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STRATEGIC MANAGEMENT IN THE DIGITAL ECONOMY

Strategic Options



SWOT Analysis

- It provides a summary of the key issues arising from an analysis of resources and capabilities and the analysis of the business environment to gain an overall picture of an organization's strategic position
 - Internal analysis: **Strengths and Weaknesses**
 - External analysis: **Opportunities and Threats**
- This analysis can also be useful as a basis for generating strategic options and assessing future courses of action



SWOT Analysis

A scoring mechanism (plus 5 to minus 5) is used as a means of getting managers to assess the interrelationship between the environmental impacts and the strengths and weaknesses of the firm

- A **positive (+)** score denotes that **the strength of the company would help it take advantage of, or counteract, a problem arising from an environmental change** or that **a weakness would be offset** by that change
- A **negative (-)** score denotes that **the strength would be reduced or that a weakness would prevent the organization from overcoming problems** associated with that change

Example: A company in the pharma industry

	Environmental change (opportunities and threats)					
	Healthcare rationing	Complex and changing buying structures	Increased integration of healthcare	Informed patients	+	–
<i>Strengths</i>						
Flexible sales force	+3	+5	+2	+2	+12	0
Economies of scale	0	0	+3	+3	+6	0
Strong brand name	+1	+3	0	–1	+4	–1
Healthcare education department	+3	+3	+4	+5	+15	0
<i>Weaknesses</i>						
Limited capabilities in biotechnology and genetics	–1	0	–4	–3	0	–8
Ever lower R&D productivity	–3	–2	–1	–2	0	–8
Weak ICT capabilities	–3	–2	–5	–5	0	–15
Over-reliance on leading product	–2	–1	–3	–1	0	–7
Environmental impact scores	+7	+11	+9	+10		
	–9	–5	–13	–12		

- If this analysis is to be useful, it must be remembered that the exercise is not absolute but **relative to its competitors**.
- SWOT analysis is most **useful when it is comparative** – if it examines strengths, weaknesses, opportunities and threats in relation to competitors.



Example: A company in the pharma industry and its competitors

	Environmental change (opportunities and threats)				
	Healthcare rationing	Complex and changing buying structures	Increased integration of healthcare	Informed and passionate patients	Overall impact
Pharmcare Big global player suffering fall in share price, low research productivity and post-mega-merger bureaucracy	-2 Struggling to prove cost-effectiveness of new drugs to new regulators of healthcare rationing	+6 Well-known brand, a flexible sales force combined with a new healthcare education department creates positive synergy	-4 Weak ICT and lack of integration following mergers means sales, research and admin are all under performing	-2 Have yet to get into the groove of patient power fuelled by the internet	-2 Declining performance over time worsened after merger
Company W Big pharma with patchy response to change, losing ground in new areas of competition	-4 Focus is on old-style promotional selling rather than helping doctors control costs through drugs	-4 Traditional sales force not helped by marketing which can be unaccommodating of national differences	+0 Alliances with equipment manufacturers but little work done across alliance to show dual use of drugs and new surgical techniques	+4 New recruits in the ICT department have worked cross-functionally to involve patients like never before	-4 Needs to modernise across the whole company

Johnson et al. (2008)

There are two main **dangers in a SWOT** exercise:

