Erasmus School of Economics

Linking Valuation to Strategy

The focal point here is the value creation of the firm in financial markets. However, this value is made up of a static component that derives from assets that are already in place, and a more dynamic component consisting strategic value of future growth opportunities. For many stocks, this strategic growth option value is a significant proportion of total firm value.

Where does value creation (EVA) or positive expanded NPV's come from? In a competitive market characterized by cost-less entry and exit and homogeneous products, early investment can produce only temporary excess profits. Eventually, potential competitors would catch up and enter the industry. In the long run, the increased supply would lower prices such that equilibrium rates of return would be driven down to their required returns. Then, future excess profits or EVA and NPV's (determined from the present value of the expected excess profits) are expected to be driven down to zero for future projects.

In a competitive environment, future excess profits can exist if the firm can generate some sort of sustainable competitive advantage. To understand the value creation of a project's positive expanded NPV, strategic management theory can explain why a particular project is more valuable for this company than for its competitors. Value creation has two underlying sources. First, it depends on the general attractiveness and opportunities in the industry in which the company operates. Second, it depends on the establishment of a competitive advantage over its rivals. The externally-based view of the firm emphasizes imperfections, strategic behavior and market power that may create a position for the firm to generate returns that exceed the opportunity cost of capital. Other approaches such as the resource-based view and dynamic capabilities are more internally focused on the exploitation of firm-specific assets, capabilities and strategic adaptability.

A key step in building a framework that relates corporate finance with strategic planning is to understand on which drivers the value of assets in place and strategic growth option value are based. Table 1 provides a summary of the value drivers that can help build a strategic position. Columns 1 and 2 show that a value-creating strategy depends on opportunities or market imperfections in the external environment. For instance, in one market a market-leader strategy might be successful because economies of scale are present, while in another market an innovative strategy might be successful if differentiation and technological innovation are critical to success.

The position of the firm is essential not only for supporting competitive advantage underlying the value of assets that are currently in place (columns 1 and 2), but also for creating valuable growth options (column 3), and helping win the competitive game to appropriate these options (column 4). For example, if a firm wants to build a learning cost advantage, it must enlarge cumulative production volume more rapidly than its competitors. When it executes first the experience curve strategy, later producers will be in a disadvantaged position in exercising their expansion options. Such entry should be assessed on the basis of its ability to create proprietary future opportunities and to rapidly expand production.

In this way an expanded strategic NPV criterion - that incorporates not only the direct NPV of measurable cash flows but also the strategic growth option value - can assist practitioners in the development of their long-run strategies.

Table 1: **Value Determinants, Strategies, and Real Options**

Value Driver	**Strategy**	**Strategic Growth Option Value**	
1	**2**	**3. Portfolio of Real Options**	**4. Strategic Moves (Game Theory)**
(i) Differentiation with unique, innovative products	**Aim:** The value creation is based on achieving proprietary knowledge, coupled with a marketing program for customer acceptance. **Important in:** Industries involving innovative or unique products, e.g., pharmaceutical industry, information technology and electronics.	The strategy encompasses a portfolio mix of compound options, e.g., R&D followed by prototyping pilot projects in new markets. High technical uncertainty over success of R&D, due to implicit leverage, coupled with high commercial uncertainty and strategic uncertainty over product acceptance. Adaptive capabilities enhance the value of flexibility.	Commitment effect of first mover advantages due to e.g., patents, buyer switching costs and network externalities. When the product has a network externality, an early mover that made more sales than its competitors in early periods develops a larger installed base. However, increased technological intensity coupled with shorter life cycles makes preventing early imitation increasingly difficult. In many cases the costs of imitation have become lower than the cost of innovation.
(ii) Leverage of reputation	**Aim:** Strategy aimed at creating a leading position in quality or service, differentiating the product from competitors. **Important in:** Industries with large brand-name capital, e.g., soft drinks or cigarette industry. The platform company should be a respected company to be a successful foothold for future growth opportunities.	Strategic/ goodwill investments in advertising and marketing generate future expansion options. Low technological and commercial uncertainty.	Commitment effect may depend on position of the firm and competitive reaction. Reputation and buyer choice under uncertainty may also be isolating mechanisms for the early-mover. If buyers have imperfect information regarding product quality, they may hold on to the first brand that performs satisfactory. Threat of reciprocating reactions: advertising may result in more advertising and price competition may make everybody worse off.
(iii) Cost advantage based on economies of scope	**Aim:** Expansion is aimed at gaining cost advantages associated with producing and selling multiple products related by a common technology, product facilities or network. **Important in:** Industries where a cost advantage exists when the same investment can support multiple profitable activities at different locations.	Options that allow switching between different technologies or products and leverage of competences onto a broad geographical or financial base. For instance, R&D generating compound options resulting from critical technologies that cut across businesses. Various simple, commercial options over a broad product line.	An advantaged strategic position results from resources that can be used in several products. As a result, a given resource position will often have consequences for several products, each yielding part of the resulting return.

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(iv) Build up scale	**Aim:** The key towards competitive advantage here is building size in a fragmented market. The strategy is aimed at market leadership with an investment and pricing policy that fully exploits economies of scale in the firm's functions. **Important in:** Fragmented industries with large fixed investments in R&D or production, banking, automobiles, oil.	Infrastructure investments that generate options to expand more quickly than competitors. This resource position enables the firm to pre-empt expansion opportunities in the market.	Value of early commitment is present when the minimum efficient scale is large relative to the market size and a limited number of firms can fit in the market without creating overcapacity. Capacity games often involve contrarian reactions. Late movers would be reluctant to pay for the resource since they would be faced with higher cost or might face the threat of price competition due to excess capacity.
(v) Absolute cost advantage	**Aim:** Expansion is aimed at achieving the lowest delivered cost position in the industry, especially if cost reduction can be made proprietary to the firm. **Important in:** Industries where proprietary knowledge, a learning cost effect, efficient supply or favorable locations result in a cost advantage, e.g., natural resource industries.	Early exercise of options may generate a cost advantage or experience curve effects. For instance, acquisition of favorable locations or exploration investments in the petroleum industry to acquire favorable areas at low cost.	Early commitment of capital (exercise of real option) to acquire a cost advantage or experience effect. Capitalizing on expansion opportunities in case of experience effects depends on the ability of the firm to keep experience effects proprietary. When experience effects are proprietary, later resource producers will face an uphill battle with earlier producers who have lower costs. Later acquirers would thus face less valuable expansion opportunities.

Source: Based on Smit and Trigeorgis (2004) Strategic Investment: Real Options and Games, Princeton NY.