Queen Mary
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# BUS359
# Contemporary Strategic Analysis

## Lecture 2: Goals, values, and performance

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## Kahoot! Things you are still remembering from previous lecture

# Recap: What is strategy & why does is matter?

Think-pair-share (5 minutes):

- What are the common elements in a successful strategy?
- Draw the basic framework for strategy analysis
- What are the sources of superior performance?
- What is realised strategy?

# Outline

- Profit as a measure of success?
- Value for whom?

# Class activity: Your thoughts on success and purpose?

**Kahoot!** (5 minutes):

How do you measure success?

- Name a successful company
- Why do you think it is successful?

**What is the role and purpose of business in society?**

# Strategy as a quest for value

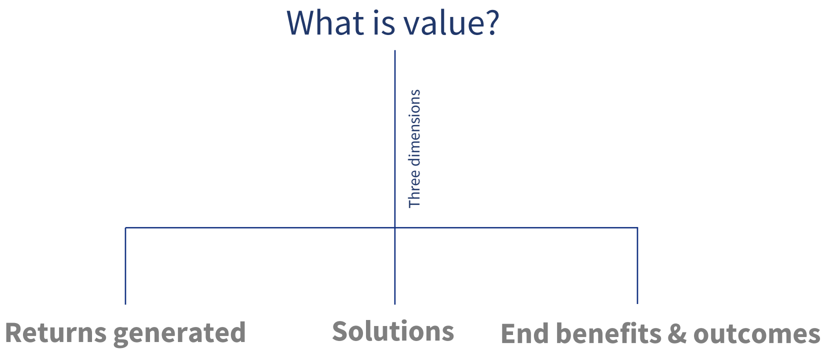
Strategist's job is to define and express a clear as well as motivating purpose for the organisation

*"Forging a compelling organisation response" is the on-going job of company leaders & the "crowning responsibility of the CEO"*

Purpose of organisation

- *How does the organisation make a difference?*
- *For whom does the organisation make that difference?*

Purpose = Value?




Montgomery, C. A. (2008). Putting leadership back into strategy. *Harvard business review*, *86*(1), 54.

# Sources of value and measuring it

**Sources:**

- Production – creates value by physically transforming products that are less valued by consumers into products that are more valued by consumers.
- Commerce – creates value by repositioning them in space and time.
  - Space: Trade, moving from *less valued area* to *more valued area*.
  - Time: Speculation, moving from *less valued point in time* to *more valued point in time*.

**Measured as value added:**

- The difference between the value of a firm's output and the cost of its material inputs.
  - Value creation = Total customer value - Real costs of production
- Neglects consumer surplus = Value consumers derive from using the product.

*'Profits are to business as breathing is to life.'*

Dennis Bakke, Founder and Former CEO, AES Corporation

# Value = Profit?

Often value added is measured by an organisation's profitability. Why?

- Competition
- Threat of acquisition
- Convergence of stakeholder interests

What is the profit?

The amount of revenue gained (amongst owners) from a business activity after expenses, costs, and taxes needed to sustain the activity have been paid.

**TABLE 2.1** Profitability measures for some of the world's largest companies, 2017

| Company | Market capitalization[a] ($ billion) | Net income ($ billion) | ROS[b] (%) | ROE[c] (%) | ROA[d] (%) | Return to shareholders[e] (%) |
|---|---|---|---|---|---|---|
| Apple | 824 | 48.4 | 26.9 | 39.0 | 16.3 | +46.8 |
| Amazon | 689 | 3.0 | 2.3 | 9.6 | 3.1 | +27.4 |
| Alibaba | 480 | 6.2 | 29.8 | 21.9 | 9.1 | +94.1 |
| JPMorgan Chase | 397 | 24.4 | 50.2 | 9.5 | 1.4 | +24.6 |
| ExxonMobil | 358 | 19.7 | 5.2 | 11.8 | 5.7 | −5.8 |
| Wal mart | 310 | 13.6 | 4.1 | 14.9 | 11.9 | +45.2 |
| Toyota | 204 | 15.8 | 7.6 | 13.2 | 4.1 | +5.8 |

***Notes:***
[a]Shares outstanding × closing price of shares on February 02, 2018.
[b]Return on sales = Operating profit as a percentage of sales revenues.
[c]Return on equity = Net income as a percentage of year-end shareholder equity.
[d]Return on assets = Operating income as a percentage of year-end total assets.
[e]Dividend + share price appreciation during 2017.

