Strategic Planning to Manage Risks

by A V Vedpuriswar

The average life expectancy of a multinational corporation has been estimated by Arie De Geus[1] a former Shell executive (and a scholar in his own right) to be between 40 and 50 years. Even individual human beings survive for about 75 years on an average. Quite clearly, most corporations do not last long enough. Unable to manage risk effectively, they submerge under a sea of red ink either over a period of time or all of a sudden.

De Geus' research has revealed that enduring organizations excel on various fronts simultaneously. They are sensitive to their environment. They do not hesitate to move into unchartered areas when the situation demands. They use money in an old fashioned way, keeping enough of it for a rainy day. In other words, long lived companies have sound strategies for managing risk. As Collins and Porras (who have done some brilliant research on what creates lasting companies in their book 'Built to Last') put it, "Visionary companies display a powerful drive for progress that enables them to change and adapt without compromising their cherished core ideals."

All companies face threats in the environment - new competition, new technology, change in market trends - but only a few of them manage these risks effectively. The Swedish company Stora, for instance has shown a remarkable ability to formulate strategies according to the needs of the environment. Once it even fought the king of Sweden to maintain its independence and identity. To cope with the changing environment, the company has from time to time changed its business profile from copper to forest exploitation to iron smelting, to hydropower and later paper, wood pulp and chemicals. In the process, the company has mastered new technologies including steam, internal combustion, electricity and the microchip. If Stora had continued in one business line it would not have survived. The same argument apples to Nokia, one of the most admired companies in the world today. Though Nokia has been in the limelight only in recent times, it is a fairly old company, having been around for more than 100 years. At one point of time, Nokia dealt in wood, pulp and paper. Today, it makes sleek cellular phones loaded with powerful software. Quite clearly, companies which are alert to the changes in the environment and which have internal mechanisms to respond to these changes are the ones which do well on a sustained basis in the long run.

In this paper, we attempt to understand how strategic planning can help companies to identify and understand the risks in the environment and cope with them effectively.

Dealing with uncertainty in the environment

From a strategic perspective, risk management is all about framing strategies that help a firm to survive and grow over a long period of time. When the environment is unfavourable, the firm will concentrate on survival and when it is favourable, it will attempt to exploit new growth opportunities. The ability of a company to adjust to the environment depends crucially on the ability of its senior managers to observe and understand what is happening outside and prepare business plans accordingly.

De Geus has argued that the process of institutional learning, which is directly linked to strategic planning, can be accelerated. However, for this to be effective, the aim of strategic planning should be not so much to draw up a course of action as to change the mental models in the heads of people. Managers when encouraged to think of various possibilities, become better placed to absorb and digest information and most importantly act as the environment changes.

Strategic planning in uncertain situations is fraught with various risks. If the prevailing uncertainty is not properly taken into consideration, the firm might end up facing threats it is ill equipped to deal with. At the same time, it may not exploit more risky opportunities with the potential to yield excellent returns. Many companies take strategic decisions relying totally on their gut instincts during times of uncertainty. This is obviously a wrong thing to do. Intuition has to be backed with some numbers for strategic planning to be effective.

1 *De Geus' book "The Living Company" is a highly recommended reading.*

© *ICFAI Press. All rights reserved.*

Courtney, Kirkland and Viguerie[2] provide a framework for strategic planning during conditions of uncertainty. They refer to the uncertainty which remains, after doing a thorough analysis of all the variables in the environment as residual uncertainty. To deal with such uncertainty, there are various options. In the most simple situation, strategies can be framed on the basis of a single forecast. At a higher level of uncertainty, a few discrete scenarios can be constructed. At the next level, a range of potential futures can be identified. Finally, in the most uncertain situations, it is difficult to construct scenarios or even predict a range of outcomes. The authors argue that even though analysis has to be necessarily qualitative, it is important not to feel overawed and act purely on instinct even in such situations.

Strategic planning in uncertain situations is fraught with various risks. If the prevailing uncertainty is not properly taken into consideration, the firm might end up facing threats it is ill equipped to deal with.

