## Chapter 3

### Strategy risk

**Chapter learning objectives:**

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
</table>
| B1. Analyse risks associated with formulating strategy | (a) Analyse relevance of the assumptions on which strategy is based  
(b) Discuss potential sources and types of disruptions to strategy | • Analysis of strategic choice  
• Scenario planning  
• Stress-testing strategy |
1. **What is strategy?**

A course of action, including the specification of resources required, to achieve a specific objective.’ - CIMA

Strategy is the direction and scope of an organisation over the long term, which achieves advantage for the organization through its configuration of resources within a changing environment, to meet the needs for markets and to fulfil stakeholders’ expectations.

- *Johnson, Scholes and Whittington (Exploring Corporate Strategy)*

The core of a company's strategy is about choosing:

- **WHERE** to compete
- **HOW** to compete

It is a means of achieving sustainable competitive advantage.

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**The strategic planning process**

*Rational Model:*

- A logical step-by-step approach
- Requires the organisation to analyse its existing circumstances
- Requires the organisation to generate possible strategies
Rational model:

1. **STRATEGIC ANALYSIS**
   - External analysis to identify opportunities and threats
   - Internal analysis to identify strengths and weaknesses
   - Stakeholders analysis to identify key objectives and to assess power and interests of different groups
   - GAP analysis to identify the difference between desired and expected performance

2. **STRATEGIC CHOICE**
   - Required to close the gap
   - Competitive strategy for each business unit
   - Directions for growth
   - Whether expansion should be achieved by organic growth/ acquisition or some form of joint arrangement

3. **STRATEGIC IMPLEMENTATION**
   - Formulation of detailed plan and budget
   - Target setting for KPIs
   - Monitoring and control
Advantages and disadvantages of deliberate long-term planning:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forces manager to look ahead</td>
<td>Difficulty of setting strategic objectives</td>
</tr>
<tr>
<td>Improved control</td>
<td>Short-term pressures</td>
</tr>
<tr>
<td>Identifies key risks</td>
<td>Difficulty of forecasting accurately</td>
</tr>
<tr>
<td>Encourages creativity</td>
<td>Bounded rationality</td>
</tr>
<tr>
<td></td>
<td>Rigidity</td>
</tr>
<tr>
<td></td>
<td>High costs</td>
</tr>
<tr>
<td></td>
<td>Dishonesty and management distrust</td>
</tr>
</tbody>
</table>

**Emergent approach (Mitzberg)**

- The strategy built on the rational model quickly becomes outdated.
- Strategy tends to evolve rather than resulting from a logical, formal process.
- An emergent approach is evolving, continuous and incremental.

**Incrementalism (Lindblom)**

- Strategic managers do not evaluate all the possible options open to them but choose between a relatively small number of alternatives.
- Strategy-selection does not normally involve an autonomous strategic planning team that impartially sifts alternative options before choosing the best.
- Strategy-making tends to involve small-scale extensions of past policy.
Problems with a lack of formal planning

- Failure to identify risks
- The organisation may not have an overall plan for the future
- Difficulty in raising finance
- High-level management skills are required

Which approach to strategy to adopt?

There is NO single correct approach.

<table>
<thead>
<tr>
<th>More formal approaches suit organisations that:</th>
<th>More informal approaches suit organisations that:</th>
</tr>
</thead>
<tbody>
<tr>
<td>exist in relatively stable industries, meaning that there is sufficient time to undertake detailed strategic analysis</td>
<td>are in dynamic, fast-changing industries where there is little time to undertake formal strategic analysis</td>
</tr>
<tr>
<td>have relatively inexperienced managers, as the formal planning approach helps to ensure they are familiar with the organisation, as well as providing a series of guidelines they can follow to help them develop a strategy</td>
<td>have experienced, innovative managers who are able to quickly identify and react to changes in the organisation and its environment</td>
</tr>
<tr>
<td></td>
<td>do not need to raise significant external finance (external investors typically prefer a formal planning approach)</td>
</tr>
</tbody>
</table>

Strategic planning for not-for-profit organisations (NFPs)

The strategic planning process can be more complex for NFPs since:

- multiple objectives are hard to prioritise
- objectives are more difficult to measure – usually non-financial
- influence/objectives of funding bodies
- recipients of the service are not the ones who pay for it

Many NFPs therefore focus on the concept of value for money – the 3Es model:

- **economy** – focuses solely on inputs to the NFP
- **efficiency** – looks at the link between inputs and outputs
- **effectiveness** – looks solely at the outputs of the NFP
The risks of using the 3Es model

- Wrong choice of measures
- Contradictory results
- Internal confusion over prioritisation
- Ease of measurement

Test Your Understanding 1 on the 3Es

The Norwich University Art Department specialises in exhibits and has a particularly fine collection of Ancient Greek sculptures. Traditionally, entrance to the department has been free to the public, but three months ago the trustees decided to start charging an entry fee. This was approved on the grounds that the primary objective of the museum was research within the department rather than public education. The trustees are now meeting again to discuss whether or not the change was a success and have decided to include the 3Es as a framework for assessment.

