**Chapter Five: Strategy Analysis and Choice**

* 1. **The nature of strategy analysis and choice**

Strategy analysis and choice seek to determine alternative courses of action that could best enable the firm to achieve its mission and objectives. The firm’s present strategies, objectives, and mission, coupled with the external and internal audit information, provide a basis for generating and evaluating feasible alternative strategies.

Unless a desperate situation confronts the firm, alternative strategies will likely represent incremental steps that move the firm from its present position to a desired future position.

Alternative strategies do not come out of the wild blue yonder; they are derived from the firm’s vision, mission, objectives, external audit, and internal audit; they are consistent with, or build on, past strategies that have worked well.

**5.2 The Process of Generating and Selecting Strategies**

Strategists never consider all feasible alternatives that could benefit the firm because there are an infinite number of possible actions and an infinite number of ways to implement those actions. Therefore, a manageable set of the most attractive alternative strategies must be developed. The advantages, disadvantages, trade-offs, costs, and benefits of these strategies should be determined.

Identifying and evaluating alternative strategies should involve many of the managers and employees who earlier assembled the organizational vision and mission statements, performed the external audit, and conducted the internal audit. Representatives from each department and division of the firm should be included in this process, as was the case in previous strategy-formulation activities. Recall that involvement provides the best opportunity for managers and employees to gain an understanding of what the firm is doing and why and to become committed to helping the firm accomplish its objectives.

All participants in the strategy analysis and choice activity should have the firm’s external and internal audit information by their sides. This information, coupled with the firm’s mission statement, will help participants crystallize in their own minds particular strategies that they believe could benefit the firm most. Creativity should be encouraged in this thought process.

Alternative strategies proposed by participants should be considered and discussed in a meeting or series of meetings. Proposed strategies should be listed in writing. When all feasible strategies identified by participants are given and understood, the strategies should be ranked in order of attractiveness by all participants, with 1 = should not be implemented,

2 = possibly should be implemented, 3 = probably should be implemented, and 4 = definitely should be implemented. This process will result in a prioritized list of best strategies that reflects the collective wisdom of the group.

**5.3 Types of strategies**

**Integration Strategies**

Forward integration, backward integration, and horizontal integration are sometimes collectively referred to as *vertical integration* strategies. Vertical integration strategies allow a firm to gain control over distributors, suppliers, and/or competitors.

**Forward Integration**

*Forward integration* involves gaining ownership or increased control over distributors or retailers. Increasing numbers of manufacturers (suppliers) today are pursuing a forward integration strategy by establishing Web sites to directly sell products to consumers.

An effective means of implementing forward integration is *franchising.*

These six guidelines indicate when forward integration may be an especially effective strategy:

* When an organization’s present distributors are especially expensive, or unreliable, or incapable of meeting the firm’s distribution needs.
* When the availability of quality distributors is so limited as to offer a competitive advantage to those firms that integrate forward.
* When an organization competes in an industry that is growing and is expected to continue to grow markedly; this is a factor because forward integration reduces an organization’s ability to diversify if its basic industry falters.
* When an organization has both the capital and human resources needed to manage the new business of distributing++++-- its own products.
* When the advantages of stable production are particularly high; this is a consideration because an organization can increase the predictability of the demand for its output through forward integration.
* When present distributors or retailers have high profit margins; this situation suggests that a company profitably could distribute its own products and price them more competitively by integrating forward.

**Backward Integration**

Both manufacturers and retailers purchase needed materials from suppliers. *Backward integration* is a strategy of seeking ownership or increased control of a firm’s suppliers.

This strategy can be especially appropriate when a firm’s current suppliers are unreliable, too costly, or cannot meet the firm’s needs.