At a very broad level, when uncertainty is high, firms have two broad strategic options. *They can make heavy commitments and attempt to control the direction of the market. Alternatively, they can make incremental investments and wait till the environment becomes less uncertain before committing themselves heavily to a strategy. In the intervening period, the firm can collect more information, forge partnerships, etc.* In short, a firm has to arrive at an optimum combination – heavy investments involving risk, marginal investments and heavy investments where risk is less. (Courtney, Kirkland and Viguerie call the last of these options a 'no regret' move). The mix would depend on the degree of uncertainty in the environment.

Conventional planning methods are not appropriate when a very high degree of uncertainty is involved.

Conventional planning methods are not appropriate when a very high degree of uncertainty is involved. Rita Gunther McGrath and Ian C Mac Millan[3] suggest the use of discovery-driven planning, which incorporates new data, as they are uncovered into the evolving plan. When Walt Disney entered Europe, an important assumption it made was that 50% of the revenues would come from admissions and the remaining from hotels, food and merchandise. Much lower ticket prices than anticipated and lesser average spending per visitor ensured that in spite of reaching a target of 11 million admissions, profitability remained below expectations. Ticket prices had to be lowered in view of the recession in Europe and the over valued franc. Disney expected people to stay in the hotel for four days but they stayed only two days on an average as there were only 15 rides compared to 45 at Disney World in the US. Disney had assumed that people would eat at the restaurants throughout the day as in the US and Japan but they crowded together during lunch time. Not only was Disney unable to seat all of them, leading to loss of revenues but it also led to dissatisfied customers and bad word of mouth publicity. Visitors to Euro Disney also purchased a much smaller proportion of high margin items such as T-shirts and hats than expected.

Mc Grath and Mac Millan have summarised the mistakes which companies make while planning new projects with a great degree of uncertainty:

- Companies do not have precise information but after a few important decisions are made, proceed as though the assumptions are facts.
- Companies have enough hard data but do not spend adequate time in checking the assumptions made.
- Companies may have enough data to justify entry into the new business or market but may make inappropriate assumptions about their ability to execute the plans.
- Companies may have the right data and may make the right assumptions to start with but may fail to notice until it is too late that a key variable in the competitive environment has changed.

Many companies swear by financial techniques such as Net Present Value (NPV) without understanding the pitfalls involved. David Sharp[4] has explained that to

2 *Harvard Business Review, November-December 1997*

3 *Harvard Business Review, July/August 1995*

deal with uncertainty one needs to look at the options generated by new investments. "NPV's effectiveness for investment appraisal is limited; the present value of an investment's cash flows excludes the valuable options embedded within the investment. These options give the company the ability to take advantage of certain opportunities later. For projects with long-term strategic consequences, the options are frequently the most valuable part of the investment. Since NPV calculations understate value, a selection process driven by NPV will reject more potentially profitable projects." In other words, when evaluating projects with a high degree of uncertainty, companies may not take a risk worth taking, due to the use of a wrong appraisal technique.

Many companies swear by financial techniques such as Net Present Value (NPV) without understanding the pitfalls involved.

Scenario planning

Man has developed the natural habit of thinking in terms of alternate scenarios and prepared himself for contingencies, since time immemorial. Just to survive, he has had to ask questions like: What if it snows?, what if there is a poor harvest? Indeed, it is this type of thinking which made man think of various actions, such as storing food, building dams, etc.

Formal scenario planning emerged in a military context during the second world war when the countries at war had to prepare themselves for different contingencies. Since then the use of scenario planning has gained in popularity. The US Air Force for example has been conducting war-game exercises for many years with the aid of computer simulations. In the late 1960s, Herman Kahn of the Stanford Research Institute began to refine the scenario planning concept so that it could be used by businesses. IBM and GM were among the first companies to embrace scenario planning. Both companies however, failed to get the maximum advantage of scenario planning. Being industry leaders, they probably had an exaggerated notion of their ability to predict and control events in the environment. What they saw as probable, essentially reflected their then existing paradigms. GM totally overlooked the changing consumer preferences in favour of smaller cars and the invasion of the US market by Japanese cars. IBM did not quite visualise emergence of smaller, less powerful but more user-friendly computers. On the other hand, the global oil giant Shell seems to have achieved great success in the use of scenario planning.

