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Strategic Management for Competitive Advantage

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For the better part of a decade, strategy has been a business buzzword. Top executives ponder strategic objectives and missions. Managers down the line rough out product/market strategies. Functional chiefs lay out "strategies" for everything from R&D to raw-materials sourcing and distributor relations. Mere planning has lost its glamor; the planners have all turned into strategists.

All this may have blurred the concept of strategy, but it has also helped to shift the attention of managers from the technicalities of the planning process to substantive issues affecting the long-term well-being of their enterprises. Signs that a real change has been taking place in business's planning focus have been visible for some time in the performance of some large, complex multinational corporations—General Electric, Northern Telecom, Mitsubishi Heavy Industries, and Siemens A.G., to name four.

Instead of behaving like large unwieldy bureaucracies, they have been nimbly leap-frogging smaller competitors with technical or market innovations, in true entrepreneurial style. They have been executing what appear to be well thought-out business strategies coherently, consistently, and often with surprising speed. Repeatedly, they have been winning market shares away from more traditionally managed competitors.

What is the source of these giant companies' remarkable entrepreneurial vigor? Is it the result of their substantial investments in strategic planning, which appear to have produced something like a quantum jump in the sophistication of their strategic planning processes? If so, what lessons can be drawn from the steps they have taken and the experience they have gained?

To explore these questions, we embarked on a systematic examination of the relation between formal planning and strategic performance across a broad spectrum of companies (see the sidebar). We looked for common patterns in the development of planning systems over time. In particular, we examined their evolution in those giant companies where formal planning and strategic decision making appeared to be most closely and effectively interwoven.

A Quest for Common Patterns

For two years, we and our colleagues studied the development of formal planning systems in 120 companies, ...

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Our findings indicate that formal strategic planning does indeed evolve along similar lines in different companies, albeit at varying rates of progress. This progression can be segmented into four sequential phases, each marked by clear advances over its predecessor in terms of explicit formulation of issues and alternatives, quality of preparatory staff work, readiness of top management to participate in and guide the strategic decision process, and effectiveness of implementation (see the Exhibit).