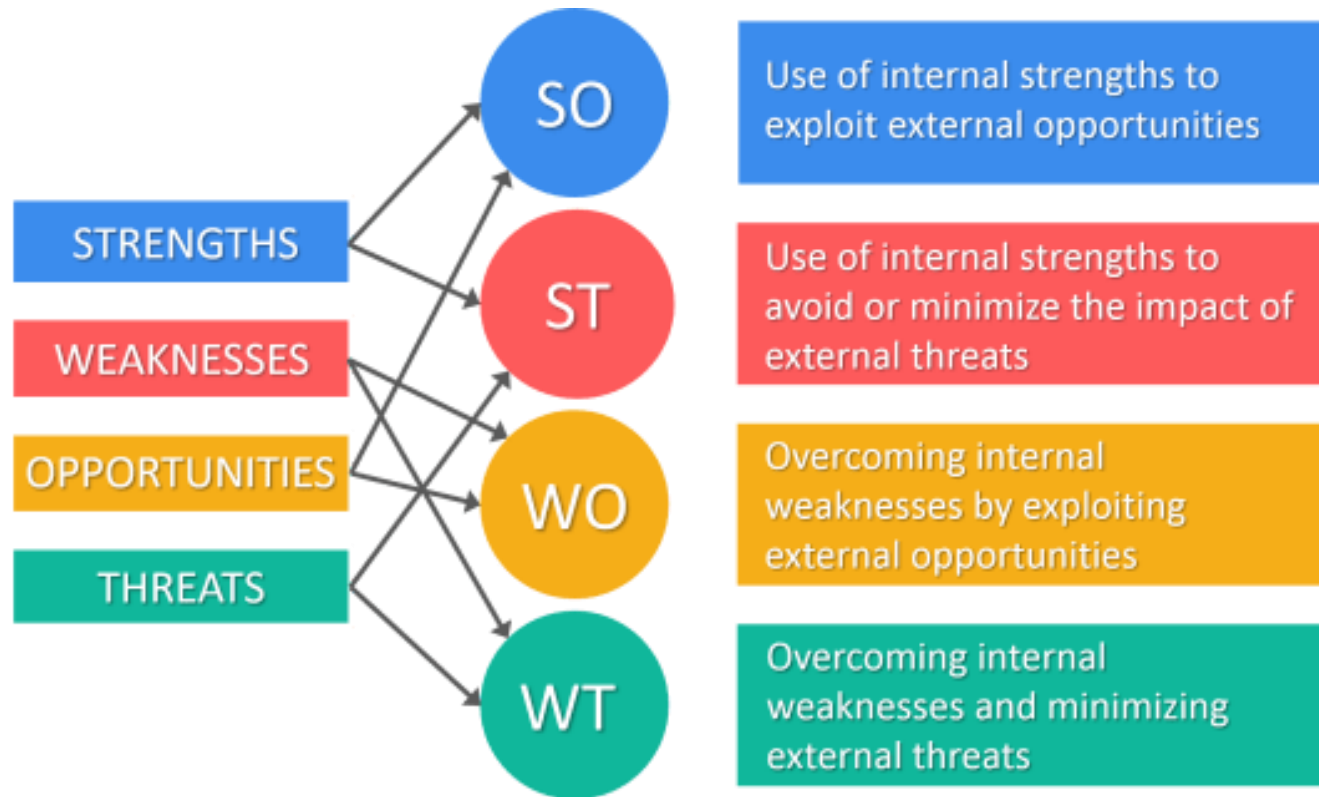
- *Listing.* A SWOT exercise can generate very long lists of apparent strengths, weaknesses, opportunities and threats, whereas **what matters is to be clear about what is really important and what is less important**. So prioritization of issues matters. Three brief rules can be helpful here:
 1. Focus on strengths and weaknesses that **differ in *relative* terms** compared to competitors or comparable organizations and leave out areas where the organization is at par with others.
 2. Focus on opportunities and threats that are **directly *relevant* for the specific organization and industry** and leave out general and broad factors
 3. Summarize the *result* and **draw concrete conclusions**.
- *A summary, not a substitute.* SWOT analysis is an engaging and fairly simple tool. It is also useful in summarizing and **consolidating other analyses**. It is not, however, a substitute for those analyses.

TOWS Framework



SWOT Analysis

This analysis can be used as a basis for generating strategic options and assessing future courses of action