(**Source:** Grant, R. M. (2018). *Contemporary strategy analysis*. John Wiley & Sons, page 39)

# A measure of profit: Economic value added

- Economic value added (EVA) is a measure of economic profit, which is the surplus after all inputs.
- EVA = post-tax operating profit – cost of capital
- Why use?
  - True reflection of performance post capital
  - Helps with allocation of resources (e.g., Diageo realised more value in low end brands, reallocated advertising)
- When firm’s maximise profits over the long term, this creates enterprise value, which is a measure of the firm’s total value.

$$\boxed{EV = MC + TD - C}$$

EV: Enterprise value
MC: Market capitalisation, equal to current stock price multiplied by the number of outstanding stock shares
TD: Total debt, equal to the sum of short- & long-term debt
C: Cash & cash equivalents, the liquid assets of a firm


(Source: Diageo)

There did not appear to be a benefit of small amounts of drinking!

Wood, Angela M, Stephen Kaptoge, Adam S Butterworth, and 239 more. 2018. “Risk Thresholds for Alcohol Consumption: Combined Analysis of Individual-Participant Data for 599,912 Current Drinkers in 83 Prospective Studies.” *The Lancet* 391 (10129): 1513–23. https://doi.org/10.1016/S0140-6736(18)30134-X.

# Applying profit to strategy choice (1/2)

## 1. Appraising a firm's or business unit's performance

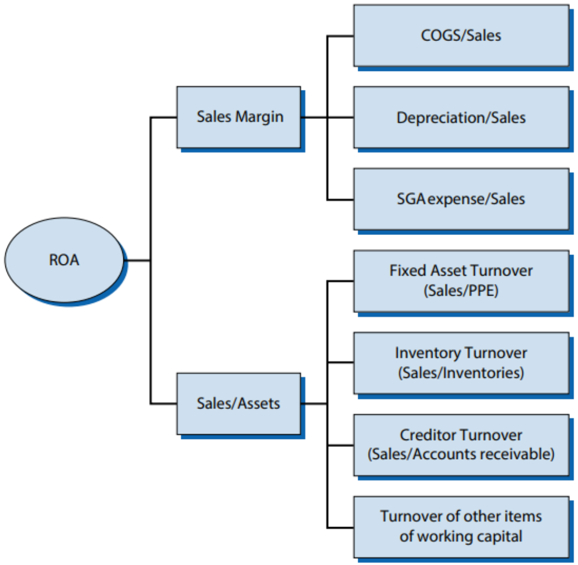
- Forward-looking – stock market valuation (sensitive to market fluctuations)
- Backward-looking – accounting ratios to generate profit from assets (e.g. ROCE, ROE, ROA)

Both allow comparison to competitors, industry average, and in general, which helps identify whether firm performance is improving or deteriorating.

## 2. Diagnosing the sources of poor performance

- Main tool is disaggregation of the return on capital.
- When combined with information about internal forces (resources and capabilities, goals, systems and structures) & external forces (environment), profit performance helps identify value drivers.

**FIGURE 2.2** Disaggregating return on assets




***Notes:***
ROA: Return on assets.
COGS: Cost of goods sold.
PPE: Property, plant, and equipment.
For further discussion, see T. Koller *et al.*, *Valuation*, 5th edn (Chichester: John Wiley & Sons, Ltd., 2010).

(**Source:** Grant, R. M. (2021). *Contemporary strategy analysis*. John Wiley & Sons)

# Applying profit to strategy choice (2/2)

## 3. Selecting strategies on the basis of their profit prospects

- Established why poor performance, take corrective actions – strategic (medium & long term), operational (short-term)

## 4. Setting performance targets

A. Financial disaggregation: Cascade of financial targets down the firm

e.g., CEO = maximise ROCE & new project investment; Operational unit manager = maximise sales, minimise costs; Department managers = equipment maintenance to minimise machine downtime.

Short-term focus undermines long-term.