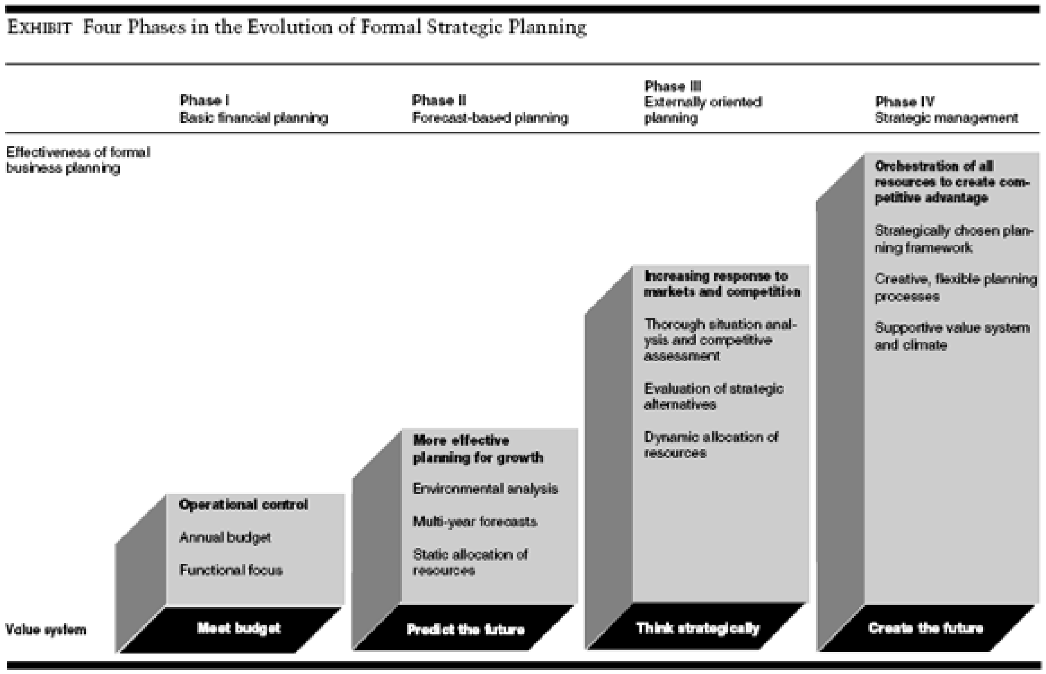

Exhibit Four Phases in the Evolution of Formal Strategic Planning

The four-phase model evolution we shall be describing has already proved useful in evaluating corporate planning systems and processes and for indicating ways of improving their effectiveness.

In this article, we describe each of the four phases, with special emphasis on Phase IV, the stage we have chosen to call strategic management. In order to highlight the differences between the four stages, each will be sketched in somewhat bold strokes. Obviously, not all the companies in our sample fit the pattern precisely, but the generalizations are broadly applicable to all.

Phase I: Basic Financial Planning

Most companies trace the origins of a formal planning system to the annual budgeting process where everything is reduced to a financial problem. Procedures develop to forecast revenue, costs, and capital needs and to identify limits for expense budgets on an annual basis. Information systems report on functional performance as compared with budgetary targets.

Companies in Phase I often display powerful business strategies, but they are rarely formalized. Instead, they exist. The only concrete indication that a business strategy exists may be a projected earnings growth rate, occasionally qualified by certain debt/equity targets or other explicit financial objectives.

The quality of Phase I strategy depends largely on the CEO and the top team. Do they really know their company's products and markets and have a good sense of what major competitors will do next? Based on their knowledge of their own cost structure, can they estimate what the impact of a product or marketing change will be on their plants, their distribution system, or their sales force? If so, and if they do not plan for the business to grow beyond traditional limits, they may not need to set up an expensive planning apparatus.

Phase II: Forecast-based Planning

The complexities of most large enterprises, however, demand more explicit documentation of the implicitly understood strategies of Phase I. The number of products and markets served, the degree of technological sophistication required, and the complex economic systems involved far exceed the intellectual grasp of any one manager.

The shoe usually pinches first in financial planning. As treasurers struggle to estimate capital needs and trade off alternative financing plans, they and their staffs extrapolate past trends and try to foresee the future impact of political, economic, and social forces. Thus begins a second phase, forecast-based planning. Most long-range or strategic planning today is a Phase II system.

At first, this planning differs from annual budgeting only in the length of its time frame. Very soon, however, the real world frustrates planners by perversely varying from their forecasts.

In response, planners typically reach for more advanced forecasting tools, including trend analysis and regression models and, eventually, computer simulation models. They achieve some improvement, but not enough. Sooner or later plans based on predictive models fail to signal major environmental shifts that not only appear obvious after the fact, but also have a great and usually negative impact on corporate fortunes.

Nevertheless, Phase II improves the effectiveness of strategic decision making. It forces management to confront the long-term implications of decisions and to give thought to the potential business impact of discernible current trends, well before the effects are visible in current income statements. The issues that forecast-based plans address—e.g., the impact of inflation on future capital needs or the inroads foreign manufacturers may make in domestic markets—often lead to timely business decisions that strengthen the company's long-term competitive position.

One of the most fruitful by-products of Phase II is effective resource allocation. Under the pressure of long-term resource constraints, planners learn how to set up a circulatory flow of capital and other resources among business units. A principal tool is portfolio analysis, a device for graphically arranging a diversified company's businesses along two dimensions: competitive strength and market attractiveness.

As practiced by Phase II companies, however, portfolio analysis tends to be static and focused on current capabilities, rather than on the search for options. Moreover, it is deterministic—i.e., the position of a business on the matrix is used to determine the appropriate strategy, according to a generalized formula. And Phase II companies typically regard portfolio positioning as the end product of strategic planning, rather than as a starting point.

