selection of the team with whom to construct the framework. Generally, a good starting point is the chief executive officer and his direct reports. An individual responsible for each major part of the organization should be in attendance, thereby allowing for a sense of ownership and understanding of the framework and ease in its implementation. A typical number of participants is six to ten, although it can range from three to thirty. The final decision rests with the organization's leader.

Once the team is assembled, calendars are set for the first workshop, and the process and its benefits are presented. Depending on the geographical or functional close-

ness of the team, some organizations conduct psychological interaction profiles to share with each participant particular personality traits and attitudes they might find useful to know. An awareness of one's innate reticence or aggressiveness, for example, may make an intense group interaction session more productive, if not at least more bearable.

A packet of information containing the results of relevant recent prior sessions (such as those involved in assessing the organization's strategic landscape) and summaries of any relevant recent surveys conducted (such as those of customers and/or employees) should be distributed to all participants for review prior to the first workshop. In addition, it is worthwhile to discuss what ground rules will be in effect throughout the process and gain the acceptance by all that they are reasonable. The first, and most important, is that the organization's leader is to remain as quiet as possible. This is to avoid a setting in which the team members do nothing more than agree with whatever is on the leader's mind. Other ground rules that are popular include:

- There is no such thing as a bad idea, some just need more work than others.
- This is a safe and secure environment.
- Frankness is encouraged; everything remains inside these four walls.
- Under-contribution is as inappropriate as over-contribution.
- If everyone's ideas were not important they would not be here.
- Success is a unified front to the world at the end of the process.

- Participation in input and analysis does not mean consensus in decisions.
- Bluntly stating the truth may be bad manners.
- Compromising the truth is unacceptable.
- If it is not substantive (occasionally disagreeable), it is not worth the effort.
- Do not sacrifice the long term for the sake of the short term.
- Do not use the long term as a reason to avoid the short term.

Whatever list is ultimately developed, ground rules should be rigorously enforced and adhered to in order to ensure candor and commitment throughout the process.

Administrative details relating to off-site room reservations, obtaining the appropriate equipment, arranging for the proper recording, and distribution of workshop results can also be addressed and resolved at the planning meeting.

Mission

The first job at the fundamentals workshop is to develop a draft mission statement. Like the foundation of a house, once it is created, it should not change. You can repaint the house, redo the kitchen, and add another room, but the foundation stays the same. The same is true for your organization. Once the mission is set, it should be timeless and provide a lasting base upon which the organization can build. Because of its importance, at this stage of the process it is vital to stress that it is simply a draft mission that is being created. At subsequent workshops, this mission can be reviewed and revised as the team sees fit, until at the end

of the process it fits the organization like a glove. Then, when over time as everything about the organization and its environment changes, its fundamental purposes and values will remain intact.

The key components of the mission are values and purposes. In a rapidly changing world—one in which the systems and procedures book is out of date the moment it comes off the press—the mission is a necessity. Stating the overall purposes of the organization allows members to determine whether an activity is related and should be pursued or is not related and, therefore, should be ignored. Likewise, stating the values important to the organization allows members to select methods with which they will pursue the organization's purposes that are commensurate with its beliefs. Jointly developed (and, therefore, shared) purposes provide a unified focus for the organization, and jointly developed (and, therefore, shared) values provide control by guiding member actions. If the mission that is developed is successful in capturing the purposes and values of the organization, and it is communicated and positively reinforced on a regular basis, different members of the organization, when faced with the same situation, are likely to make similar decisions.

The mission statement should also reflect the vision of the organization's leaders and take into account its key stakeholders.[2] One way to capture the essence of the framework development team members' ideas regarding vision is to ask each of them to write down three answers that would complete the statement, "I would really be proud of our organization in four years if . . . ." No financial-only answers should be allowed (e.g., "Increase sales

by 10% per year."). Collecting the results on a flip chart or overhead acetate or on an LCD projector using a presentation graphics program then allows for the clarification of ideas, a discussion of pros and cons, and development of a preliminary prioritization. This consensus vision list, when taken in conjunction with the stakeholder analysis, provides the basis for the participants to create purposes that represent states to be achieved in response to specific stakeholder needs.

Values, equally important to a sound mission, can be developed and discussed through informal sharing of organization war stories with a moral. For example, the reasons why people are hired and fired provide a clue to the values at work in these types of major decisions. Anecdotes of how customers are treated and how employees are rewarded or punished are also potentially good places to find an organization's values at work. For example, if one of your employees chartered a plane to deliver a part to a customer experiencing some major downtime in a remote location, should that employee be rewarded for creativity or punished for an excessive expenditure? The answer, of course, depends on the organization's values. Does it place customer service as a driving value or reward people who discover low-cost solutions to problems? The circumstances surrounding employees who become heroes or villains tend to reveal a great deal about an organization's core values.

A more formal approach, often useful after an informal value-story-sharing session, involves prioritizing and ranking various values. One way to do this is simply to list value areas that might be important to the organization and then weight them as to degree of importance on a scale of one to

five, with five being very important. As a start, more broadly defined terms are generally best. This way, the team can more quickly identify the key value areas important to the organization and refine them further as necessary to incorporate into the mission statement. A typical list of broad value areas might include:

- Teamwork
- Product leadership
- Service orientation
- Cost control
- Market presence
- Work pace
- Communications
- Fair compensation
- People

An alternative, yet still quantifiable, method is to list both ends of a value-related spectrum in two columns and have the participants place an "X" representing their view of where the organization stands on that particular value along a line between the two extremes. An "X" in the middle would indicate the organization is fairly neutral regarding that particular value, and it would move more closely to either column, depending on how close to the extreme it was perceived to be. Some sample sets of value extremes are listed in the following two columns:

Meritocracy (promote on merit)	Tenure (promote on time in grade)
Purposeful (high sense of direction)	Wandering (low sense of purpose)

Aggressive (risk taking)	Conservative (risk averse)
Long-term focus	Short-term focus
Command style (strong leader)	Consensus (management by committee)
Tight controls	Loose controls
Market leader	Market follower
Decisions made rationally	Decisions made by gut feel
Employees need strong direction	Employees primarily self-directed
Strong work ethic (overtime expected)	Balanced work ethic (family time expected)

The discussion and prioritization of values is important, because inevitably there will be situations that arise in which two values are in conflict and an understanding of which one is more critical to the organization is required. They should also be stated in a fairly precise manner. For example, if the concierge in a hotel has been instructed only that the key value is *treat the customer as royalty*, how is the decision to be made as to whether to serve first the person in a three-piece suit or the one holding a crying child? A more narrowly defined statement, such as *treat the businessperson as royalty* or *treat all families as royalty*, enables the concierge to quickly make the correct decision and more likely satisfy both parties due to swift, sure action.

Once purposes and values have been identified and discussed, it is time to break the framework development participants into small groups and let each of them craft their version of a mission. This is typically a one- to two-hour

process, followed by justification and explanation to the group. This, in turn, is followed by another breakout session and more presentations, this time using different groupings. The iterative nature of the process is important to achieve buy-in by all involved. Most annual reports of publicly traded companies, as well as most educational and government institutions, have publicly stated their missions. You would be well served to review a number of these as part of the mission creation session in order to familiarize your team with the many ways it can be stated. To limit frustration at this stage it is important to remember that the mission statement created here is just a draft.

In summary, by combining all of the above elements, your organization has crafted a mission with vision-inspired purposes to provide focus to its strategies and actions and values spelling out the organization's code of conduct providing control even when the leaders are miles away. Because the mission is designed to be timeless (or for at least ten years for those with a fear of commitment), some meat needs to be put on its bones. The niche identification process, discussed next, begins this process.

DETERMINE NICHE POSITIONS AND GOALS

Niche positions and goals represent the second level of the strategic framework and, collectively, they begin to define more concretely the future direction of the organization. The descriptive statements used at this level tend to be longer term in nature, generally describe a desired state, and are broadly based. Niches tend to be more externally oriented

and distinctive, while goals deal with areas critical to the organization's operation, but more internal and basic. Consider a bath soap company—its niche might be a creamy, pink, sweet-smelling foam, but its goal is to have the foam clean effectively whatever it comes in contact with.

Niche Positions

A niche is generally defined as, "a place or position suitable or appropriate for a person or organization." For example, professionals or organizations are often spoken of as, "finding their niche," usually after reflecting on the successes they have enjoyed. The trick in strategic framework development is to build on the strengths of the organization in such a way that niche positions are created or enhanced that can sustain the success of the organization over time.

Success in the context of the strategic framework is a relative concept. That means that your organization must ultimately be compared to the competition. In that comparison, you will have achieved success if your organization is able to achieve results that are higher and more stable than comparable entities. But do not higher rewards involve less stability and more risk? After all, we have been told for decades by stockbrokers that in order to achieve higher returns we must be willing to accept higher risk—more volatility.

However, the sailboat with the higher mast catches more wind, applying more force to the keel, thereby increasing the boat's stability. The same principle can also hold true for organizations. Consider an abbreviated income statement for two firms making the same product:

	Company X	**Company Y**
Product sales price	$1.00	$1.00
Cost of goods sold	.60	.80
Profit	$.40	$.20
Profit margin	**40%**	**20%**

Both Company X and Company Y sell the same product at the same price—$1.00. However, Company X's cost of goods sold is lower than Company Y's, resulting in a higher profit margin or result. Now consider the same two firms, except at a different point in time, after the price for the product has fallen 15%.

	Company X	**Company Y**
Product sales price	$.85	$.85
Cost of goods sold	.60	.80
Profit	$.25	$.05
Profit margin	**29%**	**6%**

Company X's profit margin is reduced from 40% to about 29%, a reduction of less than 28%, while Company Y's profit margin is reduced from 20% to about 6%, a 70% reduction. So, in this example, Company X has achieved *both* a higher result and more stable result than its competitor, Company Y. Investors and purchasers of businesses generally like this type of performance and reward organizations that are able to achieve it with considerably higher values.

How does an organization achieve better and more stable results than competition? Certainly, close attention to cash flow is part of it. But, from a strategic point of view, the niche is created when the organization achieves a position in its market that draws customers and clients and other stakeholders of importance to its doors. In practice, such positions generally require an organization to develop and focus a number of its capabilities in one or more areas of the market that are strategically significant (i.e., that determine the outcome of competition in the marketplace).

Determining appropriate niche positions requires an organization and management team that not only understands its own strengths and limitations, but also has a strong working knowledge of the external environment, including customer motivations and loyalties and competitive strategies. Once these are assembled (see, for example, the output from the exercises in Chapter 3, "Define Factors for Success" and "Identify Barriers to Success"), the strategic framework development task force can assess various aspects of the organization to discover competitive advantages that can possibly be brought together to create potential niches in which to establish or enhance positions over time. The most common way this is accomplished is by segmenting the organization into its several value-added phases and contrasting each one with what is known about these phases in similar organizations. Depending on the nature of the organization, typical value-added phases might include:

- Product research
- Process research
- Raw material procurement
- Component procurement

- Manufacturing
- Marketing
- Distribution
- Retailing
- Service
- Back room operations
- Management information systems

Usually, after a fairly thorough review of these areas, the task force is able to identify a number of competitive advantages. After some discussion, those which actually taken together would have a strategic impact in the marketplace and create a sustainable niche are agreed upon.

It is worthwhile to remember some common-sense guidelines when engaging in this part of the framework development process:

- The more functional areas that are involved in a niche, the stronger it is.
- The more resources applied toward a niche, the stronger it is.
- Building on existing strengths shortens the niche creation time.
- The value of niches changes over time.

Because it takes a fair amount of time and money to develop and maintain a niche, only a limited number (one to three) should be sought by an organization. Also, because the benefit of the niche is enhanced the more widespread it is, attention to communicating and developing a consistent organizational culture is important to facilitating inter-departmental cooperation.

Goals

Key areas in which to develop goal statements tend to be driven by the content of the mission. In the review of value-added areas in the search for niches, many organizations identify areas they consider critical to their success, but not worthy of inclusion in a niche. Accordingly, the list of typical value-added phases might be useful as a checklist in goal creation.

To a very great extent, the stratification of goals depends on how the framework development task force visualizes the company. For example, a CEO might look at the various parts of the organization in terms of how they contribute to the “Ps” learned in school (e.g., product, position, people, profit, etc.). Another might simply think of the organization chart and decide that each functional area should become a goal area and use this as a starting point for discussions among the team members.

Regardless of how the discussions begin, or the initial format goals take, the final test is simple. Collectively, with the niches, they must completely describe a state and time when the achievement of the mission (out in the future four to ten years) is complete.

This principle continues to hold true throughout the framework development process. That is, the boxes in the level below that are connected by lines to the one above it, describe the achievement of the box above in its entirety for the time period in question.

EVALUATE MISSION, NICHES, AND GOALS

Because niches and goals appear on the same line underneath mission in the framework, they are often referred to

collectively as strategic goals. The final wording of the mission and strategic goals should be examined closely. A useful exercise to ensure the task force is in agreement is to select some of the key words used in the statements and have the group write down for the record what that word means to them in the context of the organization's mission and strategic goals. For example, for one group, the word "disciplined" played a dominant role in the mission, and the team created the following list of behaviors, actions, and attitudes that might represent this in the organizational setting:

- Willpower
- Controlled thoughts
- Carefully planned
- Organized
- Unwavering
- Controlled actions
- Thoughtful execution
- Highly focused
- Uncompromising
- Defined characteristics
- Committed
- Given direction
- Not distracted

Whatever else the mission described, it is clear that the team would have a pretty sound idea of what "disciplined" meant when it came to motivating and evaluating their own and their staffs' performance on the job.