B. Balanced scorecards: Combine financial targets (short-term) with strategic and operational targets (long-term)

Top-down, starts with firm mission statement, and identifies KPIs from four perspectives:

- Financial return
- Customer
- Internal capability
- Learning and growth

Danger of too many KPIs, how target is achieved can be overlooked (e.g., NHS ambulance response time, cars instead of vans)

# Class activity: Boeing

Case discussion **(5 minutes)**:

1. How did Boeing measure success prior to 1990?

2. What has changed in the mid-1990s when a new management team took over? And why do you think that's the case?

Boeing profit drops as charges in defence unit offset commercial jet recovery

Aerospace group expects to achieve positive free cash flow in 2022


Boeing took a combined charge of $240mn related to programmes in its defence and space business © Peter Cziborra/Reuters

**Steff Chávez** in Chicago JULY 27 2022 9

Boeing was one of the most financially successful members of the Dow Jones Industrial Index between 1960 and 1990. Yet Boeing gave little attention to financial management. CEO Bill Allen was interested in building great planes and leading the world market with them: "Boeing is always reaching out for tomorrow. This can only be accomplished by people who live, breathe, eat and sleep what they are doing." At a board meeting to approve Boeing's biggest ever investment, the 747, Allen was asked by non-executive director Crawford Greenwalt for Boeing's financial projections on the project. In response to Allen's vague reply, Greenwalt buried his head in his hands. "My God," he muttered, "these guys don't even know what the return on investment will be on this thing."

The change came in the mid-1990s when Boeing acquired McDonnell Douglas and a new management team of Harry Stonecipher and Phil Condit took over. Mr Condit proudly talked of taking the company into "a value-based environment where unit cost, return on investment, and shareholder return are the measures by which you'll be judged." The result was lack of investment in major new civil aviation projects and diversification into defence and satellites. Under Condit, Boeing relinquished market leadership in passenger aircraft to Airbus, while faltering as a defence contractor due partly to ethical lapses by key executives. When Condit resigned on December 1, 2003, Boeing's stock price was 20% lower than when he was appointed.

**Sources:** John Kay, "Forget How the Crow Flies," Financial Times Magazine (January 17, 2004): 17–27; R. Perlstein, The Stock Ticker and the Superjumbo (Prickly Paradigm Press, 2005).

# The paradox of value

**The companies that are most successful in creating long term shareholder value are typically those that:**

- Have a mission – they give precedence to goals other than profitability and shareholder return.
- Have strong, consistent, ethical values.

**Thinking beyond profit**

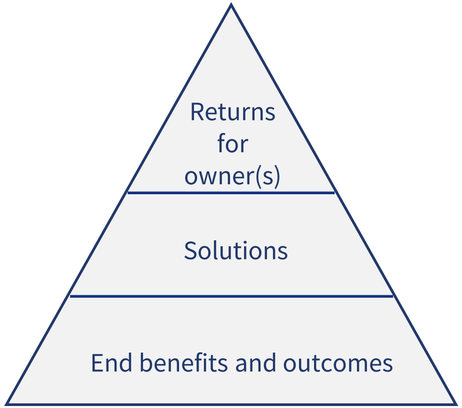
"*Breathing is essential to life, but it is not the purpose if living. Similarly, profits are essential for the existence of the corporation, but they are not the reason for its existence*" (Dennis Bakke, founder of AES Corporation)

**Why do organisations need to think beyond profit?**

- Profit may be essential, but it is not the goal for all employees.
- If stakeholders of an organisation can relate to a purpose beyond profit, it can lead to a competitive advantage and more profit.
- For a firm to survive and generate profit over the long term, it requires responsiveness and adaptability to its social, political, and natural environments.

# How did we end up with profit = value? (1/4)

## A brief history of value




“Marriage” pre-19th century

Shareholder value

Value integration

Stakeholder value

1850s | 1970s | 1980s | 1990s | 2000s | 2010s

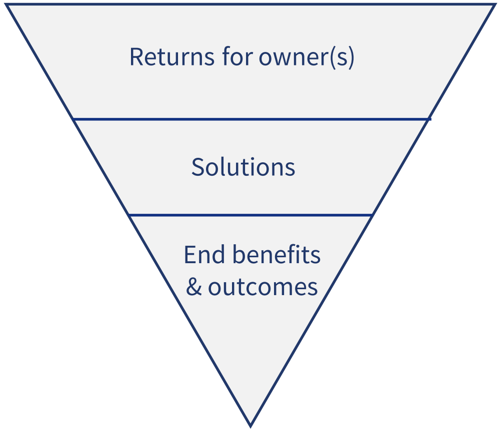
*High transparency*

(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage*.)