Match the following KPIs with the correct category within the 3Es framework. (Note: you can use the same category more than once.)

<table>
<thead>
<tr>
<th>Efficiency</th>
<th>Number of hours logged at the museum by History Department researchers</th>
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<tr>
<td>Effectiveness</td>
<td>Research papers and articles published</td>
</tr>
<tr>
<td></td>
<td>Average cost per hour of research time logged</td>
</tr>
</tbody>
</table>

2. Approaches to strategic planning

A traditional approach – stakeholders

- Starts by looking at the shareholders and their objectives
- Emphasis is on formulating plans to achieve these objectives
- Flawed because the objectives are set in isolation from market consideration and are unrealistic
- Useful for not-for-profit organisations, where a discussion of mission and objectives is key
A market-led or positioning approach

- Starts with an analysis of markets and competitor actions before objectives are set and strategies developed.
- The essence of strategic planning is to ensure that the firm has a good fit with its environment.
- The idea is to be able to predict changes sufficiently far in advance to control change rather than always having to react to it.
- The main problem with this approach lies in predicting the future, since some markets are so volatile that it is impossible to estimate to further ahead than the immediate short term.

A resource-based or competence-led approach

- Many firms that have found anticipating in the environment difficult have switched to a competence- or resource-based approach, where the emphasis of a strategy is to look at what the firm is good at – its core competences.
- Ideally, these correlate with the areas that the firm has to be good at in order to succeed in its chosen markets.

3. Strategic analysis and choice

Remember – there is no one solution that fits all!
4. **Competitive strategy**

As always, the focus for P3 is on the risks.

**Cost leadership**

The aim is to be the lowest-cost producer (the product is comparable to those of competitors but is made more efficiently).

**How can the price be lowered?**

- Reduce costs by *copying* rather than originating designs, using cheaper materials and other cheaper resources, producing products with 'no frills', reducing labour costs and increasing labour productivity.
- Reach economies of scale through high-volume sales, allowing fixed costs to be spread over a wider production base.
- Use high-volume purchasing to obtain discounts for bulk purchase.
- Operate in areas where a cost advantage exists or government aid is possible.
- Obtain learning and experience curve benefits.

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Price – higher margin if the price is the same as competitors or the business can lower the price and win more sales</td>
<td>• No fall-back position if leadership on cost is lost</td>
</tr>
<tr>
<td>• Is also a defence mechanism against price war</td>
<td>• Constant investment needed to adapt to the changing market and competitive threats</td>
</tr>
<tr>
<td>• Allows a price-penetration entry strategy into new markets</td>
<td>• Failure to pass on cost savings to customers may mean no advantage</td>
</tr>
<tr>
<td>• Enhances barriers to entry</td>
<td>• Passing on cost savings can lead to price wars with competitors</td>
</tr>
<tr>
<td>• Develops new market segments</td>
<td></td>
</tr>
</tbody>
</table>
Differentiation strategy

Our product is superior because of something unique.

Differentiation can be based:

- on product features or creating/altering consumer perception (i.e. through superior brand development to rivals).
- upon process as well as product.

It is usually used to justify a higher price.

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Products command a premium price so higher margins</td>
<td></td>
</tr>
<tr>
<td>• Demand becomes less price-elastic and so avoids costly competitor price wars</td>
<td></td>
</tr>
<tr>
<td>• Life cycle extends as branding becomes possible – hence strengthening the barriers to entry</td>
<td>• Significant marketing costs</td>
</tr>
<tr>
<td></td>
<td>• Smaller volumes</td>
</tr>
<tr>
<td></td>
<td>• Continuous investment to retain differentiation</td>
</tr>
<tr>
<td></td>
<td>• More susceptible to economic downturn</td>
</tr>
</tbody>
</table>

Focus strategy

This strategy aims at a segment of the market rather than the whole market.

Also called niching.