Once the mission and strategic goals are created in draft form, they should be contrasted to the following list and revised as necessary based on inconsistencies with it:

- Defines the nature of the organization's operations
- States the purposes of the organization
- Links the organization to the outside world
- Addresses all the organization's key stakeholders
- Expresses the organization's targeted niche(s)
- Differentiates the organization from other similar ones
- Looks toward the future
- Reflects the organization's values

Further revisions of the mission and strategic goals should take place at the beginning and end of all future workshops as more information is gathered and more specifics are identified.

SUMMARY

The strategic framework development process is well-developed, logical, and interactive. It is time effective, creating winning strategies understood and endorsed by the individuals responsible for implementation. It is comprehensive, ensuring no inconsistencies or omissions occur.

It educates the management team (and, ultimately, their staffs) to act strategically every day. It enhances their strategic understanding by providing a working knowledge of the source and application of strategic principles. It creates a shared vision with a commitment to jointly developed purposes, values, and niches.

It creates a sustainable competitive advantage and, through the framework, enables changes in circumstances and strategy to be easily communicated. It results in management team members using more precise language in

daily interactions regarding the strategic fit and importance of daily actions.

Through the clarified market focus, it combines functional and departmental perspectives and strengths to serve clients and customers and meet the needs of other organizational audiences in a superior fashion. The next steps in creating the framework, adding specific objectives and strategies to the mission and strategic goals, are contained in Chapter 5.

ENDNOTES

1. The first two steps, “Planning meeting” and “Fundamentals workshop,” are addressed in the remaining sections of this chapter; “Economic model creation” and the “Development workshop” are addressed in Chapter 5; the “Execution workshop” is addressed in Chapter 6. There is usually some “homework” prior to and between most steps.

2. See Chapter 3’s “Identity Stakeholders” for a discussion of stakeholders and an exercise to assist in profiling them.

CHAPTER 5

Formulate Sound Strategies

What does it take to run an organization? Essentially, the leadership group has two primary tasks:

1. Manage the organization's day-to-day operations
2. Allocate the organization's scarce resources

The strategic framework assists in these efforts. Day-to-day challenges can be dealt with using the mission and strategic goals as guidelines. They provide a filtering mechanism through which to evaluate alternative decisions relating to what to do and how to do it. By considering the common purposes and values as contained in the mission statement and the broadly stated strategic goals, every employee can move the organization toward achieving the consensus vision.

Allocating scarce resources is accomplished through crafting sound objectives and strategies. To ensure the organization stays on the right course, the leadership team must create a number of objectives for each strategic goal which, when taken collectively, define a measure of success for that goal. Objectives are generally developed to be achieved in a shorter period of time (i.e., one to three years) than the

desired states represented by strategic goals (which may last five to ten years). Once a list of objectives is created, it is then winnowed down to the critical few, those most important to be reached first. Then strategies are identified which, if successful, can aid in the achievement of the objectives. Before pursuing a strategy, management should evaluate it with respect to sound strategic principles and its likely impact on the overall value of the organization.

This chapter covers the steps necessary to move from the draft statement of mission and strategic goals through objectives creation and strategy selection. It introduces financial and nonfinancial methods for prioritization and evaluation. By the completion of this chapter, the organization will have built all levels of the strategic framework except that related to execution. The knowledge of and practice relating to strategic thinking contained in the following pages will greatly enhance the enthusiasm and confidence the leadership team has as it embarks on executing the strategic framework.

UNDERSTAND STRATEGIC THINKING

Although objectives appear above strategies on the framework (see Exhibit 4.1), they represent fairly straightforward statements that provide the "glue" between strategic goals and specific strategies. Accordingly, an overview of strategic thinking and guidelines is worthwhile prior to the actual exercise of formulating specific, quantifiable objectives.

At the beginning of the session in which your team encounters and begins to become more familiar with strategic thinking and guidelines, be sure to start with a brief

review and reaffirmation of the mission and strategic goals already developed. With these in mind, the strategy creation process can be highly productive. To ensure good ideas (which can occur at any time) are not lost, it is a good idea to keep two separate lists on the team room wall. One list is Possible Strategies, which may or may not ultimately be used or altered prior to selection. The other is Immediately Implementable Ideas[1]—suggestions that are commensurate with the current mission (even if it is only in draft form) and can be put into practice the next business day.

Most people have had some exposure to strategy. It may have been through participation in the development of a strategic plan, involvement in an exercise using one of the numerous strategic analysis techniques currently in fashion, or attendance at an educational seminar. Regardless, a simple yet comprehensive method of thinking strategically is important. This will enable your organization to develop a common approach in creating the strategic framework that makes the updating and enhancing process easier. In the interest of simplicity and ease of understanding, the treatment of strategy in this section is divided into three parts:

1. Philosophy
2. Dimensions
3. Guidelines

Philosophy

When dealing with and reviewing or reaffirming the mission, niches, and strategic goals of your organization, a mind-set encompassing a philosophical view of strategy is

helpful. There are three attributes to this mind-set. All relate to the perspective brought to the creative process and should guide the thinking of each team member throughout the development of the strategic framework. Each is fundamental to the survival of the organization, and accordingly all must be considered when thinking strategically about the organization. The three attributes that characterize strategies are:

1. Long term
2. Relative
3. Interconnected

Long Term The first attribute of a strategy is that it is *long term*. When creating and enunciating clear statements of desired states or positions that the organization should achieve to allow it to sustain itself in the future, you must consider the fact that the organization is currently in an imperfect state. It will take time, therefore, after programs are implemented, to see the results of the targeted changes. Because organizations, much like people, do not have the ability to change all at once, patience is required.

Creating a future vision requires the ability to envision, with all parts working in tandem, how the organization can reach the vision. A vision that is worthwhile stretches far into the future, yet considers the existing environment. It is structured in such a way that all people involved in its creation can picture their role in achieving it. The ability of the leadership team to understand their specific contribution and see how they make a difference positively impacts the timing and nature of the vision's ultimate attainment.

Because the organization will always be in an imperfect state, and the environment in which it operates will continue to change, the leadership's mind-set must be long range or *long term* in nature.

Relative The second attribute recognizes that strategy involves the outside world and should, therefore, be *relative*. Many organizations are well equipped to measure how they performed this year versus last year in terms of profitability, productivity, quality, and costs. This information is useful as a means of providing feedback to the management group that allows them to make changes to keep programs and operations on the desired track. However, this data is more tactical (short term or budget-oriented) than strategic in nature.

The strategic mind-set recognizes it is how the organization performs *relative* to other similar organizations that impacts its ability to sustain itself into the future. For example, beating a competitor's price by 1% may be all that is required to make the sale or increase market share. Beating a competitor's price by 50%, however, may still give your organization the sale, but at a cost of many more of its resources than necessary, thereby leaving the organization vulnerable to defeat over the *long term*.

Interconnected The third attribute recognizes that strategy involves the entire organization and visions and programs should be *interconnected*. If one part of the organization is experiencing success while another is failing, it may not be able to sustain itself in the future. More important, an approach combining many parts of the organization enhances the overall product or service and can create a total package more attractive than that offered by competing

organizations. For example, if, when my product is compared to the competition, not only is its price 1% less, but it has a more durable package, is offered in a wider array of colors, has a longer shelf life, is sold on more generous terms, and has less of a wait on the customer service telephone line, it may not only garner the initial sale, but result in sustained repeat sales as well. The marketing, manufacturing, quality control, finance, and customer service areas of the organization are *interconnected*, all working together to create a total concept which is superior *relative* to the various components of the competitors' offering and able to sustain its position over the *long term*.

When the strategic framework is developed with a strategic philosophy that considers the *long-term* position of the organization and its performance *relative* to similar entities, it is likely to be a framework able to be sustained and modified successfully over time. When it is also developed with a strategic philosophy that keeps all parts of the organization *interconnected*, its chances for greater *relative* and *long-term* success are further enhanced.

Dimensions

There are three major thrusts or dimensions of strategy. Each can be measured according to standard benchmarks for your organization's industry or, more directly, compared to your key competitors. Knowledge of these dimensions will enable you and your management team to take a snapshot of where your organization is or would like to be at any point in time and mark its relative position. Think of each dimension as an axis emanating from a zero point and

moving out to perfection, much like a simple line graph in elementary geometry. Another way to picture the three dimensions is as a cube, where the zero point is one corner and each of the three sides emanating from that point represent one of the dimensions. Your position can then be determined by moving along each of the three corners or lines and imagining a plane intersecting the line where your position is for each dimension. Where all three planes cross inside the cube is your current position. The current combined position of ABC Company for the three dimensions is shown in Exhibit 5.1.

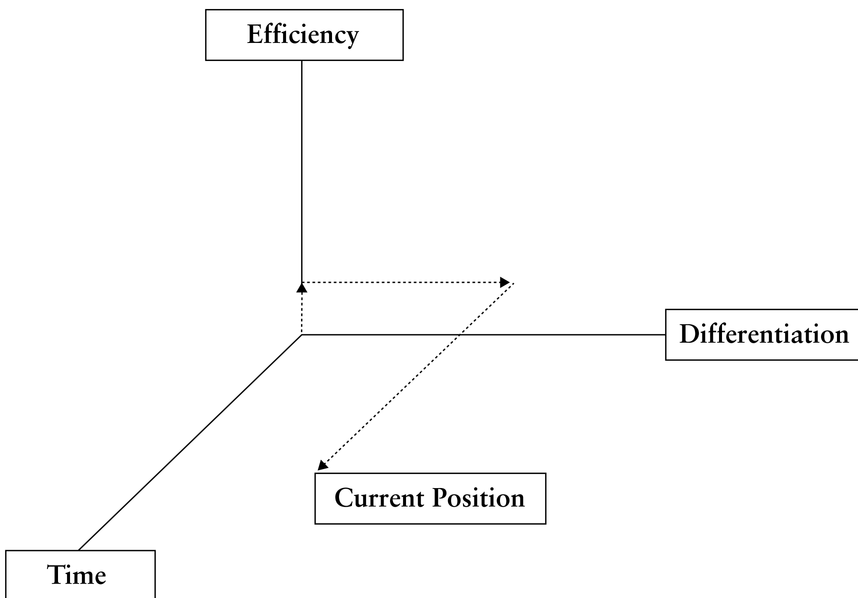

EXHIBIT 5.1 ABC Company Current Strategic Dimensions Position

As Exhibit 5.1 shows, the three dimensions of strategy are:

1. Efficiency
2. Differentiation
3. Time

ABC Company is fairly low on the *efficiency* scale, relatively more advanced on the *differentiation* scale, and fairly far along on the *time* scale. This is not surprising considering ABC Company's smaller size relative to its competitors. This small size is a drawback when it comes to achieving massive economies of scale and major *efficiency*, forcing it, therefore, to compete more through *differentiation*. However, this small size pays dividends in the *time* area, allowing it to move more quickly and effectively relative to its larger competitors.

The dimension of *efficiency* measures where on a scale of dollars spent on investment for a given level of output and cost per unit sold or provided, your organization is relative to the competition. If you build a manufacturing facility which is of an optimal size to produce products at the lowest possible cost, your organization will have achieved *efficiency* of investment. If you locate this manufacturing facility near a favorable source of raw materials and also initiate a program of cost minimization in overhead, research, and marketing areas, your organization will have achieved *efficiency* of cost.

The dimension of *differentiation* measures where on a scale of uniqueness (matching market needs, wants, and desires) your organization is relative to the competition. If you

build a durable product sold to an industry where dependability is critical, your organization will gain a reputation for high quality. If you supplement this product with a wide-spread dealer network making spare parts available quickly, your organization will gain a reputation for excellent service. If you continue to enhance your product with the latest advances in technology, your organization will gain a reputation for setting the industry standard for performance. If you accomplish all three of these objectives, you will have created an intangible image for your organization as a leader and will have achieved substantial *differentiation* in the eyes of your customers relative to your competitors.

Because of the wealth of information available today, most organizations have access to similar cost reduction techniques, operating technology, and functional skills. Therefore, the strategic dimension of *efficiency* becomes more or less simply a ticket to "start the race." To search for a lasting competitive advantage based solely on *efficiency* is futile. In fact, most organizations must strive constantly to reduce costs and improve operating efficiencies just to survive. However, if both a sound defense and strong offense are required to consistently win team sporting events, *efficiency* regarding the organization can be thought of as the defense. But *differentiation* is the strong offense, which allows superior price realization per unit of output. It, in effect, can become the way for the organization to "win the race." Put another way, you can only squeeze so much cost out of an operation, but you can continue to grow market share indefinitely!

The dimension of *time* measures where your organization is and needs to be on the scale of agility (the ability to

move quickly) relative to the competition. Not only do the moves have to be quick, they also have to be correct most of the time. To move at all, the organization needs to observe what is going on in its environment, make a decision to act, structure itself in such a way that the desired action or actions are implemented as desired, and, last, take action.

Subsequent to action, continued monitoring and modification are usually required to ensure the action achieves the desired result. For example, as you sail across the Atlantic Ocean, the boat is seldom headed precisely toward its destination. Rather, the helmsman is constantly making adjustments to the rudder based on wind and wave action on the hull. If the sum total of the actions is correct, the boat lands on a dime.

In an organization, for the strategic dimension of *time* to be effective, the lines of communication between the observers, decision makers, and implementers should be as short as possible. Frequently communicated mission statements, which effectively inculcate organization members with a unified purpose to guide direction and shared values to provide control, are most often successful in exploiting the strategic dimension of *time* to the organization's long-term competitive advantage.

Guidelines

When thinking strategically, it is important to consider not only specific competitors, but also various other sources of competitive pressures. It is also useful to examine how an organization might be structured to take advantage of strategic realities. These two aspects of strategic thinking are discussed in the following paragraphs.