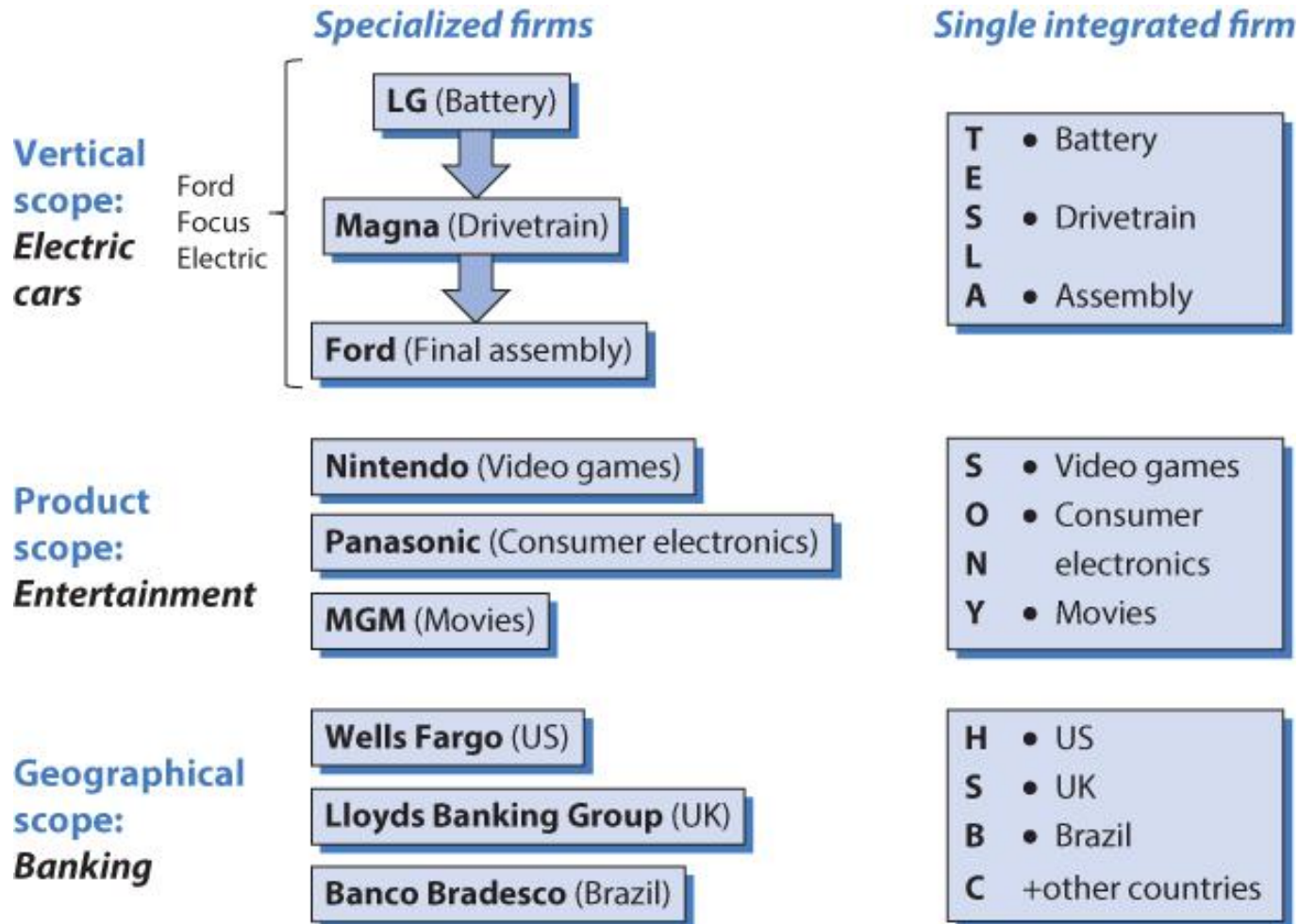
Strategic options using information from SWOT analysis

- SWOT can also help focus discussion on **future choices** and the extent to which an organization is capable of supporting these strategies.
- A useful way of doing this is to use a **TOWS matrix**, to identify options that address a different combination of the internal factors (strengths and weaknesses) and the external factors (opportunities and threats)

		Internal factors	
		Strengths (S)	Weaknesses (W)
External factors	Opportunities (O)	SO Strategic options Generate options here that use strengths to take advantage of opportunities	WO Strategic options Generate options here that take advantage of opportunities by overcoming weaknesses
	Threats (T)	ST Strategic options Generate options here that use strengths to avoid threats	WT Strategic options Generate options here that minimise weaknesses and avoid threats

Johnson et al. (2008)

The Scope of the firm: Specialization versus integration



VERTICAL INTEGRATION



- Is it better to be **vertically integrated** or **vertically specialized**?
- With regard to a specific activity, this translates in: *to make or to buy*?

Vertical integration is a firm's ownership and control of multiple vertical stages in the supply of a product

- The extent of a firm's vertical integration is indicated by the **number of stages of the industry's value chain that it spans**, and can be measured by the ratio of its value added to sales revenue.
- Vertical integration can be either **backward** (upstream) into its suppliers' activities or **forward** (downstream) into its customers' activities.

