Unit 13 Strategy Formulation and Strategic Choice

Strategy formulation is the process of choosing the best possible strategy out of several other strategic options.

"Strategy formulation is designed to guide executives in defining the business their company is in, the aims it seeks, and the means it will use to accomplish these aim….. Strategy formation combines a future-oriented perspective with concern for a firm's internal and external environment in developing its competitive plan of the action." (Pearce and Robinson)

Process of Strategy formulation

Following steps are involved in strategy formulation process:

a. **Evaluate current performance result:** In the process of strategy formulation it is essential to evaluate the concerned firm's current performance in terms of profit and loss situation and return on investment. It is also required to appraise the current mission, objectives, strategies and policies adopted by the firm.
b. **Review corporate governance:** This includes appraisal of performance of the BODs, CEOs and other top level managers. It is also essential to examine the organizational vision, mission, objectives culture and management practices as successful drives for governing the corporation.
c. **Scan and assesses the internal corporate environment:** It is also essential to assesses organizational competencies, skills, abilities and resources in order to cope with external changes. These are the determining factors to enhance organizational strength and minimize weaknesses and to fit a firm with the external challenges and opportunities.
d. **Scan and assesses the external environment:** This is related with the examination of external factors that are posing threats as well as opportunities. The firm's market shares and growth depend largely on external opportunities and threats.
e. **Analyze strategic factors:** Strategic factors are external and internal elements determining the future of a firm. At this stage of strategy formulation process, it is essential to pin point the problematic areas and issues relating to getting competitive advantages. Problems and issues are analyzed in the SWOT form. The SWOT variables are important for the effective implementation of the strategy.
f. **Generate, evaluate, and select the basic strategic options:** This is relative to the identification of the strategic options upon which a new strategy may

be build. At this stage, one or more of the strategic option is selected for implementation.

Evaluation of Strategic Alternatives

The criteria used for evaluation of strategic alternatives are:

1. **Suitability-**: It is concerned with environmental fit of the strategic alternative. It also provides the rationale to a strategy. It indicate whether the strategic alternative make sense in relation to environmental circumstances. It is also a basic of qualitative assessment concerned with testing out the rational of strategy and is useful for screening options. The assessment of suitability consists of two stages.
    - Establishing the rational: Various tools and techniques are used to establish the rational which describes the ideas whether they are good or not some of these tools are lifecycle portfolio matrix, positioning, value chain analysis and portfolio analysis.
    - Screening Options: Suitability of a specific strategic option is relative to other available options. The methods used for understanding suitability are ranking, decision tree and scenarios.
2. **Acceptability-:** It is concerned with the expected performance outcomes of a strategic alternative. It is strongly related to people expectations and therefore the issues of require careful analysis. The criteria for acceptability of strategic alternative are
    i. **Return-:** Expected return from specific strategic options is assessed. The various approaches to analyze return are
    - Profitability analysis: It assesses financial return to investment. The tools used for this analysis are return on capital employed, payback period, and discounted cash flow.
    - Cost benefit analysis: It assesses the overall economic impact of strategic options. This analysis attempts to put a money value of all the costs and benefits of strategic options.
    - Shareholder value analysis: It assesses the impact of strategic options in generating shareholders value. The shareholder value is the total shareholder return.

    ii. **Risks;** It involves probably estimate about robustness of strategic options. The level of risk is important for acceptability of strategic options. New product development carries high level of risks. The approaches for analyzing risks are.
        - Financial ratio projection,
        - Sensitivity analysis
        - Simulation modeling

- Decision matrices:

iii. **Stakeholder expectation:** It provides political dimensions to the organizations acceptability of a strategic alternative. The approaches of stakeholder are
  - Stakeholder mapping
  - Game theory.

3. **Feasibility:** It is concerned with availability of resources and competencies to deliver strategic alternatives. It determines an option implement ability and work ability in practice. It assesses the organizations capability to make the strategic alternatives succeed. The approaches for available to understand feasibility are

i. Funds flow analysis: It assesses financial feasibility. It forecasts the funds required and the likely resources of funds for strategic alternatives.

ii. Break even analysis: It studies costs volume profit relationships to assess financial feasibility. This analysis identifies BEP when revenue equal costs.

iii. Resource deployment analysis-2: It identifies need for resources and competencies for specific strategic alternatives. It is used to judge
  - Sufficiency of current resources and competencies to pursue strategic options.
  - Need for unique resources and competencies to sustain strategic advantages.

Portfolio Analysis

Portfolio is defined as the range of investment held by the organization.

Portfolio analysis is a systematic way to analyze the products and services that make up an organization’s business portfolio.

In other words, portfolio analysis is a method of categorizing a firm’s products according to their relative competitive position and business growth rate in order to lay the foundation for sound strategic planning.