In the preceding strategy discussion regarding philosophy and dimensions, competition generally is assumed to come from organizations similar to yours. In fact, competitive forces, which drive the level or intensity of competition in your industry, come from several places. In addition to similar organizations, these forces may emanate from customers, suppliers, or organizations that might, in the future, become competitors.

How does this work? Assume your organization is embarking on a program to become the most efficient or lowest cost producer of a given product. If you are successful, you should be able to deal with all the sources of existing and potential competitive forces. For direct competitors, your low cost position will result in higher and more stable returns (as shown in the "Niche" example in Chapter 4's "Niche Positions"). Your customers can exert pressure to drive down prices to the level of your next most efficient competitor. If they go too far, they will give you monopoly power over the longer term because they will drive your competition out of business.

As the low cost producer, you can also deal with suppliers who raise prices, because there is more room in your margins and, hence, more flexibility than your competitors. Organizations that might consider becoming direct competitors will likely see your low cost position and decide it might be too expensive to obtain the experience necessary to match it. However, other organizations considering competing with yours that have a new or modified technology that might replace your product with a lower cost substitute will be much more difficult to defend against. When considering strategy, therefore, a sound guideline is not only to

consider organizations similar to yours, but also to examine the leverage of your customers, suppliers, and that of potential competitors and new technologies.

Regardless of how large or complex an organization is, as a general rule, the more it is decentralized, the more authority is delegated down. When this happens, those with the most knowledge about situations and, generally, who stand to benefit the most, are making the decisions, allowing the organization to move more quickly than otherwise might be the case. Traditions or policies[2] that serve to empower the members or employees of an organization to act as owners, whereby the organization's mission and strategic goals are treated as their own personal goals, enable quick decisions to be made which, on balance, will serve the long term interests of the organization. Measurement systems that keep track of the costs associated with holding material, parts, and finished goods, and the time required to move an order or product through the organization can contribute to improved efficiency if the managers responsible for the various areas in question are charged with the appropriate associated costs and rewarded when reducing these to a minimum.

In summary, when thinking strategically about your organization, do not forget to consider all the possible sources of competitive pressure. Also, recognize the uniqueness of your organization and utilize structural and policy initiatives where appropriate to enhance the effectiveness of its strategies.

DEVELOP OBJECTIVES

Now that you and your team have a working knowledge of strategic thinking, it is time to add the next level to the

strategic framework. Underneath and associated with each strategic goal are objectives. Typically, there are two to five objectives for each strategic goal. As indicated in Exhibit 4.2, each agreed-upon objective represents a quantifiable, measurable, time-related achievement critical to goal attainment.

When taken collectively, all the objectives for a goal describe in sufficient detail precisely what and when the team members will be satisfied that the entire goal or some major part of it has been reached. Because goals typically describe states desired over the next five to ten years, and objectives relate to achievements with a one- to three-year horizon, it is not uncommon for a collection of objectives to simply describe what the organization understands to be a single phase or stage of several required for overall goal achievement.

Once your team has had time to consider the original mission and strategic goals created in the first workshop, it is likely there will be some revisions. It is usually a good idea at the beginning of each session to take the current version of the mission and strategic goals and contrast them to the checklist at the end of Chapter 4's "Evaluate Mission, Niches, and Goals." It may also be worthwhile to raise the question as to whether the strategic goals as stated, considering the consensus view of the environment, will, if achieved, result in a sufficient, sustainable competitive advantage that will allow the organization to fulfill its mission. When the team is satisfied with the updated version of the mission and strategic goals, it is time to begin to create possible objectives for each strategic goal.

Remind all team members that objectives deal simply with *what* the desired state will be, not *how* it will be

achieved. Without any further discussion of the nuances of objectives (to avoid distracting the team and turning the session into an academic exercise), three- to five-member cross-functional teams should be formed and each assigned a strategic goal. The teams are to break out into a private area and spend about an hour discussing and recording possible objectives which, if achieved, would result in attainment of the strategic goal (or a major part thereof) to which they have been assigned. One team member should be designated the *scribe* to record all the possible objectives and another the *presenter* to share the results with the group. Hand-written notes on acetates used in overhead projectors are adequate for this exercise, although some organizations enjoy using higher technology alternatives. The important point is that each possible objective be shared with the overall framework development team and suggestions or alterations which arise during the group discussion be recorded.

A second breakout session then takes place with team compositions being altered and strategic goals reassigned to ensure maximum exposure and input opportunities for all participants. This time the teams should spend 90 to 120 minutes and include the remarks recorded at the prior presentation meeting as well as begin to prioritize which of the possible objectives should occur first. Similar objectives or objectives with several components are often grouped together during this time. Once the breakout groups have completed their revised objectives listing, the entire group reconvenes and reviews and comments on the presentations for every strategic goal. If there are more strategic goals than there are teams, tackle related groups of strategic goals one at a time and repeat the process as necessary.

The purpose of charging right into this exercise without a great deal of discussion about objectives is to enable each participant to grapple with objective formation without any preconceived paradigms to limit creativity. However, before a final first draft set of objectives for each strategic goal is completed, it is worthwhile to review more completely what makes a good objective.

First, a good objective should be *well-suited* to the strategic goal. It should reflect an understanding of the internal and external environment in which it must be achieved. Often times, more research will be required to place specific numbers or attributes within an objective. However, this should not preclude its inclusion. It is perfectly acceptable at this stage to leave a blank in the objective statement until additional analysis can provide a reasonable figure (e.g., "attain a __% market share in product A in __ years"). Suitability should also be revisited once other objectives are created to ensure all objectives selected are consistent with each other.

Second, a good objective should be *quantifiable*. The ability to measure objectives allows managers to determine if they have, in fact, been achieved as well as monitor progress toward their achievement over time. Numbers are one way in which objectives can be quantified. However, in certain instances, qualitative measurements, when stated fairly specifically, are more appropriate.

Third, an appropriate objective should be *understandable* by all involved. It should be clearly stated and sufficiently explicit that it can be easily communicated without confusion. If junior high school students can understand what it means and what is meant by its achievement, it is probably worded well.

The *timing* required for completion is a fourth component of a good objective. If the objective is critical, the sooner it can be completed the better (Take enough time—but not too much!). More often than not, a specific date in the future serves this purpose well. However, it is not uncommon to tie one objective to the completion of another, thereby still including a time element, but in an indirect way.

Finally, a good objective is *feasible*. That is, given all that is known about the organization's economic, political, technical, and social environment and its existing internal capabilities, it is likely that the objective can be attained within the time allowed.

These five guidelines should be considered just that. No one can predict with certainty what actions the organization's competitors are going to take in the future, what direction the national economy will take next year, or what technological advances will become commercial in the coming months. Accordingly, it is more important to focus on ensuring that the objectives that are selected do, in fact, characterize the strategic goals in a manner considered fair and consistent by the framework development team.

Once all team members are comfortable, they understand what is meant by sound objective characteristics, and when the review of the guidelines is completed, a third round of breakout sessions is generally conducted to facilitate the creation of a first final draft of objectives for all the strategic goals. This time, as breakout groups are formed, it might be useful to have teams that represent those individuals within the organization that will likely be responsible for

achieving the ultimately agreed-upon objectives working on the related strategic goals. The *scribe* and *presenter* functions are still in effect here, but the time required should remain open, allowing each objective to be refined to a level supportable by a consensus of the entire framework development team. Once this is accomplished, the next step is to create specific strategies to achieve the objectives.

DEVELOP STRATEGIES

Now that you and your team have developed a set of objectives for each strategic goal, it is time to add the next level to the strategic framework. Underneath and associated with each objective are several strategies. Typically, there are two to five strategies for each objective. The less experienced your organization is with an objective, the more strategies there should be. This improves your chances of achievement, allowing the organization to try another strategy if an unproved one does not work out. As indicated in Exhibit 4.2, a strategy is a creative allocation or withdrawal of resources consistent with traditional principles. Every strategy should describe what resources are involved and how they will be employed.

Strategy formulation is an iterative process. Therefore, your team may want to complete the following three steps more than one time before agreeing on a set of strategies:

1. Brainstorm
2. Evaluate
3. Prioritize

Brainstorm

The first step is to convene the entire development team and, as a group, create a list of possible strategies for each objective, taken one at a time. At this stage, one member of the group should be recording all ideas. The atmosphere should be a totally nonjudgmental one, where brainstorming with abandon is taking place. Although both the left brain (analytical, linear, quantitative thinking) and right brain (intuitive, creative, qualitative thinking) of each participant should be involved, the emphasis here is on the right brain. Every strategy and idea that comes up should be included on the list, and the list should be in plain sight for all to see. The following guidelines should be reviewed and followed as much as possible to ensure the differing perspectives of the participants and the collective wisdom of the group are utilized:

- This is an idea generation exercise (no judgment or criticism of ideas is allowed and no defense of ideas is necessary).
- Far-out or wild ideas are encouraged (they often trigger more practical ones).
- Building on another's idea, or combining in two or more to come up with another approach is desirable (variation rather than improvement is all that matters).
- The more strategies, the better (quantity is preferred over quality because the more ideas there are, the more likely useful strategies may develop).
- There is no such thing as a bad idea (some just require more work and refinement than others).

Some groups prefer to go around the room continually, giving each person a turn to contribute in order. Others enjoy keeping it a free-form experience, allowing anyone to chime in whenever a thought occurs. In either case, group members should feel comfortable voicing whatever occurs to them as a strategy.

Furthermore, strategies that might be useful for one objective might come into play as a means of accomplishing another. This kind of duplication, too, should be encouraged. Because resources are generally scarce, and strategies typically use up these scarce resources, the more objectives that can be achieved with one strategy (i.e., fewer resources), the better.

Evaluate

The second step is to break out into groups, with each group responsible for one objective and its related list of brainstormed strategies. The responsibility of each group is to combine and rework the strategies so that they begin to contain a certain amount of realism. At this stage they can begin to prioritize and make suggestions regarding which strategies should be selected. Consideration should be given to how well each reworded strategy conforms to these traditional principles:

- *Focus.* Is it clearly directed toward the achievement of the objective?
- *Realism.* Does it seem do-able with available resources?
- *Mass.* Does it concentrate resources at the right place to ensure a win?

- *Exploitation*. Does it take advantage of competitors' weaknesses?
- *Indirection*. Does it concentrate resources where there is no competition?
- *Economy*. Can it be accomplished at the same level with fewer resources?
- *Cooperation*. Will it adversely impact other parts of the organization?
- *Flexibility*. Can we change course or withdraw with minimal expense?
- *Unity*. Will coordination within or without the organization be an issue?
- *Simplicity*. Is there a less complex solution available at the same cost?
- *Surprise*. Will it give the organization a sustainable lead or edge?
- *Change*. Does it take advantage of or exploit known trends?

Sometimes, one or more of these traditional principles may not apply. For example, if an idea involves a market research project, it may, at first blush, appear to not meet the realism principle (not do-able with available resources) if the organization has no market research staff or budget. However, a creative strategy might involve establishing a connection with a marketing professor at the local college who will then encourage his students to become involved in the project with little cost to the organization.

Once the group is satisfied with its initial effort, it is to present the list of reworked strategies to the entire team, making sure none of the initial brainstormed strategies have

been eliminated. This ensures that others in the group, who might have a particular inclination toward a particular idea of their own, have an opportunity to explain how it works and defend it prior to its being given a lower priority or eliminated.

Prioritize

Once the entire group has had an opportunity to review and provide input on all the strategies, the breakout groups are to retire to privacy again, incorporate the feedback, and rework and shrink down the list of strategies to come up with the final first draft of strategies.[3]

Once this is done for each objective, it is time to create a final first draft of the strategic framework for the first four levels (Mission, Strategic Goals, Objectives, and Strategies). A simplified example of how this might look is contained in Exhibit 5.2.

Notice how ABC Company's mission and strategic goals contain statements which are:

- *long term* ("to be a leader"),
- *relative* ("cleverest, fastest, and most economical"), and
- *interconnected* ("designing, assembling, and selling").

Also notice how their objectives are:

- *well suited* to the strategic goal ("reduce cost" ties directly to "most economical"),
- *quantifiable* ("0.5% annually"),
- *understandable* ("one new device every quarter"), and
- include *timing* ("within three years").