Today many leading companies accept that adapting blindly to the processes of evolution is not desirable. Learning about trends and uncertainties and how they interact with each other enables companies to prepare for different future scenarios. Scenario planning helps a company in identifying situations for which its strengths and competencies are particularly suited. It can then understand how it can influence the trends through a combination of innovations, managerial actions and alliances. On the other hand, identifying the scenarios for which it is least prepared, enables it to invest in building the competencies required or in the extreme cases even withdraw from those businesses if they do not promise strategic benefits in the long run. According to Robin Wood[5] : "Given this level of change in our environment, the only response is to accelerate our capability to learn and change so as to adapt, which then buys us time to produce a more desirable future state for ourselves. Scenarios are the most powerful technology we have encountered to accelerate learning and provoke change, in both individuals and organizations."

Scenario planning helps a company in identifying situations for which its strengths and competencies are particularly suited.

Surviving an industry shakeout

A key function of strategic panning is to ensure that major discontinuities in the industry are anticipated and dealt with in a proactive way. George S Day has emphasised the importance of being prepared for an industry shakeout. While shakeouts threaten virtually all companies in the industry, those who see it coming along can create new opportunities. Day refers to two kinds of shake out syndromes.

The *Boom-and-bust syndrome* typically applies to emerging markets and highly cyclical businesses. The dot com industry is a good example. During a boom,

4 *Sloan Management Review, Summer 91*

many players enter the industry leading to excess capacity. As competition intensifies and prices fall, quite a few fail. The companies which succeed ultimately are those with a high degree of operational excellence focussed on ruthless cost cutting.

The *Seismic-shift syndrome* applies more to mature industries. For years, such industries enjoy protected prosperity as competition is not very intense. Examples include the pharmaceutical industry before the emergence of managed health care and banking before deregulation. The protected prosperity is the result of market imperfections due to factors such as patent protection, import barriers and personal relationships with clients. A seismic shift takes place when these factors disappear. Deregulation, globalization and technological discontinuities are some of the drivers behind the seismic shift which has a disruptive impact on incumbent players.

During a boom, many players enter the industry leading to excess capacity. As competition intensifies and prices fall, quite a few fail.

Managers need to develop antennae that can sense the shakeout ahead of competition. They must learn to detect early warning signals by systematically monitoring the rate of entry of new players, the amount of excess capacity in the industry and price declines. Scenario planning, helps focus attention on change drivers and compels the management team to imagine operating in markets which may be unlike those today. Studying other markets which have already seen a shakeout and which are similar in terms of function, structure and susceptibility to the same triggers can also be of great help. Comparisons with the same industry in other countries and regions can also be made.

Day refers to survivors from a boom and bust shakeout as adaptive survivors and those from seismic shift syndrome as aggressive amalgamators. Adaptive survivors pursue a disciplined approach towards operations, customer needs and competitive threats. Dell is a good example of an adaptive survivor. During the initial shakeout in the PC industry in the 1980s, Dell survived due to its lean build to order direct selling model. In the early 1990s, Dell stumbled when it entered the retail segment and when its notebook computers failed to get customer acceptance. CEO, Michael Dell did not hesitate to make sweeping changes in the organisation. He put in place a team of experienced industry executives to complement his highly instinctive and entrepreneurial style of management. Today, Dell is the largest manufacturer of PCs in the world. Quite clearly, it has been an adaptive survivor in an industry, which has seen the exit of several players.

Survivors from a boom and bust shakeout are known as adaptive survivors and those from seismic shift syndrome aggressive amalgamators.

Aggressive amalgamators show an uncanny ability to develop the right business model for the emerging environment. The model they pursue consists of one or more of the following elements: rapidly acquire and absorb smaller rivals, cut operating costs and invest in technologies that increase the minimum scale required for efficient operations. Arrow Electronics, is a good example of aggressive amalgamator. Between 1980 and 1995, this electronics components distributor made more than 25 acquisitions, expanded internationally and cut costs by rationalising its MIS, warehousing, human resources, finance and accounting functions. In India, Gujarat Ambuja Cements seems to be emerging as an aggressive amalgamator.

For companies which find it difficult to become adaptive survivors or aggressive amalgamators, there are alternative survival strategies such as operating in a niche market segment and joining hands with other small players through strategic alliances. The final option is to exit after getting the best price. The timing of the sale is ofcourse crucial. A sale should neither look desperate nor should it be put off unduly.