Seven guidelines for when backward integration may be an especially effective strategy are:

* When an organization’s present suppliers are especially expensive, or unreliable, or incapable of meeting the firm’s needs for parts, components, assemblies, or raw materials.
* When the number of suppliers is small and the number of competitors is large.
* When an organization competes in an industry that is growing rapidly; this is a factor because integrative-type strategies (forward, backward, and horizontal) reduce an organization’s ability to diversify in a declining industry.
* When an organization has both capital and human resources to manage the new business of supplying its own raw materials.
* When the advantages of stable prices are particularly important; this is a factor because an organization can stabilize the cost of its raw materials and the associated price of its product(s) through backward integration.
* When present supplies have high profit margins, which suggests that the business of supplying products or services in the given industry is a worthwhile venture.
* When an organization needs to quickly acquire a needed resource.

**Horizontal Integration**

*Horizontal integration* refers to a strategy of seeking ownership of or increased control over a firm’s competitors. One of the most significant trends in strategic management today is the increased use of horizontal integration as a growth strategy. Mergers, acquisitions, and takeovers among competitors allow for increased economies of scale and enhanced transfer of resources and competencies. Kenneth Davidson makes the following observation about horizontal integration:

The trend towards horizontal integration seems to reflect strategists’ misgivings about their ability to operate many unrelated businesses. Mergers between direct competitors are more likely to create efficiencies than mergers between unrelated businesses, both because there is a greater potential for eliminating duplicate facilities and because the management of the acquiring firm is more likely to understand the business of the target.

These five guidelines indicate when horizontal integration may be an especially effective strategy:

* When an organization can gain monopolistic characteristics in a particular area or region without being challenged by the federal government for “tending substantially” to reduce competition.
* When an organization competes in a growing industry.
* When increased economies of scale provide major competitive advantages.
* When an organization has both the capital and human talent needed to successfully manage an expanded organization.
* When competitors are faltering due to a lack of managerial expertise or a need for particular resources that an organization possesses; note that horizontal integration would not be appropriate if competitors are doing poorly, because in that case overall industry sales are declining.

**Intensive Strategies**

Market penetration, market development, and product development are sometimes referred to as *intensive strategies* because they require intensive efforts if a firm’s competitive position with existing products is to improve.

**Market Penetration**

A *market penetration* strategy seeks to increase market share for present products or services in present markets through greater marketing efforts. This strategy is widely used alone and in combination with other strategies. Market penetration includes increasing the number of salespersons, increasing advertising expenditures, offering extensive sales promotion items, or increasing publicity efforts.

These five guidelines indicate when market penetration may be an especially effective strategy:

* When current markets are not saturated with a particular product or service.
* When the usage rate of present customers could be increased significantly.
* When the market shares of major competitors have been declining while total industry sales have been increasing.
* When the correlation between dollar sales and dollar marketing expenditures historically has been high.
* When increased economies of scale provide major competitive advantages.

**Market Development**

*Market development* involves introducing present products or services into new geographic areas. For example, Manufacturers such as Uniliver, Britain, are expanding further into Ethiopia in 2014/15. Ethiopian Airlines in 2015 began serving 5 new international destinations as part of a strategy by the newly bought boing 777.

These six guidelines indicate when market development may be an especially effective strategy:

* When new channels of distribution are available that are reliable, inexpensive, and of good quality.
* When an organization is very successful at what it does.
* When new untapped or unsaturated markets exist.
* When an organization has the needed capital and human resources to manage expanded operations.
* When an organization has excess production capacity.
* When an organization’s basic industry is rapidly becoming global in scope.

**Product Development**

*Product development* is a strategy that seeks increased sales by improving or modifying present products or services. Product development usually entails large research and development expenditures. Coca Cola Company introduced new orange flavored Fanta in 2016.

These five guidelines indicate when product development may be an especially effective strategy to pursue:

* When an organization has successful products that are in the maturity stage of the product life cycle; the idea here is to attract satisfied customers to try new (improved) products as a result of their positive experience with the organization’s present products or services.
* When an organization competes in an industry that is characterized by rapid technological developments.
* When major competitors offer better-quality products at comparable prices.
* When an organization competes in a high-growth industry.
* When an organization has especially strong research and development capabilities.