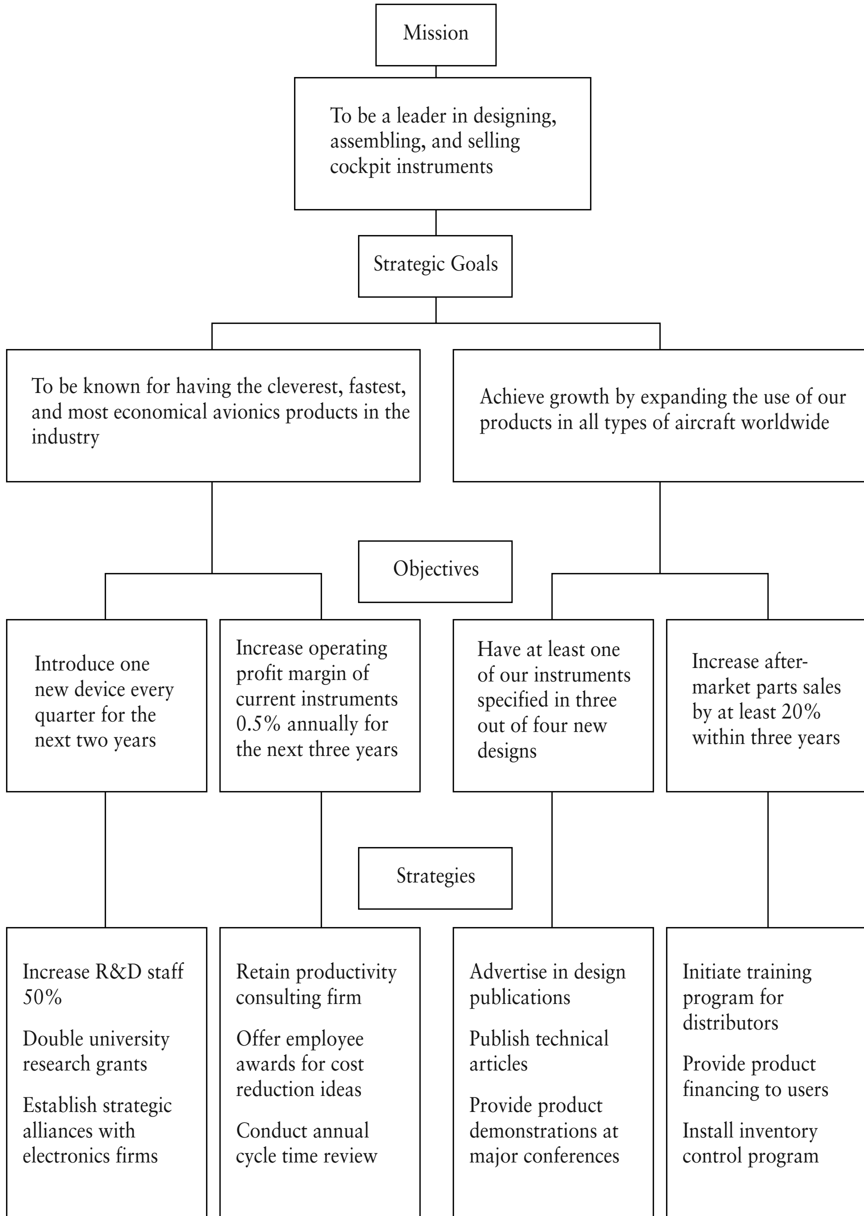

EXHIBIT 5.2 ABC Company Draft Strategic Framework

Whether or not these objectives are *feasible* is not discernible by reviewing the wording alone. However, assuming the framework was created by a knowledgeable development team, it is likely the selected objectives are achievable.

Finally, notice how the stated strategies involve allocating resources. Financial resources will be spent directly on university grants, outside consultants, employee awards, and advertising. Staff resources will be spent directly on establishing strategic alliances, conducting annual reviews, writing articles, providing product demonstrations, and training distributors. To determine the total resources required to achieve the objectives, simply add up the direct financial expenditures, multiply the staff and facility time required by an appropriate billing rate or hourly charge, and combine the two. Most organizations discover that the first time through, such a summation results in far more resources than those which are readily available to it. Hence the iterative nature of the framework development process.

SELECT VALUE-MAXIMIZING STRATEGIES

Once the development team has created a draft framework through the strategy level with which it is satisfied, the participants will have completed a most important workshop and can be freed to return to their "normal" jobs and routines. However, additional analyses of their output should be conducted to consider which combination of strategies is most likely to maximize the value of the organization and has the greatest chance for successful implementation. The first analysis is a financial one whereby strategies are converted

into cash flows and the impact on the overall valuation of the organization is determined. The second analysis contrasts the selected strategies to a qualitative checklist to ensure no major principles are violated or logic flaws exist.

Cash Flow Valuation

As a general rule, the more cash flow that can be generated and the smaller the investment required, the better the strategy and the more it enhances the organization's value. However, seldom are real-world strategies this simple or executed in a vacuum. Rather, they usually involve a variety of resources and impact a number of different financial variables.

For example, looking at Exhibit 5.2, let us contrast the value-enhancing effects of two different objectives (contained in boxes two and four from the left) and their related three strategies:

Objectives	Strategies
O.2 Increase operating profit margin of current instruments 0.5% annually for the next three years	**S.1** Retain productivity consulting firm
	S.2 Offer employee awards for cost reduction ideas
	S.3 Conduct annual cycle time review

O.4. Increase aftermarket parts sales by at least 20% within three years	**S.1** Initiate training program for distributors
	S.2 Provide product financing to users
	S.3 Install inventory control program

The first step is to start with the situation as it likely will be without either objective being achieved or any strategy implemented. This is shown in Exhibit 5.3. Note that only three years of data are used because this is the length of time involved in these two objectives.

The second step is to calculate the financial impact of achieving each objective and also the related costs of each strategy. It is important to point out that the impact of the objectives does not include the costs associated with the strategies. These are:

Objectives	Strategies
O.2 Operating profit margin is 10.5% in Year 1, 11% in Year 2, and 11.5% in Year 3	**S.1** Cost of 10 in Year 1 only
	S.2 Cost of 2 in Years 1, 2, and 3
	S.3 Cost of 5 in Year 1, 4 in Year 2, and 3 in Year 3

O.4 Operating Profit is 108 in Year 1, 116 in Year 2, and 128 in Year 3	**S.1** Cost of 6 in Year 1, 2 in Year 2, and 2 in Year 3 **S.2** Increase in working capital 1 in Year 1, 2 in Year 2, and 3 in Year 3 **S.3** Increase in fixed capital investment of 3 in Year 1 only

If we implement only the strategies aimed at achieving the first objective, O.2, the revised cash flow decreases in year one then improves markedly in Years 2 and 3, as shown in Exhibit 5.4.

EXHIBIT 5.3 ABC Company Yearly Cash Flows Before Strategy Implementation

	Year 1	**Year 2**	**Year 3**
Revenues	1060.00	1123.60	1191.02
Operating Profit Margin (%)	10.00	10.00	10.00
Operating Profit	106.00	112.36	119.10
Less:			
Taxes	42.40	44.94	47.64
Increased Fixed Capital Investment	2.40	2.54	2.70
Increased Working Capital Investment	1.80	1.91	2.02
Cash Flow from Operations	59.40	62.96	66.74

EXHIBIT 5.4 ABC Company Projected Cash Flows: Objective O.2

	Year 1	Year 2	Year 3
Revenues	1060.00	1123.60	1191.02
Operating Profit Margin (%)	10.50	11.00	11.50
Operating Profit	94.30	117.60	131.97
Less:			
Taxes	37.72	47.04	52.79
Increased Fixed Capital Investment	2.40	2.54	2.70
Increased Working Capital Investment	1.80	1.91	2.02
Cash Flow from Operations	52.38	66.11	74.46

If we implement only the strategies aimed at achieving the second objective, O.4, the revised cash flow also decreases in Year 1, but does not become greater than the original case until Year 3, as shown in Exhibit 5.5.

The cash flow results by scenario are summarized in Exhibit 5.6. When looking at the total cash flows during the period in question, it becomes obvious that implementing Objective O.2 is superior to implementing Objective O.4. Also, on the surface, when total cash flows are compared, it appears that Objective O.2 is superior to the No Objective scenario. However, considering the time value of money, No Objective may be a better value-enhancing alternative because its cash flow in Year 1 is over seven times greater

EXHIBIT 5.5 ABC Company Projected Cash Flows: Objective O.4[a]

	Year 1	Year 2	Year 3
Revenues	NA	NA	NA
Operating Profit Margin (%)	NA	NA	NA
Operating Profit	102.00	114.00	126.00
Less:			
Taxes	40.80	45.60	50.40
Increased Fixed Capital Investment	5.40	2.54	2.70
Increased Working Capital Investment	2.80	3.91	5.02
Cash Flow from Operations	53.00	61.95	67.88

[a] Revenues and Operating Profit Margins are NA (not applicable) because achieving this objective involves changes in volumes in product lines (parts versus original products) with different margins; accordingly, only the final impact on operating profit is shown.

than Objective O.2. The way to resolve these types of timing differences, of course, is to discount the cash flows to their respective present values, as covered in Chapter 2's "Master Discounted Cash Flow."

When dealing with combining several objectives and their related strategies, or selecting only some of all identified strategies and implementing as a group, one must consider the cross-financial impacts involved. However, the

EXHIBIT 5.6 ABC Company Objectives Cash Flow Comparison

Scenario	Year 1	Year 2	Year 3	Total Cash Flow
No Objective	59.40	62.96	66.74	189.10
Objective O.2	52.38	66.11	74.46	192.95
Objective O.4	53.00	61.95	67.88	182.83

methodology remains the same. Linear programming models and software abound to simplify the kind of analyses involved here.

Once the cash-flows are ultimately determined, then the comparisons of multiple strategic combinations can be accomplished. By following the guidelines in Chapter 2's "Calculate Current Organization Value" for each set of strategic combinations, the one set that yields the greatest value for the organization (and hence, maximizes its value) can be identified. The financial homework is tentatively completed, subject to the selected strategies being evaluated against principles.

Principles Evaluation

Once the more attractive cash flow valuation strategies have been selected, they should be qualitatively ranked. This is a fairly straightforward procedure that allows the organization to assess alternative strategic options for achieving similar objectives. Considering the time and effort that such

evaluations typically take, this kind of detailed qualitative evaluation is usually reserved for major strategic options only. It works best if two to four options are being contrasted at the same time.

Exhibit 5.7 provides an objective framework to contrast alternative strategic options. For exemplary purposes these are called options A, B, and C. The principles that are involved are the twelve listed in the "Develop Strategies" section of this chapter. The questions associated with each principle should be asked of every strategic option and numerically ranked on a scale of one to ten, with one indicating the option unsatisfactorily follows the principle and ten indicating it follows it completely. The results for each option are then summarized at the bottom.

Generally, the winner with the highest number of points will be clear. Considering that these are usually important strategic options under consideration, however, it is worthwhile asking three more questions concerning the mathematical results:

1. Should a low score anywhere disqualify the option completely?
2. Should some of the principles be weighted more heavily than others?
3. How do the results compare to our intuition? Does it matter?

This exercise should be completed for the major strategies developed.

Principles	**Option A**	**Option B**	**Option C**
Focus			
Realism			
Mass			
Exploitation			
Indirection			
Economy			
Cooperation			
Flexibility			
Unity			
Simplicity			
Surprise			
Change			
	________	________	________
Total			

EXHIBIT 5.7 Strategy Evaluation Worksheet

SUMMARY

The initial strategy formulation period requires a great deal of creativity and patience. Once the draft framework is completed, it can be laid to rest for a while (three to six weeks) in preparation for the next phase of its development. In this step, the key strategies are evaluated and prioritized by the organization's development team in preparation for the execution step, where action plans are developed and implementation begins.

ENDNOTES

1. Also known as the I^3 list. This collection of ideas represents concrete, yet simple ways to demonstrate how the strategic framework process can result in positive changes, starting immediately. One of the ways to implement change is to study and refine a new approach in great detail before implementing it. The ideas on this list are often better altered as necessary after they are implemented, thereby creating an action-oriented atmosphere within the organization and replacing time spent studying with time spent monitoring and altering (an approach usually benefiting overall efficiency and organization cash flow).
2. Informal Friday afternoon parties, wearing impressive uniforms, company songs, and formal award ceremonies are some of the countless techniques companies use to give employees a sense of ownership and pride in the organization.
3. To ensure no good ideas are lost in the shrinking down process, many organizations keep a strategic framework creation notebook that contains copies of all the working papers created during the iterative development process.

CHAPTER 6

Evaluate Alternative Approaches

All of the work to date is for naught if the strategic framework is not executed. Specifically, the organization needs to focus on executing the selected strategies contained in the framework. When successfully executed, these strategies should aid in the achievement of the critical few objectives which, in turn, move the organization toward strategic goal and mission attainment.

Execution is a process involving all aspects of the organization. Highly motivated people working on tasks matched to their skill levels, conscious of the actions and progress of other parts of the organization, represent the ideal in execution. Achieving this state is no simple task, but the result—enhanced organization value—is well worth the effort.

But how can you be sure the strategies developed will enhance your organization's value? The answer is simple—quantify the impact that executing the selected strategies will have on value and contrast this to the value your organization would have if none of the selected strategies is executed. In order to assist you in communicating quantifiable results in a clear and precise manner, this chapter contains

an example which you should easily be able to adapt to your organization's possible strategies. It shows you how, step by step, to make this critical comparison.

REVIEW THE SELECTED STRATEGIES

There are four objectives identified in the ABC Company Draft Strategic Framework (see Exhibit 5.2). These objectives deal with:

- New product (device) introductions
- Cost reduction (margin improvement) efforts
- New markets (designs) for existing products
- Accelerating growth (parts)

The variety of these objectives and their supporting strategies provide many examples of the specifics involved in the process of evaluating a strategic framework. These objectives (labeled "O.n") and their supporting strategies (labeled "S.n") are:

O.1 Introduce one new device every quarter for the next two years

S.1 Increase R&D staff by 50%

S.2 Double university research grants

S.3 Establish strategic alliances with electronic firms

O.2 Increase the operating profit margin of current instruments 0.5% annually for the next three years

S.1 Retain productivity consulting firm

- S.2 Offer employee awards for cost reduction ideas
- S.3 Conduct annual cycle time review

O.3 Have at least one of our instruments specified in three out of four new designs

- S.1 Advertise in design publications
- S.2 Publish technical articles
- S.3 Provide product demonstrations at major conferences

O.4 Increase after-market parts sales by at least 20% within three years

- S.1 Initiate training program for distributors
- S.2 Provide product financing to users
- S.3 Install inventory control program

Each of the twelve strategies involves the use of certain resources and is expected to achieve a certain result. The people involved in developing the cost and revenue projections associated with these strategies should be familiar with the organization and the functional areas involved. After all, major resource decisions will be based on their analysis and the level of success of the strategies will depend, to a large extent, on their assessment of the capabilities of those charged with execution.