<table>
<thead>
<tr>
<th>Benefits</th>
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</tr>
</thead>
<tbody>
<tr>
<td>• Smaller segment and so smaller investment in marketing operations</td>
<td></td>
</tr>
<tr>
<td>• Allows specialisation</td>
<td></td>
</tr>
<tr>
<td>• Less competition</td>
<td></td>
</tr>
<tr>
<td>• Entry is cheaper and easier</td>
<td>• Success can attract major competitors</td>
</tr>
<tr>
<td></td>
<td>• Size of the market may be too small to make sustainable returns</td>
</tr>
</tbody>
</table>

Risks of the generic strategies in general

Many firms end up being what Porter refers to as ‘stuck in the middle’.
5. **Product-market strategy**

**Ansoff’s matrix**

Ansoff’s matrix provides a commonly used model for analysing the possible strategic directions that an organisation can follow.

*The product/market growth framework*

<table>
<thead>
<tr>
<th>Markets</th>
<th>Products</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing</td>
<td>Existing</td>
<td>Market penetration</td>
<td>Product development</td>
</tr>
<tr>
<td>New</td>
<td>New</td>
<td>Market development</td>
<td>Diversification</td>
</tr>
</tbody>
</table>

**Market penetration**

Lowest risk => lowest trade-off.

<table>
<thead>
<tr>
<th>Aim</th>
<th>Approach</th>
<th>Key notes</th>
</tr>
</thead>
</table>
| Increasing market share using existing products within existing markets | • Stimulate usage by existing customers  
  - New uses of advertising  
  - Promotions and sponsorship  
  - Quantity discounts  
  • Attract non-users and competitors’ customers  
  - Pricing  
  - Promotion and activities  
  - Process redesign | Considered when:  
  • Overall market is growing  
  • Market not saturated  
  • Weak or leaving competitors  
  • Strong brand presence with established reputation  
  • Strong marketing capabilities exist within the company |

**Market development**

Risks involve:

- Costly entry to the market
- Failure to understand the new market
- Failure damages core brand
<table>
<thead>
<tr>
<th>Aim</th>
<th>Approach</th>
<th>Key notes</th>
</tr>
</thead>
</table>
| Increase sales by taking the present product to a new market | • Add geographical areas  
• Add demographic areas  
• New distribution channels | • Slight product modifications may be needed  
• Advertising in different areas in different ways  
• Primary research  
• High switching costs exist for transfer to other product types  
• Strong market ability is needed |

**Product development**

Risks include:

- Significant cost
- Not good enough
- Someone delivers product sooner or better
- Failure damages core brand

<table>
<thead>
<tr>
<th>Aim</th>
<th>Approach</th>
<th>Key notes</th>
</tr>
</thead>
</table>
| Development of new products for existing markets | • Develop product features of a significant nature  
• Create different quality versions | • Company needs to be innovative and strong in the area of R&D  
• Should have an established and reliable marketing database |

**Diversification**

*Approach* – new products to a new market

*Key notes:*

- Appropriate when existing markets are saturated
- Appropriate when products are reaching the end of their lifecycle
- Can spread risk by broadening the portfolio
- Leads to synergy-based benefits, allegedly
- Company has excess cash and powerful shareholders
- Objectives can no longer be met in known markets - possibly due to a change in the external environment
Benefits

- Diversification promises higher returns
- Greater use of distribution systems and corporate resources
- Possible to brand stretch, and benefits from past advertising and promotion in other SBU’s

Key risks

- The riskiest option
- Over-reliance on one market if it is related diversification
- Lack of skills or knowledge if it is unrelated

6. Acquisition

- More expensive than organic growth
- Owners of the acquired company will need to be paid for the risks they have already taken
- There is a trade-off between cost and risk
- A company can gain synergy by bringing together complementary resources in their own business and the business acquired

“Synergy is defined as the advantage to a firm gained by having existing resources that are compatible with new products or the market the company is developing.”

Acquisition Vs Organic Growth

<table>
<thead>
<tr>
<th>Advantages of acquisition over organic growth</th>
<th>Disadvantages of organic growth over acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-speed access to resources</td>
<td>Acquisition may be more costly than internal growth</td>
</tr>
<tr>
<td>Avoids barriers to entry</td>
<td>There is bound to be a cultural mismatch between the organisations</td>
</tr>
<tr>
<td>Less reaction from competitors</td>
<td>There may be differences in the managerial salaries</td>
</tr>
<tr>
<td>Can block a competitor</td>
<td>High disposal of assets</td>
</tr>
<tr>
<td>Can help restructure the operating environment</td>
<td>Risk of not knowing all about the business is minimised</td>
</tr>
<tr>
<td></td>
<td>Reduction in return on capital employed</td>
</tr>
</tbody>
</table>
Acquisition risks

- Cost
- Strategic fit
- Cultural issues
- Competition legislation
- Lack of knowledge

Acquisition control

It is not the only control by any means, but **due diligence** is a key control for any acquisition.