# How did we end up with profit = value? (2/4)

## A brief history of value

“Divorce” 1850s-1990s




Shareholder value

Value integration

Stakeholder value

Business becomes seen as separate from society

“The only social responsibility of business is to make a profit for its shareholders”

1850s 1970s 1980s 1990s 2000s 2010s

Social ills and air/water/soil pollution raise awareness

Ecological and social activism; Government regulation

*High transparency*

(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage*.)

# How did we end up with profit = value? (3/4)

## A brief history of value

(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage*.)

**"Casino economy" speculation & derivatives favour the short term**

Shareholder value

Value integration

Stakeholder value

Business becomes seen as separate from society

"The only social responsibility of business is to make a profit for its shareholders"

Deregulation

Triple bottom line: Economic targets

1850s

1970s

1980s

1990s

2000s

2010s

Social ills and air/water/soil pollution raise awareness

Ecological and social activism; Government regulation

Moral persuasion; Brundtland Commission

Green and social targets

**Climate change, water security & pollution threaten the long term**

*High transparency*

*Reduced transparency*

# How did we end up with profit = value? (4/4)

## A brief history of value

(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage*.)

**"Casino economy" speculation & derivatives favour the short term**

Shareholder value

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Stakeholder value

1850s

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Social ills and air/water/soil pollution raise awareness

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"The only social responsibility of business is to make a profit for its shareholders"

Ecological and social activism; Government regulation

1980s

Deregulation

Moral persuasion; Brundtland Commission

1990s

Triple bottom line: Economic targets

Green and social targets

2000s

Integration of environmental & social ROI

Focus is eco-efficiency

Focus is eco-effectiveness

Business ethics

"Re-set"