UNDERSTAND THE METHODOLOGY

Convincing yourself and key members of your team that effective execution of strategies improves the value of the organization requires a credible and repeatable methodology for

quantifying the financial impact of executing the proposed strategies. Specifically, the methodology employed in this example shows how to estimate the results that would be obtained by achieving all four of the objectives spelled out in the ABC Company Draft Strategic Framework (see Exhibit 5.2). These results, in turn, are used to calculate a new, higher value for the organization if all the strategies are executed.

The benchmark against which to measure the increase in value resulting from executing the above strategies will be the ABC Company Current Organization Value of $524.3 (calculated in Chapter 2's "Calculate Current Organization Value") in which "nothing in the future changes." For ease of reference it will be called the *Base Case*. By way of review, this *Base Case* value is computed using the discounted cash flow methodology. This cash flow, in turn, is generated from a five-year projection of financial performance using historical averages. The historical averages used in the projections are applied to figures representing current financial performance (Year 0 numbers).

The new ABC Company value, incorporating the twelve strategies proposed earlier, will be called the *Revised Case*. To ensure the *Revised Case* is comparable to the *Base Case*, both begin with identical figures for the current year (Year 0), the key line items of which appear in some detail, along with their five-year historical averages, in Exhibit 6.1.

Furthermore, to maintain comparability, both cases use a five-year projection period. These numbers, therefore, provide the starting point for the strategy execution value analysis embodied in the *Revised Case*.

Notice in Exhibit 6.1 that total revenues in the starting year (Year 0—the year preceding the one in which the

EXHIBIT 6.1 ABC Company Starting Year

	Year 0	Five Year Historical Average
Total Revenues	***1000***	***6% growth/year***
■ Instruments—Existing Airplane Designs	500	6% growth/year
■ Instruments—New Airplane Designs	0	
■ Parts	500	6% growth/year
■ New Devices	0	
Total Operating Profit Margin[a]	***10%***	***10%***
■ Instruments—Existing Airplane Designs	8%	8%
■ Instruments—New Airplane Designs		
■ Parts	12%	12%
■ New Devices		
Total Operating Profit	***100***	
■ Instruments—Existing Airplane Designs	40	
■ Instruments—New Airplane Designs	0	
■ Parts	60	
■ New Devices	0	
Less:		
Taxes		40% of operating profit
Incremental Working Capital Investment		3% of change in revenues
Incremental Fixed Capital Investment		4% of change in revenues

[a] Figures expressed as a percentage of associated revenues.

strategies are executed) are 1000 and that they are composed of two line items, each with 500 in revenues—instruments compatible with existing airplane designs, and parts. However, because the strategies address two new sources of revenue—new devices not currently developed or sold, and instruments compatible with new airplane designs—these line items are included for clarity's sake, even though their revenue in Year 0 is zero.

Furthermore, notice that the total operating profit margin in Year 0 is 10%, the average of 8% on instruments compatible with existing airplane designs and 12% on parts. The actual operating profit of 100 in Year 0 is also shown with the appropriate amount allocated to the two current line items. Again, for clarity's sake, line items for the two new sources of revenue are shown as line items in the operating profit sections.

Finally, note that the five-year historical averages are included. All of these are used in the *Base Case* and will be used in the *Revised Case*, unless a strategy is proposed which alters a particular historical average.

QUANTIFY THE SELECTED STRATEGIES

Determining the overall impact on the *Revised Case* value of achieving the selected objectives by executing their respective strategies requires an examination of the costs and benefits involved. The example which follows uses economics developed by the ABC Company management team after several iterations in which more cost-effective approaches were developed and the principles of strategy were revisited and incorporated. The key drivers of cash

flow for each objective are built up based on calculations at the strategy level. The methodology involved is demonstrated in the analysis of the four selected ABC Company objectives contained in the following subsections. The focus is on the incremental costs and revenues resulting from the execution of the selected strategies (i.e., those above the ones already embodied in the *Base Case*).

Objective 1: New Devices

The first strategy employed to obtain the objective of introducing a new device every quarter is to increase the research and development staff by 50%. Inasmuch as the Year 0 cost was eight, the incremental cost will be an additional four per year for the upcoming five years (Years 1 through 5). Additionally, hiring costs in Year 1 will make this value five, not four.

The second strategy is to double university research grants. These grants were one in Year 0 and, accordingly, will be two in Years 1 through 5. Included in this increase are the costs associated with directing the university researchers toward technology specifically applicable in new ABC Company devices.

The third strategy is to establish strategic alliances with electronic firms. The purpose here is to ensure ABC's new devices have access to the latest electronic technology. Cooperation from firms that have such technology will be garnered by offering them ABC technology that can be utilized by other organizations not competing directly with ABC. The ongoing costs associated with this technology transfer are estimated to be one annually in Years 1 through 5, with an additional cost of one in Year 1 to establish and negotiate relationships.

Based on these efforts, ABC Company expects to introduce two new devices in Year 1, then four devices each in Years 2 through 5. Furthermore, it expects the annual revenue generated from each new device to average ten and the operating profit margin on new devices to be the same as on parts (12%).

The additional costs and revenues resulting from the execution of these strategies are summarized in Exhibit 6.2.

Note that although the total costs remain level in Years 2 through 5, after the initial higher expenditures in Year 1, the total revenues grow from year to year as more new devices are added to the product line.

EXHIBIT 6.2 ABC Company Projected Incremental Costs and Benefits: Objective 1—New Devices

	Year 1	Year 2	Year 3	Year 4	Year 5
Costs:					
S.1 R&D Staff	5	4	4	4	4
S.2 University Grants	2	2	2	2	2
S.3 Strategic Alliances	2	1	1	1	1
Total Costs	9	7	7	7	7
Benefits:					
Total New Devices Developed	2	6	10	14	18
Total Revenue	20	60	100	140	180

Objective 2: Operating Profit Margin

The first strategy indicated to increase operating profit margins on the existing instrument product line of 0.5% annually for the next three years is to retain a productivity consulting firm. This effort requires a six-month study and six months to implement the recommendations, resulting in a cost of five in Year 1. Because the new recommendations are up and running by Year 2, there are no additional costs in Years 2 through 5.

The second strategy involves offering employee awards for cost reduction ideas. For most employees at ABC Company, the recognition is as important as the compensation. However, the costs of communicating and managing the program for the three-year horizon spelled out in the objective are substantive, resulting in an annual cost, including awards of two in Years 1 through 3.

The third strategy involves conducting cycle time reviews every year for the three-year horizon of the objective. These analyses follow the path the typical order takes from origination through product delivery and follow-up service. They identify disconnects and inefficiencies in processing and manufacturing and are fairly time consuming. However, the company gets better each year at the process, resulting in annual costs of four in Year 1, three in Year 2, and two in Year 3.

Because these three strategies focus on current instruments that have an operating profit margin of only 8% in Year 0, and are carried out only in the first three years, the benefits likely to accrue are limited to this time period as well. Accordingly, the operating profit margin for instruments-existing airplane designs grows to 8.5% in Year 1, 9.0% in Year 2, and 9.5% in Year 3, where it remains through Year 5.

EXHIBIT 6.3 ABC Company Projected Incremental Costs and Benefits: Objective 2—Operating Profit Margin[a]

	Year 1	Year 2	Year 3	Year 4	Year 5
Costs:					
S.1 Productivity Consulting	5	0	0	0	0
S.2 Employee Awards	2	2	2	0	0
S.3 Cycle Time Reviews	4	3	2	0	0
Total Costs	11	5	4	0	0
Benefits:					
Operating Profit Margin Increase	0.5%	0.5%	0.5%	0%	0%
Total Operating Profit Margin	8.5%	9.0%	9.5%	9.5%	9.5%

[a] The benefits projected apply only to the line item "Instruments—Existing Airplane Designs." However, it is possible that additional benefits, not quantified or included in this analysis, might well accrue to other aspects of the business. For example, employee suggestions for cost reduction might be made regarding new devices or parts.

The costs and benefits resulting from these strategies are summarized in Exhibit 6.3.

Note that the costs cease and the benefits do not increase after Year 3, although it is probable that by then feedback from executing the existing strategies will have been digested and further enhancements made. However, because the management team of ABC

Company is conservative, the analysis does not take this likelihood into consideration.

Objective 3: New Designs

The first strategy employed to reach the objective of having one or more ABC instruments specified in 75% or more of new designs is to advertise in aircraft design publications. A study of the average advertising expenditures for instrument companies, coupled with several meetings with the media department of the organization's advertising agency, resulted in cost projections of two for Years 1 through 5. This level of expenditure is believed to be adequate for making the desired impact on the design community.

The second strategy is for ABC employees and/or related parties to publish technical articles espousing the cutting edge technology and cost effectiveness of ABC products. Considering that much of the talent required for this strategy is in-house, its additional annual cost is estimated to be one for Years 1 through 5.

The third strategy involves setting up booths, conducting product demonstrations, and generating goodwill at major conferences and conventions. The agreed-upon approach involves starting small, presenting at only a couple of locations in Year 1. Then, as the people working the exhibits gain more experience, and feedback from customers and prospects is evaluated, the number of events with which the organization is associated increases, as does the sophistication and effectiveness of its conference and convention efforts. Accordingly, the costs associated with this strategy grow from one in Year 1 to two in Year 2 to three in Years 3 through 5.

The combined result of executing these strategies is then estimated, based on the following assumptions:

- The industry average is eight new designs per year.
- ABC is specified in six new designs per year (75%).
- The average annual ABC revenue for each design in which its products are specified is four in the first year, six in the second year, and eight in the third year and beyond.

Accordingly, the number of new designs into which ABC instruments are specified grows by six per year from six in Year 1 to thirty in Year 5. Because these are existing instruments, the operating profit margins will rise 0.5% per year as defined in Objective 2.

The additional costs and revenues resulting from the execution of these strategies are summarized in Exhibit 6.4.

Note that in this case both costs and revenues rise over time.

Objective 4: Parts

The first strategy to achieve the objective of increasing parts sales by at least 20% within three years is to initiate a training program for distributors. The time involved to conduct a distributor survey to assess the level of existing ABC product knowledge and desire for some form of training suggests first year expenses will be higher than ongoing expenses. However, in addition to preparing materials and conducting the actual training, consideration was given to the necessity to regularly upgrade the program content. Accordingly, the

EXHIBIT 6.4 ABC Company Projected Incremental Costs and Benefits: Objective 3—New Designs[a]

	Year 1	Year 2	Year 3	Year 4	Year 5
Costs:					
S.1 Publication Advertising	2	2	2	2	2
S.2 Technical Articles	1	1	1	1	1
S.3 Conference Demonstrations	1	2	3	3	3
Total Costs	**4**	**5**	**6**	**6**	**6**
Benefits:					
Cumulative New Designs In	6	12	18	24	30
Total Revenue	24	60	108	156	204

[a] The first year in which ABC products are specified in a new design, its revenues are 4, the second year they are 6, and the third year and beyond they are 8. For example, in Year 3, ABC is specified in 6 first-year designs, 6 second-year designs, and 6 third-year designs. Accordingly, revenue in Year 3 is calculated as $(6 \times 4) + (6 \times 6) + (6 \times 8) = 108$.

costs associated with executing this strategy are estimated to be four in Year 1 and two in Years 2 through 5.

The second strategy is to provide product financing to users or customers. This would allow them to keep more parts inventory, yet not necessarily bear the additional cost

of financing the added working capital involved. After substantial analysis by the accounting department, ABC projected this strategy would raise the level of their accounts receivable (and, hence, short-term working capital requirement) by a factor of 1% of average annual revenues.

The third strategy involves installing an inventory control program. If effective levels of inventory are maintained, ABC would not lose sales on out-of-stock items or incur excess financing costs related to low turnover items. Furthermore, by monitoring customer usage patterns, such a program would enable ABC to keep its customers informed when their inventories might be running low, thereby enhancing the level of service to an important group of stakeholders in the organization.

The manufacturing, marketing, and finance team put together to analyze this strategy identified two major cost elements. The costs involved with designing, installing, and testing the system in the first year were estimated to be three, and the costs associated with the ongoing operation and maintenance of the system were estimated to average one per year. There was also a financial benefit particular to this strategy. As a result of better controls, the level of inventories required (and, hence, the short-term working capital requirement) would be reduced by a factor of 1% of average annual revenues.

The combined impact on parts sales of these strategies is estimated to improve over time. Because of the substantial amount of initial development work required, parts revenue growth in Year 1 is expected to remain only at the historical level of 6%. However, as the training, financing, and inventory

programs are executed, this growth rate is expected to increase to 7% in Year 2, 8% in Year 3, and 9% in Years 4 and 5.

The combined costs and benefits resulting from these three strategies are summarized in Exhibit 6.5.

Notice how, for this objective, a significant investment is required before the benefits are achieved. Note also that the

EXHIBIT 6.5 ABC Company Projected Incremental Costs and Benefits: Objective 4—Parts Sales[a]

	Year 1	Year 2	Year 3	Year 4	Year 5
Costs:					
S.1 Distributor Training	4	2	2	2	2
S.2 Product Financing	0	0	0	0	0
S.3 Inventory Control	3	1	1	1	1
Total Costs	7	3	3	3	3
Benefits:					
Working Capital Reduction	0	0	0	0	0
Annual Parts Revenue Growth	6%	7%	8%	9%	9%

[a] The cost associated with the Product Financing strategy is an increase in the ABC annual working capital requirement of 1% of revenues. However, one of the benefits of the Inventory Control strategy is a decrease in the ABC annual working capital requirement of 1% of revenues. Accordingly, these effects cancel each other out and are recorded as "0" in both the cost and benefit sections.

negative impact on working capital resulting from the product financing strategy is canceled out by the positive impact on working capital of the inventory control strategy.