Phase II systems also do a good job of analyzing long-term trends and setting objectives (for example, productivity improvement or better capital utilization). But instead of bringing key business issues to the surface, they often bury them under masses of data. Moreover, Phase II systems can motivate managers in the wrong direction; both the incentive compensation program and informal rewards and values are usually focused on short- or medium-term operating performance at the expense of long-term goals. In sum, Phase II planning all too easily becomes a mechanical routine, as managers simply copy last year's plan, make some performance shortfall adjustments, and extend trend lines another 12 months into the future.

Phase III: Externally Oriented Planning

In an environment of rapid change, events can render market forecasts obsolete almost overnight. Having repeatedly experienced such frustrations, planners begin to lose their faith in forecasting and instead try to understand the basic marketplace phenomena driving change. The result is often a new grasp of the key determinants of business success and a new level of planning effectiveness, Phase III.

In this phase, resource allocation is both dynamic and creative. The Phase III planners now look for opportunities to "shift the dot" of a business on a portfolio matrix into a more attractive sector, either by developing new business capabilities or by redefining the market to better fit their companies' strengths. A Japanese conglomerate with an underutilized steel-fabricating capacity in its shipyard and a faltering high-rise concrete smokestack business combined them into a successful pollution control venture.

In the search for new ways to define and satisfy customer needs, Phase III strategists try to look at their companies' product offerings and those of their competitors from the viewpoint of an objective outsider. For example, one heavy equipment manufacturer assigned a strategy team to reverse-engineer the competitor's product, reconstruct its manufacturing facilities on paper, and estimate the manufacturing cost for the competitor's product in the competitor's plant. The team members discovered that design improvements had given the competitor such a commanding advantage in production cost that there was no point in trying to compete on price. But they also found that their own product's lower maintenance and fuel costs offered customers clear savings on a life-cycle cost basis. Accordingly, the sales force was trained to sell life-cycle cost advantages. Over the next three years, the company increased its market share by 30% and doubled its net profit.

Another strategy, derived from an external perspective, was devised by a U.S. industrial commodity manufacturer. When sales in one of its major product lines declined swiftly following the introduction of a new, cheaper competitive product, it decided to find out the reason. Through field interviewing with customers, it discovered that the sales slide was nearly over, something competitors had not realized. Since sales of the product had dropped off to a few core markets where no cost-effective alternative was available, it decided to put more support behind this product line, just as the competition was closing its plants.

The manufacturer trained the sales force to service those distributors who continued to carry the line and revised prices to pick up competitive distribution through master distributor arrangements. It even resisted the move of the trade association to reduce government-mandated safety requirements for handling the newer products. By the time its strategy was obvious to competitors, the manufacturer had firmly established a distribution lead in a small but attractive product/market segment.

The SBU Concept

A distinguishing characteristic of Phase III planning in diversified companies is the formal grouping of related businesses into strategic business units (SBUs) or organizational entities large and homogeneous enough to exercise effective control over most factors affecting their businesses. The SBU concept recognizes two distinct strategic levels: corporate decisions that affect the shape and direction of the enterprise as a whole, and business-unit decisions that affect only the individual SBU operating in its own environment. Strategic planning is thus packaged in pieces relevant to individual decision makers, and strategy development is linked to strategy implementation as the explicit responsibility of operating management.

There are limitations to the SBU concept. Many enterprises, such as vertically integrated companies in process-oriented industries, cannot be neatly sorted out into discrete business units because their businesses share important corporate resources—sales, manufacturing, and/or R&D. In other situations, strategy may dictate a concerted thrust by several business units to meet the needs of a shared customer group, such as selling to the automotive industry or building a corporate position in Brazil. In still other cases, the combined purchasing power of several SBUs or the freedom to transfer technologies from one business to another can be more valuable than the opportunity to make profit-oriented decisions in discrete business units. For example:

- A major chemical company found that several of its competitors, who had grown large enough to integrate backward into feedstock production, were beginning to gnaw at its historic competitive edge as a fully integrated producer. Part of the reason was that by licensing certain technology to the competition, the company had given away a raw-material cost advantage that it could not match with its own, older plants. The basic problem, however, was that its product managers were preoccupied with competitive threats in only a handful of the many product/market segments they served. Decisions that seemed to make sense at the individual business-unit level were adding up to deep trouble for the company as a whole.