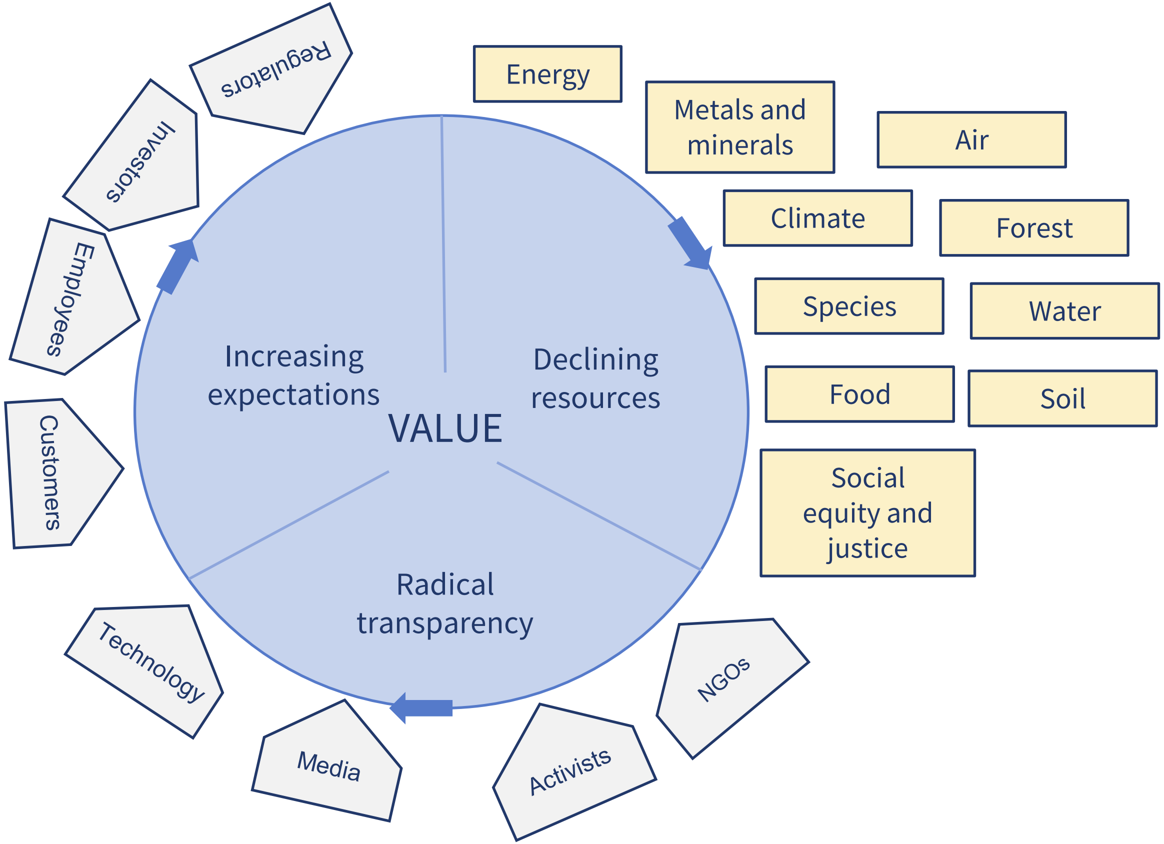
Sustainable Value

2010s

**Climate change, water security & pollution threaten the long term**

*High transparency* → *Reduced transparency* → *High transparency*

# Redefining the way business creates value (1/2)




(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage.*)

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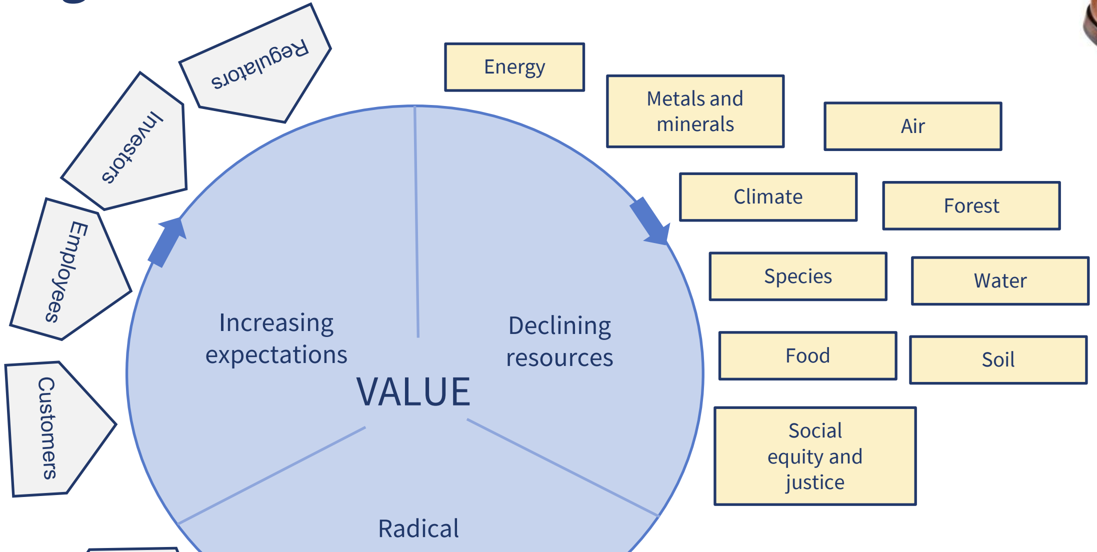
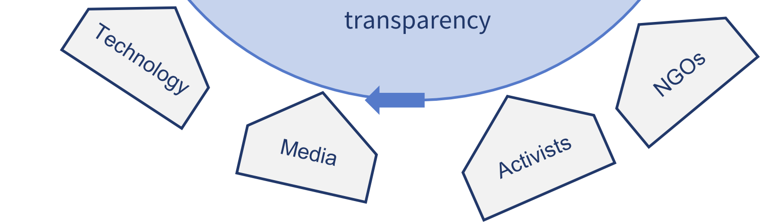
# Redefining the way business creates value (2/2)

## Making shoes

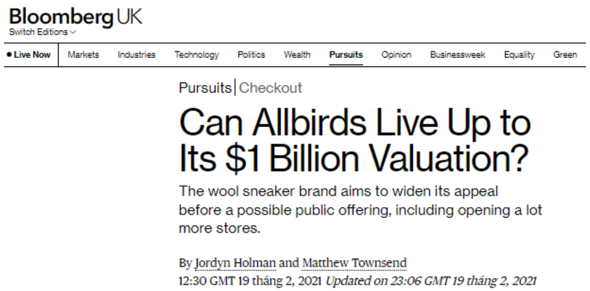


(Source: The WSJ)

eather shoes

- 16,600 litres
- 1kg of leather



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Can Allbirds Live Up to Its $1 Billion Valuation?

The wool sneaker brand aims to widen its appeal before a possible public offering, including opening a lot more stores.