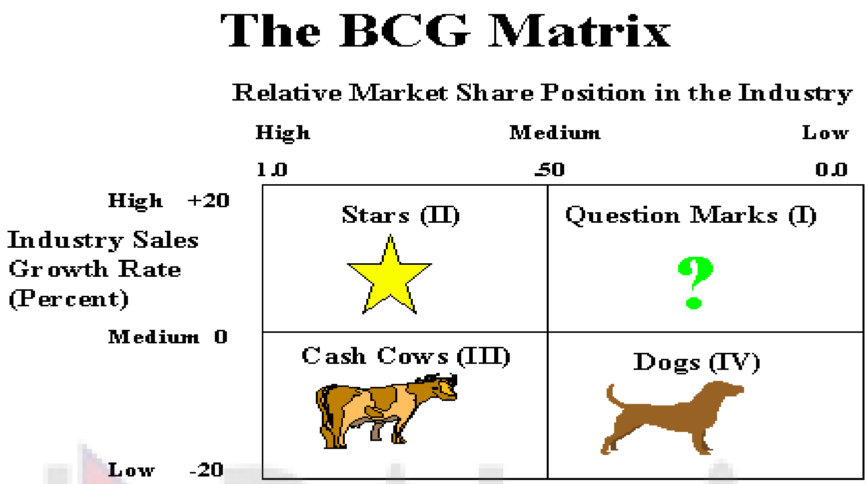
Portfolio analysis method is a technique of strategy examination at the corporate level.

Following are the techniques for portfolio analysis:

1. Boston Consulting Group(BCG) Matrix
2. General Electric Matrix (GE nine cell matrix)

3. Hofer's Matrix (Product life cycle)

a. **Boston Consulting Group (BCG) Matrix:** It is developed by Boston Consulting Group. It uses relationship between market share and market growth to balance the portfolio.



Market growth rate: The projected rate of sales growth for the market being served by a particular business.

Relative competitive strength: The market share of a business divided by the market share of its largest competitors**.**

BCG matrix is divided into four cells which give the information of relative competitive position of business (SBUs) for comparing the relative strength of businesses in the firm's portfolio in terms of position in respective market.

- **Stars (High growth-High market share):** Stars are businesses in rapidly growing markets with large market shares. These businesses represent the best long-run opportunities (growth and profitability) in the firm's portfolio. They acquire substantial investment to maintain (and expand) their dominant position in a growing market.
- **Cash cows (Low growth-High market share):** They are businesses with a high market share in low growth markets or industries. Because of their strong competitive positions and their minimal reinvestment requirements, these businesses often generate cash in excess of their needs.
- **Dogs (Low growth-Low market share):** Low market share and low market growth businesses are the dogs in the firm's portfolio. Facing mature markets with intense competition and low profit margins, they are

managed for short-term cash flows (e.g. through ruthless cost cutting) to supplement corporate level resource need.

- **Question Marks:** They are businesses whose high growth rate gives them considerable appeal but whose low market share makes their profit potential uncertain. They are cash guzzlers (consume excessively) because their rapid growth results in high cash needs, while their small market share results in low cash generation.