- A major supplier of industrial equipment divided its electric utility business into two SBUs, a power generation business and a power transmission business. Much too late, top management discovered that neither SBU had considered pollution control equipment to be part of its legitimate charter. As a result, the company found itself unable to bid on that business—which accounted for a full quarter of electric utility capital spending.

The most significant way in which Phase III differs from Phase II is that corporate planners are expected to offer a number of alternatives to top management. Each choice is usually characterized by a different risk/reward profile or gives priority to a different objective (for example, greater employment security at some cost to ROI). This change is quite pervasive; in fact, one simple way of determining whether a company has advanced to Phase III is to ask managers whether their boss would regard presenting strategy alternatives as a sign of indecisiveness.

The "alternate strategies" approach becomes both the strength and the weakness of Phase III planning, for it begins to impose a heavy—sometimes unacceptable—burden on top management. As the organizational capability for detailed product/market and business-unit planning spreads through the organization, the number of issues raised, alternatives surfaced, and opportunities developed expands alarmingly. Top managers soon recognize that explicit choices are being made by planners and managers deep down in the organization without top-level participation—and that these decisions could significantly affect their company's long-term competitive strength and well-being. This knowledge unsettles top management and pushes it to a heavier involvement in the planning process, Phase IV.

Phase IV: Strategic Management

Phase IV joins strategic planning and management in a single process. Only a few companies that we studied are clearly managed strategically, and all of them are multinational, diversified manufacturing corporations. The challenge of planning for the needs of hundreds of different and rapidly evolving businesses, serving thousands of product/markets in dozens of distinct national environments, has pushed them to generate sophisticated, uniquely effective planning techniques. However, it is not so much planning technique that sets these organizations apart, but rather the thoroughness with which management links strategic planning to operational decision making. This is largely accomplished by three mechanisms:

1. A planning framework that cuts across organizational boundaries and facilitates strategic decision making about customer groups and resources.

2. A planning process that stimulates entrepreneurial thinking.

3. A corporate value system that reinforces managers' commitment to the company's strategy.

Planning Framework

As noted previously, many Phase III companies rely on the SBU concept to provide a planning framework—often with disappointing results. However, there are frequently more levels at which strategically important decisions must be made than the two implicit in SBU theory. Moreover, today's organization structure may not be the ideal framework in which to plan for tomorrow's business, and a strategically managed company may arrange its planning process on as many as five distinct planning levels:

1. Product/market planning—The lowest level at which strategic planning takes place is the product/market unit, where typically product, price, sales, and service are planned, and competitors identified. Product/market planners often have no control over different sets of manufacturing facilities and so must accept a predetermined set of business economics.

2. Business-unit planning—The bulk of the planning effort in most diversified make-and-sell companies is done at a level where largely self-contained businesses control their own market position and cost structure. These individual business-unit plans become the building blocks of the corporate strategic plan.

3. Shared resource planning—To achieve economies of scale or to avoid the problem of sub-critical mass (e.g., in R&D facilities), resources are shared. In some cases, the assignment of resource priorities to different business units or the development of a plan to manage a corporate resource as a whole is strategically important. In resource-based or process-oriented industries, strategies for shared resource units often determine or constrain business-unit strategy.

4. Shared concern planning—In some large companies, a distinct level of planning responsibility is required to devise strategies that meet the unique needs of certain industry or geographic customer groups or to plan for technologies (e.g., microprocessors, fiber optics) used by a number of business units.

5. Corporate-level planning—Identifying worldwide technical and market trends not picked up by business-unit planners, setting corporate objectives, and marshaling the financial and human resources to meet those objectives are finally the responsibility of corporate headquarters.