By Jordyn Holman and Matthew Townsend
12:30 GMT 19 tháng 2, 2021 *Updated on 23:06 GMT 19 tháng 2, 2021*

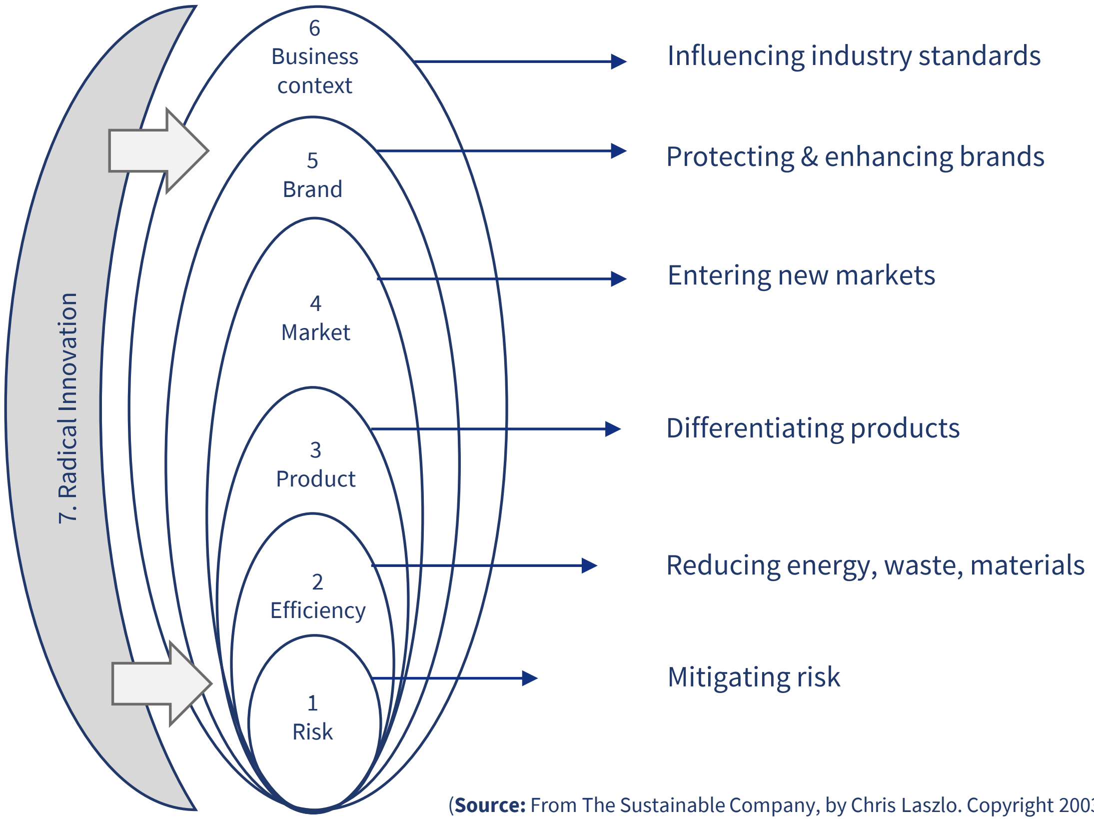
(Source: Allbirds)

Allbirds

Wool & tree runners

(Source: Laszlo & Zhexembayeva, 2011. *Embedded sustainability: The next big competitive advantage.*)

# Sustainable value as a source of profit?




## Value creation:

- Mitigating risk (e.g., cost of oil spill)
- Efficiency opportunity (e.g., reduce resource costs) Differentiation (e.g., green customers/investors)
- A pathway to new markets (e.g., GE's expertise in turbines enabled entry wind power generation)
- Protects & enhances the brand (e.g., reputation, trust)
- Influencing industry standards (e.g., shape standards in their favour to keep competitors out)
- Driver of radical innovation (e.g., cement manufacturing process that captures and stores $CO_2$ )

# Summary and next week

**Recap:**

- Three dimensions of value
- Why is profit used to measure value?
- How can analysis of profit performance can guide strategy?
- The paradox of value
- Sustainable value

**Seminar session 2:**

- Required reading: The Lego case.
- Discussion questions, refer to the QMplus module page.

**Forthcoming:**

- Lecture 3: Macro-environment analysis & industry analysis
- PESTEL analysis
- From macro-environment to industry environment
- Porter's Five Forces
- How industry structure determines competition

# All voices are heard…

https://forms.gle/xRPGv7RPJfoxNiWi8

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