A framework for making strategic moves

The strategic moves of a company can be broadly classified into three: *Diversification, Vertical Integration and Capacity Expansion.* (A fourth move, Merger/acquisition needs special treatment and is beyond the scope of this paper). Each of these decisions is risky in the sense that various assumptions are made which may ultimately not turn out to be true. A careful understanding of these risks and how they can be

5 *In the book "Managing Complexity"*

minimised if not eliminated hence becomes important. We now examine each of these strategic decisions.

Managing Diversification

Many companies prefer to concentrate their risks by focussing on one business. The main argument in favour of concentration is that managerial attention and effort can be focussed on a few opportunities rather than spreading resources thin over several opportunities. Yet, concentration beyond a point is a risky strategy as demonstrated by Arvind Mills in India. On the other hand, diversification is a powerful way to manage risks.

The famous management guru, Peter Drucker[6] has remarked: "Every business needs a core – an area where it leads. Every business must therefore specialize. But every business must also try to obtain the most from its specialization. It must diversify." Drucker argues that while a central core should guide which businesses it enters, diversification is a must in this era of fast changing markets and technologies.

These comments were made by Drucker more than 30 years back. Today the business environment has become much more volatile and dynamic. Putting all eggs in on basket can be a very risky strategy. So, diversification cannot be avoided. The right question to ask is not whether to diversify but where to diversify. Drucker in his authoritative style offers a general guiding principle in this context: "A company should either be diversified in products, markets and end-uses and highly concentrated in its basic knowledge area; or it should be diversified in its knowledge areas and highly concentrated in its products, markets and end-uses. Anything in between is likely to be unsatisfactory."

In general, entry into a new business is advisable if it has a beneficial impact on the existing businesses. Beneficial impact can come in various forms - better distribution, improved company image, defense against competitive threats and improved stability of earnings. When entering a new business, the firm must be able to bring to the table a distinct value proposition in the form of lower prices or better quality. Alternatively, it should have discovered a new niche or found a way to market the product in an innovative way Jumping into a new business just because it is growing fast or current profitability is high, is the type of risk, which is best avoided.

Business strategy, has been dominated by the theory of core competence in recent times, unlike the 1960s and 1970s when companies diversified, aiming to smoothen earnings, gain administrative economies of scale and reduce risk. Since the 1980s, consultants have argued that risk reduction can be better achieved by individual investors and led a campaign for breaking diversified businesses into smaller focused units. They have argued that a company should concentrate on the industry and activities it knows best.

How valid is the theory of core competence today? Most successful companies have a portfolio of businesses rather than just a single one. And the dividing line between core and non core activities, related and unrelated businesses is tenuous. Consider Microsoft. Starting off with operating systems, it diversified into applications software. In recent times, it has moved aggressively into areas such as enterprise software and web hosting and management services. While all these activities may be built around computer software, the technical and management capabilities required are obviously diverse and the markets are quite different. Yet, Microsoft looks at entry into these new businesses as a means of maintaining growth and profitability.

Most successful companies have a portfolio of businesses rather than just a single one. And the dividing line between core and non core activities, related and unrelated businesses is tenuous.

Or take GE, which is today engaged in a wide range of businesses from plastics to aircraft engines. One of the stars in GE's portfolio is GE capital, a business which is as different as one can imagine from its traditional engineering industries. GE's diversified portfolio has lent a high degree of stability to earnings, which might have been unlikely with a very sharp focus. The company's ability to maximise value for shareholders has withstood the test of time.

Sometimes, companies can miss great opportunities by not embracing a new business. A good example is AT&T, which refused an offer from the National Science Foundation (NSF) of the US to transfer to it internet operations at no cost. AT&T felt that the Internet offered an inferior technology and would not play a significant role in telephony. Effectively, AT&T let go by an

6 *Managing for Results, pp. 208-209*

opportunity to get a monopoly on what has become the most powerful communication medium in recent times. Due to straight jacketed thinking and an inability to visualise alternative scenarios, AT&T gave up a golden opportunity to build a business that could have operated across the value chain, combining the operations of a telecom company, internet service provider and switching equipment manufacturer.