Benefits from vertical integration

- **Technical economies** from the physical integration of processes: cost savings that arise from physically integrating adjacent processes
- Avoiding **transaction costs** in vertical exchanges:
 - in the vertical stages with **predominance of market contracts**, there are **low transaction costs** (there are many buyers and sellers, information is readily available, switching costs for buyers and sellers are low)
 - In the vertical stages **where two actors need to make investments in integrated facilities**, a competitive market is impossible, as the market becomes a set of bilateral monopolies → each supplier must negotiate with a single buyer, and it will depend on the relative bargaining power with subsequent **high transaction costs**.
 - These **transaction-specific investments encourage vertical integration**.
- **Coordination benefits**: Tesla's cars are innovative designs that require specially designed components. In-house production limits the need for continuous coordination with suppliers.

Costs of vertical integration

- **Differences in optimal scale between different stages of production:** UPS would have no efficiency or advantage in manufacturing its own vans
- **Need to develop distinctive capabilities:** by specializing in a few activities, a firm can develop distinctive capabilities in those activities. Think of large tech-based companies like Boeing, Intel, Philips that outsource their IT requirements to specialists such as IBM or Accenture (who learn from working with multiple clients):
 - **outsourcing works best** when the capabilities in different vertical activities are independent of our another and are generic rather than customized.
- **Incentive problems:** with vertical integration, **internal supplier-customer relationships are subject to low-powered incentives** (motivation of the buyer to secure the best deal and motivation of the seller to pursue efficiency and service).

Costs of vertical integration

- **Competitive effects:** vertical integration allows a monopolist to extend its monopoly position at one stage on an industry's value chain to an adjacent stage. However, rather than strengthening a firm's competitive position, vertical integration risks damaging it, as the firm becomes a competitor of its customers or suppliers
- **Flexibility:** Vertical integration may be disadvantageous in responding quickly to new product development opportunities that require new combinations of technical capabilities.
 - Extensive outsourcing is a feature of fast-cycle product development (e.g., Amazon's Kindle or Apple's iPhone).
 - Exception: where system-wide flexibility is needed, vertical integration may facilitate speedy, coordinated adjustments.
- **Investing in an unattractive business:** where backward or forward vertical stages are low-margin industries
- **Compounding risk:** vertically integrating the business have inherent risks

Designing vertical relationships

- **Long-term contracts:** instead of spot transactions that work well under competitive conditions (many buyers and sellers and a standard product), long-term contracts may be appropriate where closer supplier-customer ties are needed.
- **Vertical partnerships:** based on trust and mutual understanding, such relationships can provide security to support transaction-specific investments, flexibility to meet changing circumstances, incentives to avoid opportunism.
- **Franchising:** Agreement where franchisee produces and markets the franchisers' product or service in a specified area. This approach allows to match the brand, marketing capabilities and business system of the large corporation, with the entrepreneurship and local knowledge of small firms.