- Due diligence is an investigation of a business prior to signing a contract.
- It relates to the process through which a company will evaluate a target and their assets prior to acquisition.
- It should provide information that allows for more informed decision-making regarding the acquisition.

7. **Joint methods of expansion**

Joint venture

A joint venture is a separate business entity whose shares are owned by two or more business entities. Assets are formally integrated and jointly owned. It is a useful approach for:

- Sharing cost
- Sharing risk
- Sharing expertise
Strategic alliance

This is defined as a cooperative business activity formed by two or more separate organisations for a strategic purpose that allocates ownership, operational responsibilities, financial risk and reward to each member while preserving their separate identities and autonomy.

Seven characteristics of a well-formed alliance:

- Strategic synergy
- Positioning opportunity
- Limited resource availability
- Reduced risk
- Cooperative spirit
- Clarity of purpose
- Win-win

Franchising

Franchising is the purchase of a right to exploit a business brand in return for a capital sum and a share of profit or turnover.

- The franchisee pays the franchisor an initial capital sum and thereafter the franchisee pays the franchisor a share of profit or royalties.
- The franchisor provides marketing, research and development, advice and support.
- The franchisor normally provides the goods for resale.
- The franchisor imposes strict rules and controls to protect its brand and reputation.
- There is lower risk, as the franchisee buys a successful formula.
- The franchisor gains capital as the number of franchises grow.

Licensing

Licensing is the right to exploit an invention or resource in return for a share of proceeds. Licensing differs from franchising, as there will be little central support.

Outsourcing

Outsourcing means contracting out aspects of the work of the organisation, previously done in-house, to specialist providers. Almost any activity can be outsourced.
KEY RISKS OF JOINT DEVELOPMENT METHODS

- Strategic fit
- Cost sharing
- Knowledge sharing
- Profit sharing
- Loss of control
- Loss of development opportunities

8. International growth

- **Exporting strategy** – the firm sells products made in its home country to buyers abroad.
- **Overseas manufacture** – the firm manufactures its products in a foreign country and then either imports them back to its home country or sells them abroad.
- **Multinational** – these firms co-ordinate their value-adding activities across national boundaries.
- **Transnational** – these are ‘nation-less’ firms that have no ‘home’ country. Employees and facilities are treated identically, regardless of where they are in the world. The company may be listed on several national stock exchanges.

**Risks:**

- **Political risk** - government policy may make it difficult to operate in the new country
- **Foreign exchange risk** – earnings could be reduced by currency fluctuations
- **Need for capital investment** – this will be lower if an exporting strategy is used
- **Risks to customer relationships**
- **Increased risks in the supply chain** – bigger distance, higher transportation costs
- **Ethical risks** – if operating in countries with less developed labour laws, should the company take advantage of this to keep costs low?
- **Cultural risks** – differences in language, customs and even marketing

**Test Your Understanding 2 on development methods**

Manolo is a high-end shoe retailer operating in France. Manolo is the market leader there, but in the last three years, its market share has fallen due to increased price competition from its three nearest competitors from Italy. As a result, in the last 9 months Manolo has expanded its operations into Spain and the UK through the acquisition of established small shoe retailers.
Which form of international expansion strategy has Manolo undertaken through the acquisition of the small shoe retailers in Spain and the UK?

A. A transnational strategy
B. An exporting strategy
C. A franchising strategy
D. A foreign direct investment strategy

9. Disruption

Disruptive innovation

One of the key risks to an organisation’s strategy in the modern business world

Where a new development (often involving technological advancements) changes an existing market or even creates a new market, which means that the old market is no longer viable, potentially leading to a significant drop in sales.

Successful disruption

Not all disruptions are successful. Here are some key considerations for why a disruption may or may not work.