The message is very clear. Diversification as a means of reducing risk is a strategic tool which cannot be ignored. Yet, if this strategic tool is handled wrongly, disaster can result. The Indian subsidiary of Metal Box, the packaging company diversified into bearings. This move destroyed the company and even after divesting the bearings division, Metal Box continues to totter on the brink of bankruptcy. Walt Disney's entry into Europe a major geographic diversification, (briefly covered earlier) resulted in losses of more than $1 billion by 1994. Zap mail cost Federal Express $600 million before the new fax service was withdrawn. Polaroid lost heavily (about $200 million) when it diversified into instant movies. Sony had a hellish time when it acquired Columbia Pictures.

> ***Diversification as a means of reducing risk is a strategic tool which cannot be ignored. Yet, if this strategic tool is handled wrongly, disaster can result.***

Managing vertical integration

A key strategic issue for any company is deciding which segment of the industry value chain to operate in. Or in other words it needs to understand what to do in house and what to outsource. The classic example is IBM, which in a bid to get its PC project going fast, decided to outsource the operating system from Microsoft. The rest, as we know is history. Similarly Visakhapatnam Steel Plant (VSP) made a strategic blunder, when it decided not to develop its own port. By depending on the Visakhapatnam Port Trust, a monopoly in the real sense of the word, VSP gave up all the competitive advantages it could have potentially reaped as the country's only shore based integrated steel plant.

> ***Competitive advantage is generated by building superior resources or capabilities or through product differentiation. The resources or capabilities outsourced should not be responsible for the present or future competitive advantage of a firm.***

Competitive advantage is generated by building superior resources or capabilities or through product differentiation. The resources or capabilities outsourced should not be responsible for the present or future competitive advantage of a firm. Thus, those competencies which allow a firm to gain cost leadership or achieve differentiation must be protected and nurtured. If such resources are outsourced, the long term competitive position of the firm would be threatened. For example, much of the research efforts of global pharmaceutical companies involve tremendous risk but cannot be outsourced. This is because research is the basis for competition in the pharmaceuticals business.

It has now become a fad to argue that all non core activities or competencies can be outsourced. What is often forgotten is that dependence on suppliers beyond a point can make the firm vulnerable even in the case of non core activities. Where there is only a small number of suppliers with tremendous bargaining power, outsourcing can be a risky strategy. Riskiness also tends to increase if vendors are selected too early in the procurement process. Sometimes, opportunistic outsourcing partners can renegotiate terms in their favour as their bargaining power increases.

Three important points have to be kept in mind to minimise outsourcing risk:

i) not to outsource those activities which are central to the company's competitive position

ii)not to outsource when suppliers are few in number unless they are exceptionally reliable

iii) to avoid dependency on the supplier after finalisation of the contract.

Robert Hayes and Williams Abernathy[7] have argued that the key strategic issue in vertical integration is striking the balance between gaining control over crucial elements of the value addition process and encouraging technology development among suppliers:

"In deciding to integrate backward because of apparent short-term rewards, managers often restrict their ability to strike out in innovative directions (ability to absorb the most advanced technologies into the production process) in the future." Where the basic raw materials are commodities, backward integration can generate more profits but where they are sophisticated components, bidding from specialised suppliers may make more sense. Making parts inhouse, can lock a company into an outdated technology and also distract it from doing its core job well.

Robert Hayes and Williams Abernathy[8] have argued that the key strategic issue in vertical integration is striking the balance between gaining control over crucial elements of the value addition process and encouraging technology development among suppliers:

Ted Kumpe and Piet T Bolwijn[8] however disagree with this view: "Without integration, technology-based corporations may wind up beggaring upstream components producers in order to earn premiums for downstream assembly and distribution operations, businesses that are comparatively flush. This cannot go on indefinitely". So manufacturers who do not invest in vertical integration may enjoy some cash advantages but in the long run they may even find themselves dependent on vertically integrated competitors for supply of components.

According to Michael Porter[9], "The essence of the vertical integration decision is not the financial calculation itself but rather the numbers that serve as the raw material for the calculation. The decision must go beyond an analysis of costs and investment requirements to consider the broader strategic issues of integration versus use of market transaction as well as some perplexing administrative problems in managing a vertically integrated entity that can affect the success of the integrated firm. These are very hard to quantify."