For corporations involved in only a few, closely related product/markets, a two- or three-level planning framework may be entirely adequate. Even when additional planning levels are required, these companies need not insert another level of organizational hierarchy in order to plan shared resources or customer sector problems. Experience suggests, however, that it is important to recognize such issues where they exist and to assign explicit planning responsibility to an appropriate individual or group in the organization.

Otherwise, critical business decisions can slip between the cracks, and the corporation as a whole may find itself unable to capitalize on its strategic opportunities. Because the selection of a framework for planning will tend to influence the range of alternatives proposed, few strategic planning choices are more important. The definition of a strategic planning framework is, therefore, a pivotal responsibility of top management, supported by the corporate planning staff.

Planning Process

While planning as comprehensively and thoroughly as possible, Phase IV companies also try to keep their planning process flexible and creative.

A principal weakness of Phase II and III strategic planning processes is their inescapable entanglement in the formal corporate calendar. Strategic planning easily degenerates into a mind-numbing bureaucratic exercise, punctuated by ritualistic formal planning meetings that neither inform top management nor help business managers to get their jobs done. Division managers have been known to attempt to escape from the burden of "useless" annual planning by proposing that they fold their businesses into other SBUs, at least for planning purposes.

To avoid such problems, one European conglomerate has ordained that each of its SBUs initially study its business thoroughly, lay out a detailed strategy, and then replan as necessary. It has found that well-managed businesses in relatively stable industries can often exist quite comfortably with routine monitoring against strategic goals every quarter and an intensive strategic review every three to five years. The time saved from detailed annual planning sessions for every business is devoted to businesses in fast-changing environments or those not performing according to the corporate blueprint.

Because it is hard to institutionalize a process that can reliably produce creative plans, strategically managed companies challenge and stimulate their managers' thinking by:

- *Stressing competitiveness*—The requirement for thorough understanding of competitors' strategies recently has been the planning keynote of a U.S. electrical products company well known for its commitment to planning. Top management comes to the planning meetings prepared by its staff to bore in on a few key issues or events. "If, as you say, our competitors are only three years away from introducing microprocessors in their control units, why are they already talking about it in their annual reports?" the president might ask. "What cost savings could our customers achieve with microprocessor-controlled equipment?" or

"Who are our competitors' leading engineers?" It takes only one such grilling session to make division managers aware of gaps in their competitive information.

- *Focusing on a theme*—Several major companies periodically reinvigorate their planning processes by asking their managers to key annual plans to a specified theme. International business, new manufacturing process technology, the value of our products to customers, and alternative channels of distribution have all been used successfully. This approach has obvious limitations: it doesn't work with business units in trouble, and it should be avoided until the value of formal planning is well established.

- *Negotiating objectives*—Several companies are trying to negotiate strategically consistent objectives between corporate headquarters and business-unit general management. "We want two years and $35 million in additional investment to prove to you we can make this into a 35% gross margin business," said the new general manager of a division in trouble. "During that time we will make zero profit, but we'll strengthen our market share by three points and reduce material waste at our Atlanta plant from 10% to 3%. Alternatively, you can have $4 million per year at the bottom line next year and $6 million the year after that. No investment, and only minimal share loss. But be prepared to sell out the whole division, because after that it's all downhill." Faced with clear options, corporate management could suggest ideas and concessions that would promise them most of their share growth and some profitability for much less cash commitment up front.

- *Demanding strategic insights*—Avoiding competition by an indirect approach is the essence of creative and innovative strategy: a reformulation of a product's function, the development of new manufacturing methods or distribution channels, or the discovery of dimensions of competition to which traditional competitors are blind. One way to generate this kind of thinking is to ask each business manager to describe the specific business advantage he or she intends to achieve. Top management reviews each business plan skeptically. As one CEO tells division heads: "If you can't tell me something about your business I don't already know, you probably aren't going to surprise our competitors either." This technique relies heavily on the corporate planning staff, who are charged with demonstrating to uncreative business-unit planners that there are new ways of looking at old businesses.