## Diversification Strategies

There are two general types of *diversification strategies*: related and unrelated.

Businesses are said to be *related* when their value chains posses competitively valuable cross-business strategic fits; businesses are said to be *unrelated* when their value chains are so dissimilar that no competitively valuable cross-business relationships exist.

Most companies favor related diversification strategies in order to capitalize on synergies as follows:

* Transferring competitively valuable expertise, technological know-how, or other capabilities from one business to another.
* Combining the related activities of separate businesses into a single operation to achieve lower costs.
* Exploiting common use of a well-known brand name.
* Cross-business collaboration to create competitively valuable resource strengths and capabilities.

Diversification strategies are becoming less popular as organizations are finding it more difficult to manage diverse business activities.

The greatest risk of being in a single industry is having all of the firm’s eggs in one basket. Although many firms are successful operating in a single industry, new technologies, new products, or fast-shifting buyer preferences can decimate a particular business.

For example, digital cameras are decimating the film and film processing industry, and cell phones have permanently altered the long-distance telephone calling industry.

Diversification must do more than simply spread business risk across different industries, however, because shareholders could accomplish this by simply purchasing equity in different firms across different industries or by investing in mutual funds. Diversification makes sense only to the extent the strategy adds more to shareholder value than what shareholders could accomplish acting individually. Thus, the chosen industry for diversification must be attractive enough to yield consistently high returns on investment and offer potential across the operating divisions for synergies greater than those entities could achieve alone.

Many strategists contend that firms should “stick to the knitting” and not stray too far from the firms’ basic areas of competence. However, diversification is still sometimes an appropriate strategy, especially when the company is competing in an unattractive industry.

## Related diversification

Six guidelines for when related diversification may be an effective strategy are as follows.

* When an organization competes in a no-growth or a slow-growth industry.
* When adding new, but related, products would significantly enhance the sales of current products.
* When new, but related, products could be offered at highly competitive prices.
* When new, but related, products have seasonal sales levels that counterbalance an organization’s existing peaks and valleys.
* When an organization’s products are currently in the declining stage of the product’s life cycle.
* When an organization has a strong management team.

## Unrelated Diversification

An unrelated diversification strategy favors capitalizing on a portfolio of businesses that are capable of delivering excellent financial performance in their respective industries, rather than striving to capitalize on value chain strategic fits among the businesses. Firms that employ unrelated diversification continually search across different industries for companies that can be acquired for a deal and yet have potential to provide a high return on investment. Pursuing unrelated diversification entails being on the hunt to acquire companies whose assets are undervalued, or companies that are financially distressed, or companies that have high growth prospects but are short on investment capital. An obvious drawback of unrelated diversification is that the parent firm must have an excellent top management team that plans, organizes, motivates, delegates, and controls effectively. It is much more difficult to manage businesses in many industries than in a single industry.

Ten guidelines for when unrelated diversification may be an especially effective strategy are:

* When revenues derived from an organization’s current products or services would increase significantly by adding the new, unrelated products.
* When an organization competes in a highly competitive and/or a no-growth industry, as indicated by low industry profit margins and returns.
* When an organization’s present channels of distribution can be used to market the new products to current customers.
* When the new products have countercyclical sales patterns compared to an organization’s present products.
* When an organization’s basic industry is experiencing declining annual sales and profits.
* When an organization has the capital and managerial talent needed to compete successfully in a new industry.
* When an organization has the opportunity to purchase an unrelated business that is an attractive investment opportunity.
* When there exists financial synergy between the acquired and acquiring firm. (Note that a key difference between related and unrelated diversification is that the former should be based on some commonality in markets, products, or technology, whereas the latter should be based more on profit considerations.)
* When existing markets for an organization’s present products are saturated.
* When antitrust action could be charged against an organization that historically has concentrated on a single industry.

## Defensive Strategies

In addition to integrative, intensive, and diversification strategies, organizations also could pursue retrenchment, divestiture, or liquidation.