Firms often vertically integrate to reduce uncertainties in sourcing and marketing. They may also feel that by controlling a larger portion of the value chain, there could be greater scope for differentiation. While these arguments are well taken, what makes vertical integration risky is that different activities along the value chain typically have to be managed differently. A point often overlooked, when moving up or down the value chain, is that the dividing line between vertical integration and unrelated diversification is very thin. For example, manufacturing and retailing very obviously demand quite different sets of managerial skills. As Porter puts it[10], "Organisational structure, controls, incentives, capital budgeting guidelines and a variety of other managerial techniques from the base business may be indiscriminately applied to the upstream or the downstream business. Similarly, judgements and rules that have grown from experience in the base business may be applied in the business into which integration occurs. This tendency to apply the same managerial style to both elements of the chain is another risk of integration." Thus, experience in one part of the value chain does not automatically qualify the company to enter upstream or downstream businesses.

Managing capacity expansion

When firms add capacity, the risk is that they may be saddled with excess capacity. On the other hand, not adding capacity could be equally risky in that a competitor could preempt and gain a huge market share. Capacity expansion is risky because of a number of uncertainties which exist in the environment.

i) Future demand – quantity and price realisation

ii) Future prices of inputs

iii) Threat of technological obsolescence

iv) Reactions of competitors

v) Impact on industry capacity

The risk of building excess industry capacity is particularly high in commodity type businesses. Since products are not differentiated, firms tend to add capacity to cut costs by generating economies of scale. Risk is also high when capacity can be increased only in big lumps. Over capacity may also result in industries characterised by significant learning curve advantages, economies of scale and long lead times in adding capacity. Indiscriminate capacity expansion may also take place when there is a large number of players and there is no credible market leader.

7 *Harvard Business Review, July-August, 1980*

8 *Harvard Business Review, March-April 1988*

9 *In his classic book, "Competitive Strategy"*

10 *Competitive Strategy*

A preemptive capacity expansion strategy aims to lock up the market before competitors can. No only does this strategy imply heavy investments, but also in many cases, the firm should have the capacity to withstand adverse financial results in the short run. A preemptive strategy is quite risky in that if competitors do not back down or demand does not rise as expected the firm can land in big trouble. The preempting firm should have a certain degree of credibility and must be able to convey clearly that pre emption is its motive. Preemptive expansion of capacity is generally not advisable when competitors have non economic goals, consider the business to be strategic in nature and have substantial staying power.

Risk management has to be tightly integrated into the strategic planning processes of an organization. That calls for mechanisms to understand the changes in the environment by sensitising mangers and building organisational processes that facilitate the necessary responses. Unless this is done, risk management will tend to be ad hoc. Companies should look at strategic planning as an exercise that facilitates organizational learning. By considering various possibilities, building different scenarios and framing alternative plans of action, they would be much better placed to make better strategic decisions like capacity expansion, vertical integration and diversification. Strategic planning thus helps a company to take a proactive approach towards the risks it faces across the enterprise. Quite clearly, strategic planning has to be the foundation for a risk management strategy. ■

Reference # 15-01-11-08

CEOs Say

"DuPont will be 200 years old in 2002. This makes us one of the most sustainable industrial companies anywhere in the world – sustainable in the sense of longevity."

Chad Holliday, Chairman & CEO

"As we think about the new century, we have determined that our central focus must be on "sustainable growth." By this I mean, we must create both shareholder and societal value while we reduce our environmental footprint."

Chad Holliday, Chairman & CEO

"The high-tech stocks stole the show early in the year. But it didn't last. And while technology still has a lot to offer, the bloom is off the dot-com rose."

David J. O'Reilly, Chairman and Chief Executive Officer Chevron Corporation

"Commitment, confidence, successful execution, and superior skills will differentiate the companies that will satisfy both the energy-supply and investor-return missions."

David J. O'Reilly, Chairman and Chief Executive Officer Chevron Corporation

"Commitment, confidence, successful execution, and superior skills will differentiate the companies that will satisfy both the energy-supply and investor-return missions."

Henry B. Schacht, Chairman & CEO, Lucent Technologies