Strategic option for making portfolio

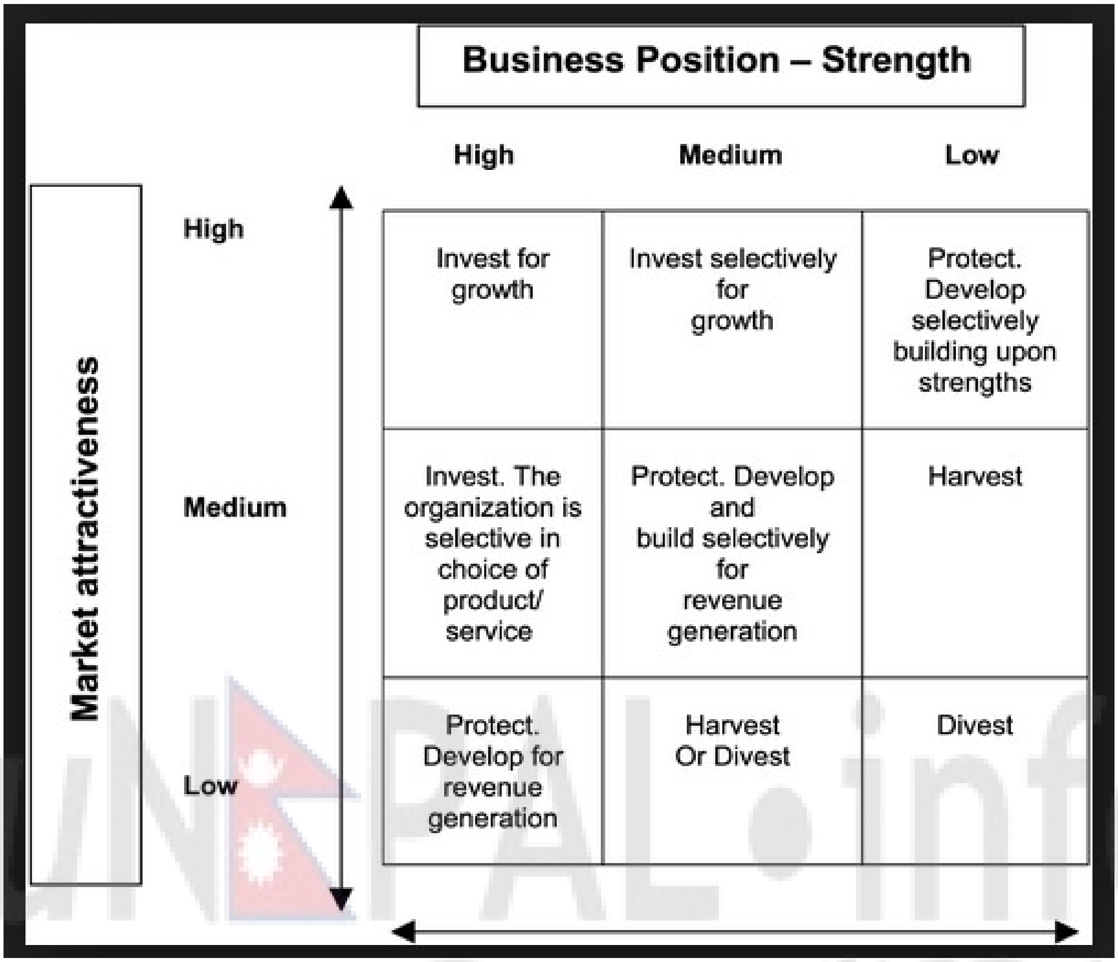
- **Build**: Allocate more resources to Star and Question Marks to gain and sustain market share.
- **Hold**: Allocate present level resources to Cash Cows to defend market share
- **Harvest**: Allocate less resource to weak cash-cows. Eventually withdraw them from the market.
- **Divest**: Do not allocate resources to Dogs. Liquidate them.

Limitation of BCG Matrix:

The BCG Matrix produces a framework for allocating resources among different business units and makes it possible to compare many business units at a glance. But BCG Matrix is not free from limitations, such as-

- BCG matrix classifies businesses as low and high, but generally businesses can be medium also. Thus, the true nature of business may not be reflected.
- Market is not clearly defined in this model.
- High market share does not always leads to high profits. There are high costs also involved with high market share.
- Growth rate and relative market share are not the only indicators of profitability. This model ignores and overlooks other indicators of profitability.
- At times, dogs may help other businesses in gaining competitive advantage. They can earn even more than cash cows sometimes.
- This four-celled approach is considered as to be too simplistic.

b. **General Electric (GE) Nine Cell Matrix:** Developed by McKinsey &Company at General Electric, the GE matrix shows a 9-cell business screen useful to make a strategic choice on the basis of industry attractiveness and competitiveness.



- **Industry Attractiveness (Long-term market attractiveness):** It refers to the subjective assessment based on the broadest possible range of external opportunities and threats beyond the strict control of management. The high/medium/low portfolio shows how attractive the industry is to invest or divest or in between that depends on the log-term attractiveness.
- **Competitive or business position:** It refers to the subjective assessment of how strong a competitive advantage created by a broad range of the firm's internal strengths and weakness is. Strong/Average/Weak determine the competitiveness or business position of a firm.
  i. Business in high priority cells is suggested to **invest more.**
  ii. Business in medium priority cells is suggested to **invest selectively.**
  iii. Business in low priority cells is suggested to **divest and close down**.

Advantages of GE Nine Cell Matrix:

i.It used 9 cells instead of 4 cells of BCG

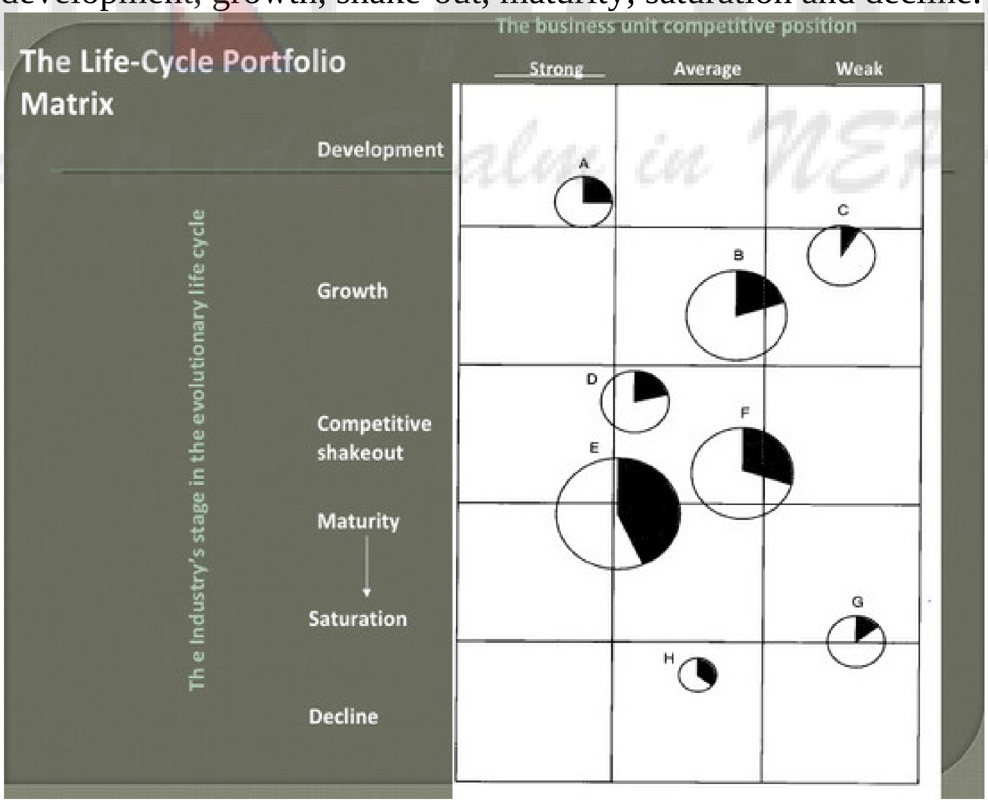
ii. It considers many variables and does not lead to simplistic conclusions

iii. High/medium/low and strong/average/low classification enables a finer distinction among business portfolio
iv. It uses multiple factors to assess industry attractiveness and business strength, which allow users to select criteria appropriate to their situation

Limitation of GE matrix:

i. It can get quite complicated and cumbersome with the increase in businesses
ii. Though industry attractiveness and business strength appear to be objective, they are in reality subjective judgments that may vary from one person to another
iii. It cannot effectively depict the position of new business units in developing industry
iv. It only provides broad strategic prescriptions rather than specifics of business policy.

c. **Hofer's Product-Market Evolution Matrix:** Developed by Hofer, a 15-cell matrix is used to study interactions between the competitive position and stages of product/market evolution. The circle in the figure represents the size of the industry. The competitive positions are described in terms of strong, average and weak and stages of product/market evolution are explained in terms of development, growth, shake-out, maturity, saturation and decline.



- Strategic business unit”A” seems to be a potential”Star”. It holds a large market share; it is in the stage of life cycle development and has a strong competitive position on the market. As such, unit”A” represents a potential candidate in the competition for corporate resource competition.
- Unit”B” is very similar to unit”A”. Nevertheless, investments in unit”B” must take into account the fact that although it has a strong market position, its market share is quite small. Consequently, the cause for which market share has such a small value must be identified. Furthermore, a strategy that may contribute to the increase of market share must be developed, thus accounting for the future necessary investment.
- Unit”C” has a small market share, its salient feature resides in the fact that it holds a competitively weak position and it entered a small market whose development is underway. A strategy that may increase the market share and develop the competitive position must be elaborated so that the future investments are accounted for. For the unit”C” a strategy residing in the elimination from the market must be applied, so that the investment for the first two units may be favourised.
- Unit”D” is characterized by a strong competitive position on the market and it holds a large market share. In this case, it is recommended that investments be made with a view to maintaining the current position on the market. On the long run, it will become a “Cash Cow”. Unit”E” together with unit”F” are included into the “Cash Cow” category and they should be capitalized on because of great cash flows that they generate.
- Unit”G” is included into the “Dogs” category and the management thereof is recommended, with a view to generating short-term cash flows in as much as it is possible. Nevertheless, on the long term the strategy of limitation or liquidation on the market must be selected.

Advantages of Hofer matrix:

i. Used to identify developing winners.

ii. Illustrates how businesses are distributed across the stages of industry evolution. This helps to predict how the portfolio will develop in the future.

iii. Market life-cycle represents one of the main factors that contribute to the adoption of strategic decisions at the level of the SBU.

Limitation of Hofer matrix:

- This model does not focus on all the relevant factors that influence the level of attractiveness on the market.
- Product life cycle is not same to all types of products.