CALCULATE REVISED CASE VALUE

It is now time to calculate the combined increase in organization value which would result by achieving all four of the objectives spelled out in the ABC Company Draft Strategic Framework (see Exhibit 5.2). When the strategies are carried out successfully and the objectives achieved, the overall value of the organization indicated by the *Revised Case* should be greater than that indicated by the *Base Case*. There are six steps involved in calculating the *Revised Case* value:

1. Create a five-year income statement embodying the new costs and benefits
2. Calculate the cash flow from operations for five years
3. Determine the weighted cost of capital (discount rate)
4. Calculate the cumulative present worth of the five-year cash flows
5. Calculate the value of the organization at the end of five years
6. Combine the output from steps 4 and 5 to obtain the *Revised Case* value

Step 1: Income Statement

The *Revised Case* five-year income statement embodying the new costs and benefits is shown in Exhibit 6.6.

EXHIBIT 6.6 ABC Company Revised Case Income Statement

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Total Revenues[a]	***1000***	***1104***	***1249***	***1416***	***1595***	***1781***
■ Existing Designs	500	530	562	596	631	669
■ New Designs	0	24	60	108	156	204
■ Parts	500	530	567	612	668	728
■ New Devices	0	20	60	100	140	180
Operating Profit Margin %	***10.0***	***10.2***	***10.5***	***10.7***	***10.8***	***10.8***
■ Existing Designs	8.0	8.5	9.0	9.5	9.5	9.5
■ New Designs		8.5	9.0	9.5	9.5	9.5
■ Parts	12.0	12.0	12.0	12.0	12.0	12.0
■ New Devices		12.0	12.0	12.0	12.0	12.0
Gross Operating Profit	***100***	***113***	***131***	***152***	***172***	***192***
■ Existing Designs	40	45	51	57	60	64
■ New Designs	0	2	5	10	15	19
■ Parts	60	64	68	73	80	87
■ New Devices	0	2	7	12	17	22
Less:						
Total Execution Costs	***0***	***31***	***20***	***20***	***16***	***16***
■ Existing Designs	0	11	5	4	0	0
■ New Designs	0	4	5	6	6	6
■ Parts	0	7	3	3	3	3
■ New Devices	0	9	7	7	7	7
Net Operating Profit	***100***	***82***	***111***	***132***	***156***	***176***

[a] Revenue growth for existing designs is 6% annually, the same as the *Base Case* against which the *Revised Case* value being calculated is to be contrasted. The numbers for the balance of the revenue components are a result of the strategies executed, whose results are highlighted in Exhibits 6.2 through 6.5.

It includes the revenue growth, operating profit margins, and execution costs for each of the major organization components affected by the 12 strategies. These components—instruments sold for use in Existing Airplane Designs, instruments sold for use in New Airplane Designs, After-Market Parts, and New Instrument Devices—reflect the quantification of the 12 strategies discussed in the prior section. The component operating profit margins are applied to the revenue components to generate gross operating profit. The components are then summed to total amounts, which are identified by italics. Finally, the execution costs are subtracted from the gross operating profit to obtain the net operating profit by year, which is the basis for calculating the cash flow in the next step.

Step 2: Cash Flow Statement

The *Revised Case* five-year cash flows are calculated from net operating profit and are shown in Exhibit 6.7.

The major component that reduces net operating profit is annual taxes. The incremental working and fixed capital investments also reduce net operating profit in arriving at cash flow and are calculated as a percentage of the change in total revenues. Exhibit 6.1 indicates that ABC Company's historical average percentage for working capital is 3% and for fixed capital is 4%. This percentage is applied to the change in total revenues from the prior year. For example, to calculate the change in revenues for Year 1 subtract the total revenues for Year 0 from Year 1 (1104 – 1000 [as shown in Exhibit 6.6] = 104).When this amount is multiplied by the 3% working capital percentage (104 × .03 = 3.1), the impact of the incremental working capital invest-

EXHIBIT 6.7 ABC Company Revised Case Cash Flow Statement

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Operating Profit	82.0	111.0	132.0	156.0	176.0
Less:					
Taxes	32.8	44.4	52.8	62.4	70.4
Incremental Working Capital Investment	3.1	4.4	5.0	5.4	5.6
Incremental Fixed Capital Investment	4.2	5.8	6.7	7.2	7.4
Cash Flow from Operations	41.9	56.4	67.5	81.0	92.6

ment on cash flow in Year 1, as shown in Exhibit 6.7, is determined. In summary, subtracting taxes and incremental working and fixed capital from net operating profit yields cash flow from operations.

Step 3: Discount Rate

To calculate the present worth of the cash flows derived in the previous step, a discount rate is required. The discount rate reflects the time value of money and the risk associated with operating the organization. The discount rate used to calculate organization value is the weighted cost of capital (see Chapter 2's "Determine Cost of Capital"). The two

components of this cost of capital are the cost of equity and the cost of debt. The former is affected by the riskiness of the organization's operations relative to other organizations and the latter by the amount and nature of the organization's debt.

The strategies selected by the management team for ABC Company, and the resultant objectives if achieved, are incremental in nature and, therefore, should not change either the overall risk associated with operating the organization or the amount of long-term debt required. Accordingly, the *Revised Case* uses 14%, the same weighted cost of capital and, therefore, discount rate as that used in the calculation of the *Base Case* value (see Chapter 2's "Determine Cost of Capital").

However, many strategies, such as building a new plant or buying a competitor, are not just incremental in nature. They involve bold decisions that may alter both the organization's risk and debt levels. In such cases, the weighted cost of capital should be recalculated before using it as a discount rate in any comparison.

Step 4: Cash Flow Value

By applying the discount rate of 14% from the prior step to the cash flow statement of Step 2 (Exhibit 6.7), it is possible to calculate the cumulative present worth of the five-year cash flows associated with the *Revised Case*. The annual cash flow from operations, discount factor, and present worth of the cash flow are highlighted in Exhibit 6.8.

The last line of this exhibit shows the cumulative present worth of the cash flows as it increases each year to a total of 221.9 in Year 5.

EXHIBIT 6.8 ABC Company Revised Case Discounted Cash Flows

	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow from Operations	41.9	56.4	67.5	81.0	92.6
Discount Factor	0.8772	0.7695	0.6750	0.5921	0.5194
Present Worth of Cash Flow	36.8	43.4	45.6	48.0	48.1
Cumulative Present Worth of Cash Flows	36.8	80.2	125.8	173.8	221.9

Step 5: Ending Value

The next step is to calculate the value of the organization at the end of five years, after the twelve strategies have been executed. The number resulting from this calculation is called the ending value. The rationale and detail behind this calculation are contained in Chapter 2's "Master Discounted Cash Flow." The specific line items needed to calculate this value and the amounts for the *Revised Case* are as follows:

Item	**Amount**
Year 5 net operating profit	176.0
Year 5 taxes	70.4
Discount rate	14%
Year 5 discount factor	.5194

To calculate the *Revised Case* ending value, subtract the Year 5 taxes from the Year 5 net operating profit (176 – 70.4 = 105.6). Then divide the result by the discount rate (105.6/.14 = 754.3). Finally, multiply the result by the Year 5 discount factor (754.3 × .5194 = 391.8). Therefore, the ending value at the end of five years for the *Revised Case* is 391.8.

Step 6: Revised Case Value

In order to obtain the total *Revised Case* value, reflecting the execution of the twelve strategies discussed above, simply combine the cumulative present worth of the five-year cash flows from Step 4 and the ending value from Step 5. Therefore, the *Revised Case* value is 221.9 + 391.8 or 613.7.

MEASURE VALUE ENHANCEMENT

Having completed the analysis of the *Revised Case*, it is now time to compare it to the original *Base Case*. For the time being, assume these are the only two alternatives available to ABC Company. That is, they can continue to operate the organization as they have historically—the *Base Case*, or they can go about executing the dozen strategies selected in the strategic framework they developed—the *Revised Case*.

A good place to start is to contrast the characteristics and financial implications of each case. Accordingly, the differences in revenue growth, operating profit, and cash flow generation are highlighted in Exhibit 6.9.

Each of these three elements are examined as follows:

EXHIBIT 6.9 ABC Company Base Case Versus Revised Case Financial Performance[a]

	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1–5 Total
Total Revenues:						
■ Base Case	1060.0	1123.6	1191.0	1262.5	1338.2	**5975.3**
■ Revised Case	1104.0	1249.0	1416.0	1595.0	1781.0	**7145.0**
Net Operating Profit:						
■ Base Case	106.0	112.4	119.1	126.3	133.8	**597.6**
■ Revised Case	82.0	111.0	132.0	156.0	176.0	**657.0**
Cash Flow from Operations:						
■ Base Case	59.4	63.0	66.7	70.8	75.0	**334.9**
■ Revised Case	41.9	56.4	67.5	81.0	92.6	**329.4**

[a] For the original source and calculation of *Base Case* figures see Exhibit 2.2.

Revenue Growth

Three of the four objectives in the *Revised Case* (O.1—introducing new devices, O.3—specifying instruments in

the *Base Case*. Moreover, over the five-year period, total operating profit is 10% greater for the *Revised Case* than for the *Base Case*, and is, in fact, over 30% greater in Year 5 alone.

Cash Flow from Operations

Cash flows are generally derived from operating profit. Accordingly, they are also lower in Years 1 and 2 for the *Revised Case* than for the *Base Case*. However, because they are also a function of working and fixed capital requirements, which rise with the overall level of revenues, the total cash flows for the *Revised Case* over the five-year period are actually somewhat less than those for the *Base Case* (329.4 versus 334.9). However, by Year 5, as the new strategies take hold, the *Revised Case* cash flow is already 24% greater than that for the *Base Case*.

In summary, a review of the differences in financial characteristics of the two cases indicates that positive revenue enhancements come quickly but that, due to the additional costs associated with spending additional resources on strategies, operating profit and cash flow improvements take a while. Therefore, it is important not to lose the long-term focus when analyzing value-enhancing strategies. Often, the management of public companies is accused of being overly concerned with short-term profits. As the ABC Company comparison shows, a management looking only at short-term profits might very well be inclined not to execute value-enhancing strategies because of the negative near-term impact on profits.

However, the long term is where the real value lies. In reexamining the two components of organization value—

analyze alternative strategies and combinations of strategies to achieve its desired objectives.

The ability to enhance value by simply following the steps outlined in the preceding sections exists for all organizations. However, it requires a thoughtful approach to building the components of the strategic framework prior to engaging in strategy selection. If shortcuts are taken, the likelihood of selecting strategies which are not supported by the skills, resources, people, equipment, or facilities of the organization can be quite high, resulting in less-than-perfect execution. Remember, if the strategy is not executed properly and the objective not attained, then the increase in value will not necessarily follow. But, with practice, continued use and modification of the Strategic Framework will allow you and your management team to generate and execute strategies that maximize the value of your organization well into the future.

CHAPTER 7

Execute for Value

Well-crafted, value-enhancing strategies have no worth on their own. They become significant only when executed. In order to accomplish this, the last level of the strategic framework must be completed. This straightforward process simply involves creating and attaching action plans to each strategy.

Then, once the final strategic framework is complete, its execution can begin. This process can be done forcefully, using direct, in-your-face, confrontational methods or can be approached more gently, employing indirect, subtle, roundabout means. In practice, most organizations use a combination of both. Regardless of which style an organization prefers, however, successful implementation will depend, in large part, on how effectively it is able to direct activities toward achieving and maintaining the agreed-upon niches and long-term goals.

This concentration of effort on enhancing the organization's expertise in areas which have a significant impact on success in the marketplace is what will allow it to continue to differentiate itself over time and survive and prosper well into the future. It is not a focus on generating cash flow for its own sake, but rather an emphasis on serving targeted

tives, and that achieving these objectives in this fashion will, indeed, increase the overall value of the organization, the task force should reconvene for an action planning workshop. The purpose of this session is to decide which individual or group or department is ultimately responsible for achieving which objectives.

It is not necessary that a single individual or department perform all the tasks required to obtain an objective. Efforts can cross organizational lines. Likely interdepartmental interfaces should be spelled out and highlighted so agreement as to levels of involvement and time and resource commitments can be anticipated. It is during such discussions that a spirit of cooperation should be fostered and all participants reminded that it is the organization working together which creates the goal of marketplace differentiation and long-term success.

Once responsibilities for each objective and related strategies are clearly spelled out, the formal session is over. The next step is for every team member to take the agreed-upon strategic framework (from the top mission level all the way through the strategy level) and present it to their staffs. The intimate knowledge of the methodology behind and the rationale for the framework obtained during the various sessions involved in its creation is usually enough to ensure its enthusiastic endorsement by the members of the organization. However, a high level of enthusiasm coupled with some basic sales techniques should facilitate each original team member's chances for achieving buy-in from the staff on the first go 'round. The goal is for the staff to agree that the urgency and importance of achieving the stated objectives are commensurate not only with the success of the organization but also their long-term well-being.

However, if major objections, road blocks, and/or conflicts arise during the staff presentations, they should not be overlooked or just set aside. Another action planning workshop should be scheduled where team members consider all the feedback obtained from the organization. By now the iterative nature of the overall process should be second nature to the participants. Accordingly, they should calmly reflect on the new internal input and, after referring to the purposes and values elements of the mission, revise responsibilities, objectives, and strategies as necessary in an appropriate way.