Corporate Value System

The value system shared by the company's top and middle managers provides a third, less visible linkage between planning and action. Although the leadership styles and organizational climates of companies that can be called strategically managed vary considerably, and in even one company a great deal of diversity can be found, four common themes emerge from interviews with personnel at all levels in strategically managed companies:

1. The value of teamwork, which leads to task-oriented organizational flexibility.

2. Entrepreneurial drive, or the commitment to making things happen.

3. Open communication, rather than the preservation of confidentiality.

4. A shared belief that the enterprise can largely create its own future, rather than be buffeted into a predetermined corner by the winds of environmental change.

Teamwork on task force projects is the rule rather than the exception in strategically managed companies. Instead of fearing these uniquely dangerous expeditions beyond the security of the organizational thrust, managers learn to live with the ambiguity that teams create in return for the excitement and variety of new challenges.

The resulting continual reorganization can appear bizarre from outside the organization. For example:

- Observers trying to make sense of top management personnel changes in one highly successful telecommunications company were left scratching their heads, as first the chairman stepped down to become president and then he was further demoted to become CEO of a major subsidiary. Who was running the company, observers asked. Which individual was responsible for their brilliantly executed strategy? No one. The whole team at the top was so strong that no single manager deserved sole credit. The changes in title visible to the public were more an indication of the successful execution of phases of the company's strategy than they were signals of the rise or fall of a single individual's career.

Entrepreneurial drive among managers and technical personnel at all levels is a valued form of behavior in strategically managed companies. One organization's top management was eager to get in on the ground floor of a synthetic fuel equipment business. Six levels down from top management, an applications engineer in the specialty metals division was faced with a notice of a substantial cost overrun on an expensive piece of test equipment.

Instead of cancelling the order to source the equipment from a less costly supplier and thereby incur a six-month delay, the engineer went to the boss, and eventually to the boss's boss, to find out whether the delay to execution of the company's strategy was worth the cost savings. As a result, the engineer did overrun the project budget, but the test equipment was available when needed.

Confidentiality about the company's strategy is one of the hardest things for top management to give up. And yet it is impossible for a company to be strategically managed without the involvement of wide niches of relatively junior people in many aspects of the company's strategic plans. It is not necessary for top managers to divulge everything, but as a minimum, junior managers should know the strategic purposes their actions serve.

In retrospect, one chairman confided that he had overestimated the value of confidentiality. “We had a good idea for a strategy for our specialty business. But we couldn’t implement it without letting everyone in the company know about it. We took the chance; now I suspect everyone in the industry knows what we’re doing. But they can’t get their act together to overtake us. We’re moving too fast.”

A shared commitment to creating their own future is the underlying ethic of strategically managed companies. Instead of marginal improvements—a few more shares of market or a few percentage points of cost reduction—managers set for themselves ambitious goals that if accomplished will lead to a sustainable competitive advantage for their company. For example:

- A Japanese television manufacturer, faced with rising material and labor costs, ordered its engineers to reduce the number of component parts in its color TV sets by 30%. Innovative design approaches have since enabled the manufacturer to increase volume substantially while halving the number of workers in its assembly plant.

- A machine tool manufacturer has undertaken to change the way a whole industry buys its machinery. Into a sales environment where close personal relations on the plant floor and with the process engineers was formerly the key to success, it is systematically injecting a top-management-oriented, technically and financially argued sales approach.

At the same time, it is radically upgrading its research and development capabilities, adding computer-aided engineering, software development, and systems engineering support. “Very little of our product advantage has patent protection,” concedes the CEO. “But if we can persuade the industry to buy on productivity rather than on cost and delivery, the premium we can charge for engineering value will fund enough research to keep us three to four years ahead." Using this approach the manufacturer has already built one of the five largest machine tool companies in the world.

As the economic system becomes more complex and the integration of single business units into multinational, diverse organizations continues, ways must be found to restore the entrepreneurial vigor of a simpler, more individually oriented company structure. Strategic management, linking the rigor of formal planning to vigorous operational execution, may prove to be the answer.

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