**Retrenchment**

*Retrenchment* occurs when an organization regroups through cost and asset reduction to reverse declining sales and profits. Sometimes called a *turnaround* or *reorganizational strategy,* retrenchment is designed to fortify an organization’s basic distinctive competence.

During retrenchment, strategists work with limited resources and face pressure from shareholders, employees, and the media. Retrenchment can entail selling off land and

buildings to raise needed cash, pruning product lines, closing marginal businesses, closing obsolete factories, automating processes, reducing the number of employees, and instituting expense control systems.

Five guidelines for when retrenchment may be an especially effective strategy to pursue are as follows:

* When an organization has a clearly distinctive competence but has failed consistently to meet its objectives and goals over time.
* When an organization is one of the weaker competitors in a given industry.
* When an organization is plagued by inefficiency, low profitability, poor employee morale, and pressure from stockholders to improve performance.
* When an organization has failed to capitalize on external opportunities, minimize external threats, take advantage of internal strengths, and overcome internal weaknesses over time; that is, when the organization’s strategic managers have failed (and possibly will be replaced by more competent individuals).
* When an organization has grown so large so quickly that major internal reorganization is needed.

**Divestiture**

Selling a division or part of an organization is called *divestiture.* Divestiture often is used to raise capital for further strategic acquisitions or investments. Divestiture can be part of an overall retrenchment strategy to rid an organization of businesses that are unprofitable, that require too much capital, or that do not fit well with the firm’s other activities. Divestiture has also become a popular strategy for firms to focus on their core businesses and become less diversified.

Six guidelines for when divestiture may be an especially effective strategy to pursue follow:

* When an organization has pursued a retrenchment strategy and failed to accomplish needed improvements.
* When a division needs more resources to be competitive than the company can provide.
* When a division is responsible for an organization’s overall poor performance.
* When a division is a misfit with the rest of an organization; this can result from radically different markets, customers, managers, employees, values, or needs.
* When a large amount of cash is needed quickly and cannot be obtained reasonably from other sources.
* When government antitrust action threatens an organization.

**Liquidation**

Selling all of a company’s assets, in parts, for their tangible worth is called *liquidation.*

Liquidation is recognition of defeat and consequently can be an emotionally difficult strategy. However, it may be better to cease operating than to continue losing large sums of money.

These three guidelines indicate when liquidation may be an especially effective strategy to pursue:

* When an organization has pursued both a retrenchment strategy and a divestitute strategy, and neither has been successful.
* When an organization’s only alternative is bankruptcy. Liquidation represents an orderly and planned means of obtaining the greatest possible cash for an organization’s assets. A company can legally declare bankruptcy first and then liquidate various divisions to raise needed capital.
* When the stockholders of a firm can minimize their losses by selling the organization’s assets.

2.2 level of strategy

Strategy can be formulated on three different levels:

* corporate level
* business unit level
* Functional or departmental level.

**Corporate Level Strategy**

Corporate level strategy fundamentally is concerned with the selection of businesses in which the company should compete and with the development and coordination of that portfolio of businesses.

In this aspect of strategy, we are concerned with broad decisions about the total organization's scope and direction. Basically, we consider what changes should be made in our growth objective and strategy for achieving it, the lines of business we are in, and how these lines of business fit together. It is useful to think of three components of corporate level strategy: (a) growth or directional strategy (what should be our growth objective, ranging from retrenchment through stability to varying degrees of growth - and how do we accomplish this), (b) portfolio strategy (what should be our portfolio of lines of business, which implicitly requires reconsidering how much concentration or diversification we should have), and (c) parenting strategy (how we allocate resources and manage capabilities and activities across the portfolio -- where do we put special emphasis, and how much do we integrate our various lines of business).

**Business Unit Level Strategy**

A strategic business unit may be a division, product line, or other profit center that can be planned independently from the other business units of the firm.