Once the revised framework is complete, it should be presented again to the members of the organization. Where changes have been made, the reasons should be explained. Where no changes have been made, in spite of protestations from some members of the organization, the rationale behind keeping things as they were should also be spelled out. Remember it is unlikely any document will please all members of an organization.

Once the strategic framework is complete down to the strategy level and buy-in at all levels of the organization is more or less complete, the next step is for every individual with objective-achievement responsibilities to convene an action planning workshop. Prior to doing so, however, each team member should review the material on action planning discussed later in this section.

The methodology for the staff action planning workshop is very straightforward and similar to that used in previous top management team workshops. The leader should be the individual with overall responsibility for objective achievement. Breakout groups should be organized and sent off to

develop specific action plans indicating who, what, where, when, how, and how much. Each breakout group generally works on one strategy at a time, creating however many action plans seem to be required to accomplish it fully.

Financial Considerations

When working with staff members on the creation of action plans, regardless of which techniques and guidelines might be employed, it is critical to stress that one of the key reasons behind all the implementation effort is to increase the overall value of the organization. The way this gets done is by each individual and group making decisions that always contribute to this end. The way to achieve this is to make everyone aware of one simple, mathematical truth:

> The value of the organization is enhanced each time an investment is made that has a higher return than the organization's weighted cost of capital.

The participants need to know only one number—the organization's weighted cost of capital (see Chapter 2's "Determine the Cost of Capital"). This number should be the same regardless of which area of the organization is involved in creating action plans.[1] The participants also need to know how to calculate an estimated return on investment. Most organizations supply calculators, economic models, or spreadsheets that simplify this process. The participant answers just a few questions related to the investment and the return is calculated.

With the weighted cost of capital in one hand and the return on the investment in the other, decision making is simple. For example, if one expects to invest $100 at the

management information systems. Indirect methods utilize imprecise means such as symbolic actions aimed at altering the organization's culture. Regardless of which method is being employed, however, the leader involved should be aware that one of the biggest challenges to be faced is removing the emotion and fear that staff members typically bring to such processes. Clear communications as to methodology, expectations, and roles to be played go a long way toward quelling such concerns.

To better understand the direct approach, let us consider the first strategy under the first objective for ABC Company (see Chapter 6's "Review The Selected Strategies"). This strategy is to "Increase R&D staff by 50%," and one way to achieve the objective is to "introduce one new device every quarter for the next two years." One possible direct approach would be to create a detailed action plan spelling out who, what, where, when, and how.

> Mr. Smith, Director of Human Resources will run help-wanted advertisements in the local Sunday paper for six months starting next week; Mr. Smith will authorize a project aimed at identifying competitive compensation and benefits for R&D personnel offered by other companies in the area; a committee of Mr. Smith, Ms. Jones, Manager of Technology, and Mr. Jackson, Chief Financial Officer, will develop a statement of job specifications and candidate requirements to be used in the advertisement and screening process; all submissions will be reviewed by the committee weekly and candidates selected will be invited to visit promptly. Up to $5,000 in advertising and 50 labor hours will be spent

to generate up to ten offers to ensure the two positions which need to be filled will be done so within eight months.

Another direct approach would be to institute a management information systems procedure. For example, screening criteria to apply to the employee database will be run periodically to identify potential new R&D staff transfers within the organization. Also, revisions to budgets and the organization chart should be made (other direct methods) to reflect the increased expenses and management time associated with new hires.

Now let us assume ABC is also interested in using indirect means that will support the same objective and strategy discussed above. By using the employee newsletter and press releases, the company reminds all its stakeholders it has a continuing commitment to innovation in the devices it sells and to overall corporate growth. This formal, written communication helps paint a picture of a nice place to work for the candidates identified by the direct means and may even generate unsolicited inquiries from other interested parties. At staff meetings, managers may share stories of bonuses and promotions employees have received in the past for referring candidates or submitting product improvement ideas, further communicating and inculcating the organization's values of excellence, rewards, and growth. Flowers in the R&D reception area, plaques on the walls, well-designed research smocks, clean facilities, above-average research capabilities and access, and other symbolic yet substantive enhancements all contribute in an indirect way to achieving the implementation of the strategy and the objective.

The main lesson to be learned here is that a combination of direct and indirect methods is generally more effective in achieving objectives than an approach that just focuses on one or the other. Also, by bringing in different departments and functions, the expertise resident therein can aid in more efficient (less costly) and more effective (longer lasting) results.

Practical Aids

With so many different team members off working with their staff members to design action plans, the chances for a breakdown in communications and overall confusion multiply. One way to minimize the risk of this happening is to create consistency in the way plans are evaluated, documented, communicated, and monitored. Because each organization is different, there is no one way that is likely to provide the ideal solution for everyone.

The ABC Company uses a structure which is identical across all departments. It appears as Exhibit 7.1.

Notice how the relevance of the action plan is emphasized right at the top of the page. The ABC Strategic Framework is emphasized and tied into by requiring the Long-Term Goal and Niche to which the action plan is related to be stated. The supporting objective and specific strategy are also highlighted. This reminds the staff that the action they are planning is important to the overall success of the organization and shows them specifically how this is so.

If repetition is one of the keys to ownership, this form does a good job of creating a sense of organizational entrepreneurship among all those involved in action planning. The columns underneath the heading area allow for multiple

Niche:

Long-Term Goal:

Objective:

Strategy:

Activity	Responsibility	Timing	Resources	Costs

EXHIBIT 7.1 ABC Company Action Planning Form

entries by row, but require important information for each event or activity that is likely to take place. Specifically, who is responsible, what timing is involved, what resources will be required, and what costs will be incurred. The form used by ABC may be a useful starting point as your organization wrestles with designing something which will be appealing and effective in all corners of the organization.

Often, action planning is more complicated than performing a single task by a single individual or committee. Multitask jobs or projects are generally best designed and controlled using a form similar to that contained in Exhibit 7.2.

Prior to filling out the form, agreement is reached in five areas:

- *Description.* Clear definition of what will take place where
- *Outcome.* What the project will accomplish
- *Timing.* Targeted start and completion dates
- *Requirements.* People, facilities, supplies, and equipment involved
- *Costs.* Projected dollars and employee time involved

The next step is to list and number the various tasks in the order in which they most likely will be accomplished, as shown in Exhibit 7.2. If one task must be completed prior to starting another, it is noted by number in the Follows column. The next four columns—Duration, Target Start, Target Finish, and Responsibility—are filled out prior to beginning the project. Finally, once the project begins, the actual finish date for each task along with the actual dollars and time spent are tracked in the last three columns.

#	Task	Follows	Duration	Target Start	Target Finish	Who	Actual Finish	Actual Dollars	Actual Time

EXHIBIT 7.2 ABC Company Project Planning and Monitoring Form

Forms such as the preceding are a good starting point and an excellent means of communication during the action plan development stage. Of course, all those involved recognize that results may not be exactly as expected and/or that circumstances may change as the project moves forward. However, these realities should not stand in the way of an effort to describe each task in as much detail as possible or reasonable.

Prestart Review

The final step to take before actually embarking on framework execution is to review all the action and project plans. The following list of questions may prove useful in this regard:

- Are steps, tasks, and responsibilities stated in sufficient detail so that an outsider can clearly understand them?
- Are anticipated costs and timing reasonable when all action plans are considered together?
- Do the various plans contain both direct and indirect methods?
- Are there both short-term and long-term plans, and is it easy to differentiate which is which?
- Do the plans individually and collectively clearly focus on achieving the stated niches and long-term goals?
- Do the plans demonstrate a thorough understanding of the types of managerial competencies required in their execution?
- Considering the importance of people in achieving strategic goals, are staff members aligned with the right jobs across all tasks and projects?

- Are there action plans for functional units (e.g., finance, personnel) as well as line units (e.g., Division A, Division B)?
- Is communication of strategic framework elements (e.g., mission and niche explanations) included and is it a one-time effort or a continuing program?
- Are staff rewards for action plan and project task completion built in?
- Is there a clear difference between operational and strategic plans, and have mechanisms been included to ensure one is not emphasized at the expense of the other?
- Are there plans to share progress in a timely way and on a regular basis with all members of the organization?
- Is there a credible and repeatable way to quantify and track the cash flow and financial returns on the investments being made in the action plans?
- Are the plans aggressive enough to achieve the desired changes yet modest enough so the staff will not burn out and lose their motivation trying to attain them?
- Is the organization's leader solidly behind the execution of action plans in both words and deeds?

Once the above questions have been asked and correctly answered, the timing is right to begin execution.

PLAN IMPLEMENTATION

This section addresses the steps involved in actually executing the action plans created. Consideration is given to creating an atmosphere conducive to successful plan implementation, prioritizing action plans consistent with strategic imperatives,

and incorporating action plan activities into the daily routine. Special attention is given to balance, technology, and customer issues. The section closes with a discussion of the potential pitfalls inherent in action plan execution.

Cultural Considerations

The first job facing the leadership of an organization that is about to embark on plan implementation is to create an atmosphere or culture that supports and encourages taking action. Although the strategic framework is developed, by and large, with an eye toward the organization as a whole, taking action is primarily an individual matter.

Managers and staff charged with executing action plans should have a sound understanding of what the ground rules are and the personal traits on which they should focus to be successful in implementation. If your organization is one involved in a fast-paced industry, most of the staff is probably already attuned to taking action fairly quickly, just to keep up. On the other hand, if your organization has slowly evolved over time, the effort required to introduce and support action steps may be more intense. The ABC Company has several guidelines regarding action plans which may be useful for your organization. They are:

- Make a definite, clear, concise, and public commitment to achieve it.
- Use all available resources to achieve it.
- Take responsibility for all tasks under your control.
- Accept the good as well as the bad results from your actions.

In addition to a shift in the organization's culture, the action plans created to support the strategic framework often require the skills of people not currently part of the organization and/or information not currently created or captured by its management information system. Accordingly, plans to hire people and upgrade management information systems generally are ranked before most others. It is awfully tough to get something done if you do not have the right person for the job or enough information to make an intelligent decision.

An important conceptual tool in action plan prioritization is to envision the time available to the organization over a year as comprising a pie. Before the start of action plan execution, slices of different sizes comprise the various tasks which fill the organization's typical year. Part of the prioritization process is to identify those older tasks (pieces of pie) that, from a strategic and/or operational point of view, are now of less importance. New slices, representing strategically important tasks, are likely to replace these. It is also important to identify critical, ongoing, operating tasks that must be done. By recognizing the importance of these tasks, it is less likely that the new, strategically important tasks will be left undone owing to the pressures of existing operations.

Those using the pie approach should recognize that action plans do not cover everything in which an organization is involved. When they do exist, action plans often involve repetitive projects. Nonetheless, in the prioritization process it is important to identify and rank those critical few matters that warrant immediate, planned action. After completing a logic check, which ensures no task is to be

started before other required tasks are completed, the sequencing of action plans should be complete.

Balance Consideration

A sense of urgency when it comes to achieving action plans is important. It is contagious and ensures a sustained effort over time. However, a sense of moderation and balance when all the action plans are considered together is also critical for several reasons. By avoiding extremes, the organization is likely to be able to endure longer and act more wisely in the process. There is more staff enjoyment and less turnover. It is easier to maintain a sense of ongoing motivation in the organization's work force. With balance and moderation the norm, staff members are more likely to arrive at work each day refreshed and looking forward to many years of productive, fun-filled participation in the organization's activities.

The organization should also balance executing action plans related to products and markets with those involving the various support functions. Getting too far ahead in one area may mean that a higher level of activity cannot be effectively supported or that support resources are being wasted on low levels of business.

The less familiar an organization is with how to achieve a particular objective, the more likely it will not be able to structure an action or project plan that will take it to the desired result. Accordingly, several different test action plans may be implemented simultaneously and, then, closely monitored to see which one is working the best. When this is determined, the others can be dropped.

It is perfectly normal to have both types of action plans underway during execution. In fact, balance should be sought between these two types. If there aren't at least a few simultaneously executed test action plans, then it is likely the organization is not pursuing enough change to be meaningful.

Technology Considerations

The information revolution is so pervasive that action plans often require enhanced electronic equipment and systems. The cost of outfitting the organization with the desired level of technology can be quite high and subject to fairly quick obsolescence. A sound understanding of the interface between the organization's strategic framework and its information technology needs is important.

There are four critical steps to accomplishing this:

1. Identify the elements of the framework involved in or requiring technology
2. Define clearly the solution desired by technology for each element
3. Match the costs and benefits associated with each element and contrast with the cost of capital
4. Obtain competitive quotes for a system that supplies well-bounded solutions for those elements where the investment is warranted

Because the strategic framework has been created for the long term, the chances of making unnecessary or unwise information technology investments is significantly reduced.

Customer Consideration

Without customers or clients, most organizations would cease to exist. It is useful when executing action plans to consider the customer is king! Generally, customers define your organization's product and/or service by paying only for what gives them value. While organizations and their offerings differ widely, customers seem to be driven primarily by wanting things faster, cheaper, and better. Action plans which assist the organization in accomplishing this will be the most productive.

To grow, the organization must increase at least one of three things:

1. The longevity of the customer (number of repeat purchases/visits)
2. The sales per customer
3. The number of customers

Achieving success in one or more of these areas requires recognizing and adapting to changes in the marketplace. Action plans which involve researching and monitoring the industry in which the organization operates, as well as its competitors and vendors, will likely be more fruitful.

Potential Pitfalls and Recovery Techniques

Sound action plans are supported by well-thought-out procedures, operating instructions, rules, and regulations. This supporting documentation minimizes confusion and mistakes during execution. They also have feedback systems. When problems are imminent, an early warning system

should trigger some responsive action. Well-designed feedback systems also can predict not only upcoming delays, but also new opportunities for alternate, more economical approaches and results.