- **Simplicity** - making life easier or making the process of buying easier
- **Resources** - sustainability is often a selling point for innovations
- **Cost** - the option to buy something that costs less is always attractive
- **Accessibility** - the more people have access to the disruption, the more likely it is to be successful
- **Quality** - if a product/service is better than the alternatives, it will be attractive

10. Scenario planning

**Process:**

1. Identify high-impact, high-certainty factors in the environment
2. For each factor, identify different possible features
3. Cluster together different factors to identify various consistent future scenarios
4. Write the scenarios
5. For each scenario, identify and assess possible courses of action for the firm
6. Monitor reality to see which scenario is unfolding
7. Revise (redeploy) scenarios and strategic options as appropriate
Construction of scenarios:
The following are considered:

- Use a team for a range of opinions and expertise
- Identify time-frame, market, products and budgets
- Stakeholder analysis – who will be most influential in the future?
- Trend analysis and uncertainty identification
- Building initial scenarios
- Consider organisational learning implications
- Identify research needs and develop quantitative models

<table>
<thead>
<tr>
<th>The upside of scenario planning</th>
<th>The downside of scenario planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focuses management attention on the future and possibilities</td>
<td>Costly and inaccurate</td>
</tr>
<tr>
<td>Encourages creative thinking</td>
<td>Tendency towards cultural distortion and people getting carried away</td>
</tr>
<tr>
<td>Can be used to justify a decision</td>
<td>Risk of self-fulfilling prophecy</td>
</tr>
<tr>
<td>Encourages communication via the participation process</td>
<td>Many scenarios considered will not actually occur</td>
</tr>
<tr>
<td>Can identify the sources of uncertainty</td>
<td></td>
</tr>
<tr>
<td>Encourages companies to consider fundamental changes in the external environment</td>
<td></td>
</tr>
</tbody>
</table>

Game theory

In many markets, it is important to anticipate the actions of competitors as there is a high interdependency between firms.

Game theory is concerned with the interrelationships between the competitive moves of a set of competitors and, as such, can be a useful tool for analysing and understanding different scenarios.

Key principles:

- Strategists can take a rational, informed view of what competitors are likely to do and formulate a suitable response.
- If a strategy exists that allows a competitor to dominate the firm, the priority is to eliminate that strategy.
Example – prisoners’ dilemma:

<table>
<thead>
<tr>
<th>YOU</th>
<th>YOUR ACCOMPLICE</th>
</tr>
</thead>
<tbody>
<tr>
<td>If you stay silent</td>
<td>FREE</td>
</tr>
<tr>
<td></td>
<td>5 years</td>
</tr>
<tr>
<td>If you confess</td>
<td>2 years</td>
</tr>
<tr>
<td></td>
<td>2 years</td>
</tr>
</tbody>
</table>

11. Stress testing

An organisation must now go further than scenario planning and look at extreme (and potentially unlikely) situations that could affect it.

Key considerations in stress testing

- **Prioritisation**: Who is the organisation selling to? How do you prioritise your stakeholders?
- **Measurement**: What is the scope of your organisation? What KPI should be measured?
- **Productivity**: How committed are your employees to helping each other? How are you using creative tension?
- **Flexibility**: What uncertainties affect your organisation?

**Stress testing in non-financial companies**

Stress testing has become commonplace in financial institutions, particularly since the financial crash in 2007. It should not be solely limited to these types of organisations, though, as in the modern business world unexpected and extreme disruption can occur in any industry.
Those organisations that have thought about what this might be and how they would react will be best-placed to survive.

12. Solutions to TYUs

Solution to Test Your Understanding 1 on the 3Es

<table>
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<tr>
<th>Effectiveness</th>
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Solution to Test Your Understanding 2 on development methods

The correct answer is D.

The acquisition of the overseas companies is an example of foreign direct investment. This can happen either via buying a company in the target country or by expanding the operations of an existing business in that country.

Franchising would have involved working with franchisees to share the capital costs of expansion.

A transformational business conducts operations in several countries with varying degrees of coordination and integration of strategy and operations. Manolo seems to have a single degree of control.

An export strategy would have involved shipping domestic goods overseas for sale.
13. Chapter summary

CHAPTER 3

Strategy risk

What is strategy
- risks of formal planning
- problems with a lack of formal planning
- which strategy to choose
- risks associated with the 3Es

Disruption
- what is it?
- the role of technology
- consideration for successful disruption

Stress testing
- what is it?
- how to stress test
- stress testing for nonfinancial companies

Scenario planning
- process
- game theory

Approaches to strategic planning

Product-market strategy
- Ansoff’s matrix
- risks

Acquisition
- risks
- joint methods of expansion
- joint development methods
- risks

Competitive strategy
- cost leadership
- differentiation
- focus
- risks

International growth