At the business unit level, the strategic issues are less about the coordination of operating units and more about developing and sustaining a competitive advantage for the goods and services that are produced. ***Competitive Strategy often called Business Level Strategy.*** This involves deciding how the company will compete within each line of business (LOB) or strategic business unit (SBU).

 At the business level, the strategy formulation phase deals with:

* positioning the business against rivals
* anticipating changes in demand and technologies and adjusting the strategy to accommodate them
* influencing the nature of competition through strategic actions such as vertical integration and through political actions such as lobbying.

Michael Porter identified three generic strategies (*cost leadership*, *differentiation*, and *focus*) that can be implemented at the business unit level to create a competitive advantage and defend against the adverse effects of the five forces.

**Functional Level Strategy**

The functional level of the organization is the level of the operating divisions and departments. The strategic issues at the functional level are related to business processes and the value chain. Functional level strategies in marketing, finance, operations, human resources, and R&D involve the development and coordination of resources through which business unit level strategies can be executed efficiently and effectively.

Functional units of an organization are involved in higher level strategies by providing input into the business unit level and corporate level strategy, such as providing information on resources and capabilities on which the higher level strategies can be based. Once the higher-level strategy is developed, the functional units translate it into discrete action-plans that each department or division must accomplish for the strategy to succeed. These more localized and shorter-horizon strategies deal with how each functional area and unit will carry out its functional activities to be effective and maximize resource productivity.

**Long-Term Objectives**

*Long-term objectives* represent the results expected from pursuing certain strategies. Strategies represent the actions to be taken to accomplish long-term objectives. The time frame for objectives and strategies should be consistent, usually from two to five years.

**The Nature of Long-Term Objectives**

Objectives should be quantitative, measurable, realistic, understandable, challenging, hierarchical, obtainable, and congruent among organizational units. Each objective should also be associated with a timeline. Objectives are commonly stated in terms such as growth in assets, growth in sales, profitability, market share, degree and nature of diversification, degree and nature of vertical integration, earnings per share, and social responsibility.

Clearly established objectives offer many benefits.

* They provide direction,
* allow synergy,
* aid in evaluation,
* establish priorities, reduce uncertainty,
* minimize conflicts,
* stimulate exertion, and aid in both the allocation of resources and the design of jobs.
* Objectives provide a basis for consistent decision making by managers whose values and attitudes differ.

Objectives serve as standards by which individuals, groups, departments, divisions, and entire organizations can be evaluated.

Long-term objectives are needed at the corporate, divisional, and functional levels of an organization. They are an important measure of managerial performance.

Without long-term objectives, an organization would drift aimlessly toward some unknown end.

**The Balanced Scorecard**

Developed in 1993 by Harvard Business School professors Robert Kaplan and David Norton, and refined continually through today, the Balanced Scorecard is a strategy evaluation and control technique.3 *Balanced Scorecard* derives its name from the perceived need of firms to “balance” financial measures that are oftentimes used exclusively in strategy evaluation and control with nonfinancial measures such as product quality and customer service. An effective Balanced Scorecard contains a carefully chosen combination of strategic and financial objectives tailored to the company’s business.

The overall aim of the Balanced Scorecard is to “balance” shareholder objectives with customer and operational objectives.

Obviously, these sets of objectives interrelate and many even conflict. For example, customers want low price and high service, which may conflict with shareholders’ desire for a high return on their investment. The Balanced Scorecard concept is consistent with the notions of continuous improvement in management (CIM) and total quality management (TQM).

Financial measures and ratios are vitally important. However, of equal importance are factors such as customer service, employee morale, product quality, pollution abatement, business ethics, social responsibility, community involvement, and other such items. In conjunction with financial measures, these “softer” factors comprise an integral part of both the objective-setting process and the strategy-evaluation process.

These factors can vary by organization, but such items, along with financial measures, comprise the essence of a Balanced Scorecard. A Balanced Scorecard for a firm is simply a listing of all key objectives to work toward, along with an associated time dimension of when each objective is to be accomplished, as well as a primary responsibility or contact person, department, or division for each objective.