Good action plans should also have financial monitoring capabilities built in. For example, when the estimated return on investment from an action or project plan falls below the cost of capital due to unforeseen circumstances during its execution, the organization should be immediately informed so a decision as to whether to continue or withdraw can be made. Each dollar invested after a project becomes financially untenable reduces, unnecessarily, cash flow and hence, organization value.

Well-publicized remedial steps associated with action plans send the message to staff members that action plans are important, everyone knows they are imperfect, and that proceeding with all due haste is desirable, because any losses due to circumstances beyond the control of the responsible party will be minimized. An organization that publishes its action planning failures is actually doing everyone a favor. It is much better to learn from another's mistake than to repeat it yourself.

EMBRACE CHANGE

The strategic framework provides a structure that allows the organization to stay focused on accomplishing its mission and enhancing cash flow through the actions of motivated employees guided by shared values. Its flexible structure also allows the organization to continually adapt and reorient its operations in response to changes in its

environment. This section addresses the differing levels of impetus to change, the challenges of change, and various ways to confront these challenges within the context of the strategic framework.

Impetus to Change

The urgency which different departments within the organization feel regarding how important it is to implement their action plans varies depending on how threatened they believe the organization's survival is. Informally, there are three broad levels of urgency which seem to exist. Ranked from low to high they are:

1. "Let's think about it."
2. "We ought to do something soon."
3. "It's now or never!"

In the first case, there is a sense that the health of the organization is okay, but that changes in the environment, if not addressed at some point, may cause harm to the organization. In the second case, there is some proof that organizational performance is not what it should be now, that the early warning signs of a downturn have already appeared, and that some action should be taken in the not-too-distant future. In the third case, the implementation of action plans has been put off so long that the organization is now in a crisis mode and its very survival is threatened. Confronting change and taking resolute action provides the only hope of survival.

In practice much of society operates according to the theory of countervailing power. That is, people or groups

wait until a situation becomes critical before taking action to compensate for past indifference and to counteract the forces of destruction. One of the challenges in implementation, therefore, is to provide a sense of urgency and commitment when the organization is only at level one or two, before the impetus to change reaches level three.

Challenges to Change

Change is inevitable. If you do not recognize this fact and embrace it, it will crush you. The organization must face change not only as it occurs internally, but also as it is manifested in the overall external environment in which it operates. The challenge to the organization is to deal with both simultaneously, ensuring that actions taken in one arena reflect the changes occurring in the other.

Internally, as action plans are executed, the organization and its people will grow and be stretched, but along the way some rough moments will be encountered. Some staff members, after attempting to adjust to the new value system and culture dictated by the strategic framework, will likely not see themselves as fitting in. The causes for this may have more to do with changes in prior vested interests and relationships than with actual differences in values or personalities. Being aware of this, the challenge to management is to allow people time to change their interests and relationships so that they are aligned with the new framework, rather than just forcing or accepting employee turnover as the only option.

Another challenge internally is dealing with those staff members who continue to embrace the status quo. They frequently will give lip service to accepting the idea of change, but, if not watched closely, may obstruct progress at every turn.

Other employees may be resistant to embarking upon change because of the fear of failure. The internal challenge in this case is to encourage new actions that simultaneously create an atmosphere in which failure and losses are acceptable learning experiences, not embarrassing or career-threatening catastrophes.

Externally, the organization operates in an environment where technological change is more revolutionary than evolutionary, customer or client needs and perceptions of value can shift rapidly, and competition is increasingly global. Against this backdrop, the challenge to the organization is twofold. First, it must have research and data-gathering systems in place to ensure that critical information is provided in a timely fashion to all personnel requiring it. Second, it must continually monitor niches and long-term goals to see that they are still relevant and provide that combination of attributes which will encourage existing and potential customers and clients to beat a path to its door.

In summary, the challenges of implementation in the organization are both internal and external. The organization must determine how to take actions and adapt behavior and culture to achieve the niches and long-term goals it has set for itself in the strategic framework, while facing and dealing with the demands of a rapidly changing world.

Responses to Change

The responses to change are really the secret to successful strategy execution. They include:

- Inculcating the organization's vision and values in all employees on a regular and consistent basis

- Communicating effectively across the board
- Empowering managers successfully
- Leading by example from the top

Inculcation If the strategic framework is designed properly, the vision and values will remain constant over time, even if everything else about the organization and its environment changes. Decisions made at every level of the organization that are in line with its overall vision will move it in the desired direction. Decisions made in line with the organization's shared values will provide the proper control.

The job of inculcating vision and values is similar to conditioning the crew on a racing sailboat. Each crew member has a job to do and in changing winds and high seas there is not enough time to think about what to do. The decision and action have to be almost automatic. This conditioning involves training over a long period of time and continued practice even after the appropriate skills are mastered.

Similarly, conditioning all employees to automatically respond in line with the organization's vision and values is a process that takes time and repetition. Some organizations view it as a task that should be repeated daily, such as showering or brushing one's teeth. This way every individual is reconditioned and ready to act correctly in the face of whatever challenges and changes come their way.

If the organization's traditional vision and related values are different than those developed in the strategic framework, some effort may be required to position the new, desired culture as more desirable than the old. By clearly demonstrating that the new culture will result in a more

trouble-free and profitable future, and that continuing in the old ways would be more painful, the organization can ease potential resistance and accelerate the conditioning process. Questions such as, “What is the future likely to be if we don’t change?” and “What positive results can we expect if we do change?” can facilitate acceptance if the answers are clearly documented and logically correct.

Once acceptance is generally achieved throughout the organization, regular conditioning can take place. The ways to accomplish this are limited only by the imagination of the organization. A list of suggestions developed by ABC Company is contained in Exhibit 7.3. As your organization experiments with different approaches to accomplishing this, it may be useful to recall that every sharpshooter who hits a bulls-eye has missed many shots in the past. Finding the collection of methods that works for your organization may be painful at times, but that is nothing compared to the results which can be expected if it chooses to avoid the conditioning process altogether.

Communication Communication is a more complicated process than is generally assumed. There are four elements, all of which have to take place in order for communication to happen. First, information is provided. For example, the strategic framework is a piece of information; a project plan is a piece of information. Second, there has to be understanding. For example, the parts of the strategic framework are interrelated; the time to complete project tasks is an estimate. Third, what is seen and understood must be believed. For example, the values in the framework, if followed, will

EXHIBIT 7.3 ABC Company Alternative Methods for Spreading Our Mission

1. Person-to-person meetings
2. Seminars
3. Information sheets
4. Annual reports
5. Paycheck inserts
6. Invoice inserts
7. Organization letterheads
8. Internal memo letterheads
9. Group and department briefings
10. Training sessions
11. Audiovisual shows at investor conferences
12. Booths and handouts at industry meetings
13. Product and service brochures
14. New employee orientations
15. Organization-sponsored local team uniforms
16. Speeches at community functions
17. Advertisements in local school publications
18. Informal stories at organization social events
19. Networking through local service clubs
20. Individual business cards
21. Website design and content

assist in attaining the agreed-upon vision; the project tasks, if completed, will achieve the specified results. Finally, there must be acceptance. For example, a willingness to follow the framework values in practice; agreement that project completion is good for the organization.

Communication takes place in small groups where attitudes are formed as well as plans made. Using sound communication skills can keep the discussion on track and keep participation positive. Generally recognized communication skills include:

- Using people's names
- Looking at people intently when they speak
- Listening nonjudgmentally
- Rewording questions to ensure understanding
- Responding in a positive manner with a positive phrase
- Saying so when you do not know the answer
- Encouraging input from all participants
- Avoiding arguments
- Sidestepping foolish questions
- Relating to participants in a kind and gentle way

Organizations also communicate symbolically through language, signs, ceremonies, and events. For example, hotel employees are more likely to treat customers better if they think of them as guests rather than boarders; a sign with three lights out at the entrance to the best restaurant in the city does not indicate a first class establishment; employee award banquets communicate what types of behavior the organization truly encourages; and the location of the annual holiday party reveals how much the organization values its employees.

Empowerment The language used by superiors to empower their subordinates has a great deal to do with how effectively they are able to motivate them. Phrases such as, "I won't, we can't, they don't know how," seldom instill the desire to learn or perform at one's highest level. However, providing gentle instruction and information couched in phrases such as, "We can, I will, they did it!" builds confidence and skills in all team players.

One of the advantages of having a vision and values that become part of the personality of the workforce is that it enables management to push decision making down to the appropriate level—the people in the field who are best able to assess the current situation. Successful delegation involves an ability to communicate clearly and effectively. It also requires a desire to provide adequate support and an ability to obtain commitments. The following guidelines may be useful in this regard:

- Describe what needs to be done and when.
- Explain the results anticipated and the measurements to be used.
- Point out possible hurdles to overcome.
- Place the task within the context of the framework so its relevance is clear.
- Provide the resources required for successful completion,
- Obtain a firm commitment to perform and an acceptance of the job.
- Grant the authority required, including interfaces with other departments.

Another aid to empowering employees is a good story. By sharing an example of others who got a tough job done

or creatively solved a problem on their own, you are demonstrating a positive approach and the realm of possibility open to the empowered.

Leadership It is at the top of the organization where the ability to encounter, embrace, and exploit change is predetermined. This is where a positive attitude in responding to change and dealing with risk sets the tone for the how the entire organization acts.

Leaders and how they spend their time are noticed. Do not expect an organization where the leader spends no time monitoring the competition, checking up on project plan completions, tracking the returns on investments, or tweaking the strategic framework to be very good at dealing with change, restructuring the culture, maximizing organization value, or planning for the future.

Effective leadership in response to change requires setting an example. When the organization needs to be rearranged, people notice who gets promoted and for what. The leader who outwardly professes to believe in the value of rewards based on merit, yet promotes staff members based on time in grade sends a mixed message. The one that employees receive is the one conveyed by what actually happens, not what is spoken or written in a framework.

Employees also are sensitive to how the organization's money is spent in the process of change. A leader who scrupulously reviews prospective investments for appropriate returns and makes expenditures commensurate with the organization's vision and values reinforces the strategic framework and sets an example for all his managers to follow. One who spends the organization's money on low-

return pet projects and no-return perquisites also sets an example. In this case, however, it is not one of maximizing the organization's value or the security and happiness of its employees.

Leaders who deal effectively with change generally have the ability to:

- Listen carefully to learn the source and nature of change.
- Anticipate the direction of change based on small shifts in trends.
- Probe as deeply as necessary to retrieve important details.
- Build solid, trusting relationships with outside advisors.
- Maintain a flexible approach to achieving objectives.
- Act in a courageous, calm, and decisive way when required.

When these abilities are combined with a knack for motivating people, a commitment to framework vision and values, and the discipline to operate within the required return constraints, the leader is well on the way to enhancing the organization's value over the long term. That is, strategic leadership assists the organization in anticipating and initiating changes that will ensure its future viability.

EXECUTE THE FRAMEWORK

This section provides a review of the execution process in the context of the strategic framework as a whole. The summary which follows it reviews all seven steps covered in this book that lead toward maximizing the organization's value.

The best strategic document will be useless if it does not prove possible to implement the framework that has been formulated. Whether it can be successfully executed very largely depends on whether it proves possible to direct the organization's efforts toward the niches and long-term goals that define its vision. This requires more than simply initiating a few selected measures. All activities, departments, and decisions should be justified only if they build or sustain the chosen niches and supporting long-term goals.

The main aim of strategic framework design is to define a few central and key factors in the form of viable niches and orient all the organization's resources toward their achievement. It is then that the individual areas and divisions of the organization will no longer operate in isolation, directed by the considerations of their specific interests. Instead, they will be concentrated on the organization's chosen niches.

Once consensus is reached on the action plans, the execution of the framework begins in earnest. The framework becomes meaningful when it leads to concrete action in the real world, where successful implementation is the result of having small decisions made strategically every day. Well-conceived and -communicated execution ensures this result is achieved. It consistently raises the organization's level of operational efficiency and, hence, cash flow.

SUMMARY

The overall process discussed in this book covers seven steps which deal with:

1. *Strategic audits*—where have we been?
2. *Current organization value*—what are we worth today?
3. *Strategic landscape*—where do we operate?
4. *Strategic framework overview*—what is our mission?
5. *Strategic framework development*—what do we accomplish and how?
6. *Strategic framework evaluation*—what are the highest value strategies?
7. *Strategic framework execution*—how do we implement the framework?

The seven steps represent two contrasting elements. The first element is structural and is represented by the framework. This framework, developed in steps one through six, provides the intellectual foundation for proposed action by and changes to the organization. These steps create the road map that should be followed to enhance the long-term value of the organization. The second element is dynamic and represents the sum total of actions taken to effect changes and achieve objectives during execution (Step 7). It requires a combination of top management muscle power and gentle finesse to obtain the desired results. It is dynamic because management must continue to be flexible and make modifications over time to ensure the desired increases in organizational value are attained.

If balance in these elements can be achieved and the seven steps followed, the organization is well on its way to enhancing its value and that of its stakeholders. In most cases, the long-term organizational value improvement

more than pays for the time and money spent in framework creation, execution, monitoring, and modification.

ENDNOTES

1. For large, multidivisional organizations that have a portfolio of businesses, each with different risks, a separate cost of capital for each division is sometimes created to reflect the variations in risk across the components of the portfolio.

Epilogue

We invite you to contact the author via e-mail at georgemnorton@cs.com with questions and/or suggestions for the next edition. We also welcome stories of success and/or failure as well as modifications your organization made to the process and how they turned out. We remain dedicated to making organizations more fun in which to work, able to do a better job for all their stakeholders, and more viable and profitable over the long term.

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