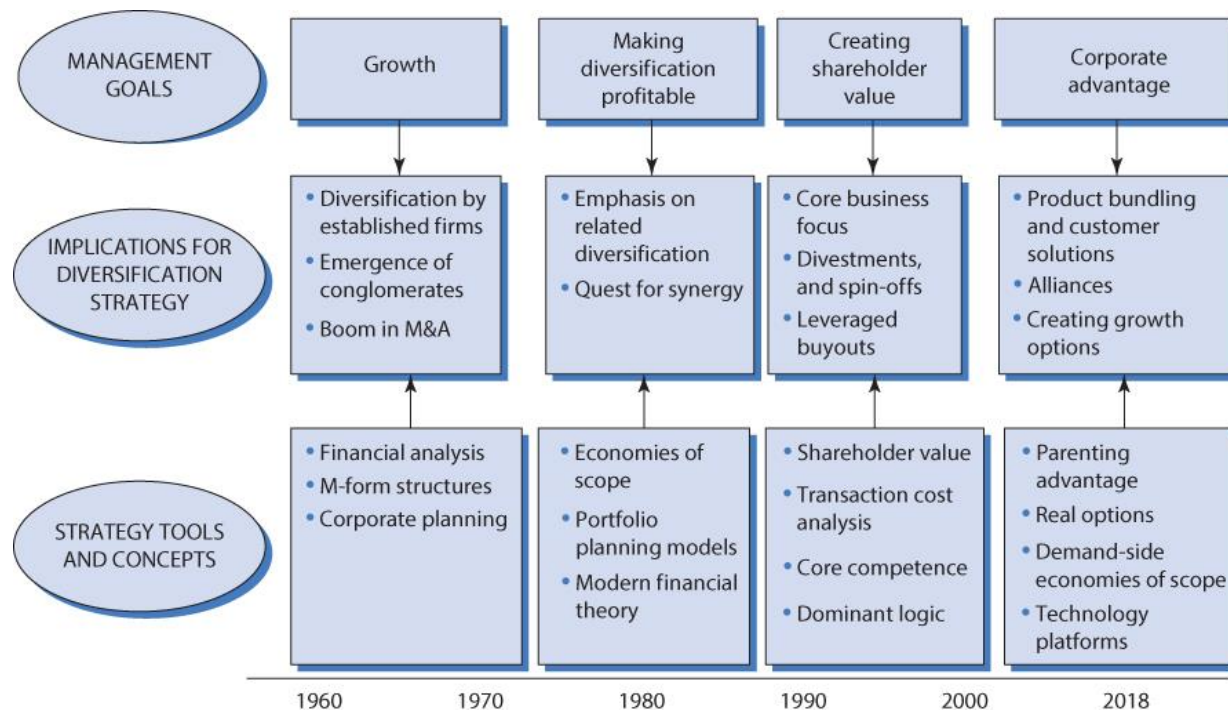
DIVERSIFICATION



- Firms' choice over their product scope change over time.
- **Diversification** represents a conundrum: it liberates firms from the constraints of a single industry, yet it has caused more value destruction than almost any other type of strategic initiative
- Diversification decisions by firms involve two issues:
 1. How attractive is the industry to be entered?
 2. Can the firm establish a competitive advantage?

Motives for diversification

- **Growth**: diversification typically generates revenue growth, especially when it is achieved through acquisition, but with the **uncertainty for profitability**
- **Risk reduction**: argument of risk spreading, though empirical evidence shows the **absence of shareholder benefit** from diversification



Porter's Essential Tests

- **Attractiveness and cost-of-entry test:** industry attractiveness alone is not sufficient to justify diversification. The **cost of entry may counteract the attractiveness** of the industry.
- **Better-off test:** if two different businesses are brought together under the ownership and control of a single enterprise, is there any reason why either should become any more profitable? The issue is one of **synergy**

Porter's Three Tests



What are these synergies between different businesses and how are they exploited?

- **Economies of scope**, which exist when using a **resource** across multiple activities uses less of that resources than when the activities are carried out independently.
- **Economies from internalizing transactions**: they exist when the firm has the other **resources and capabilities required for successful diversification**. For example: Starbucks' licensing agreement with Nestlé to supply Starbucks' packaged coffee acknowledges the Starbucks' lack of resources and capabilities for global distribution to the grocery trade.
- **Parenting advantage**: parenting value comes from applying the **management capabilities** of the parent company to a business, emphasizing the value-adding role of the corporate center.
- **Diversified firm as an internal market**, where different businesses compete for investment funds.

Related or unrelated diversification?

Corporate management function	Determinants of strategic similarity
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for senior business unit executives
Strategy formulation	Similar key success factors Similar stages of the industry life cycle Similar competitive positions occupied by each business within its industry
Targeting, monitoring and control of business unit performance	Goals defined in terms of similar performance variables Similar time horizons for performance targets

Grant, R. M. (1988). On 'dominant logic', relatedness and the link between diversity and performance. *Strategic Management Journal*, 9(6), 639-642.

- Considering the company you have analyzed, **prepare a SWOT analysis and provide strategic options (using TOWS framework)**
- You can download a template at this [LINK](#). Fill it in and upload a PDF (one per team, including all names of people involved)



ASSESSMENT OF STRATEGIC OPTIONS



The SAFe evaluation criteria of suitability, acceptability and feasibility are useful to evaluate possible new strategic initiatives



- **Suitability is concerned with assessing which proposed strategies address the *key opportunities and threats* an organisation faces** through an understanding of the strategic position of an organisation
- It is therefore concerned with the **overall *rationale*** of a strategy
- A suitability analysis involves assessing the extent to which a proposed strategy:
 - exploits the *opportunities* in the environment and avoids the *threats*;
 - capitalises on the organisation's *strengths* and avoids or remedies the *weaknesses*.

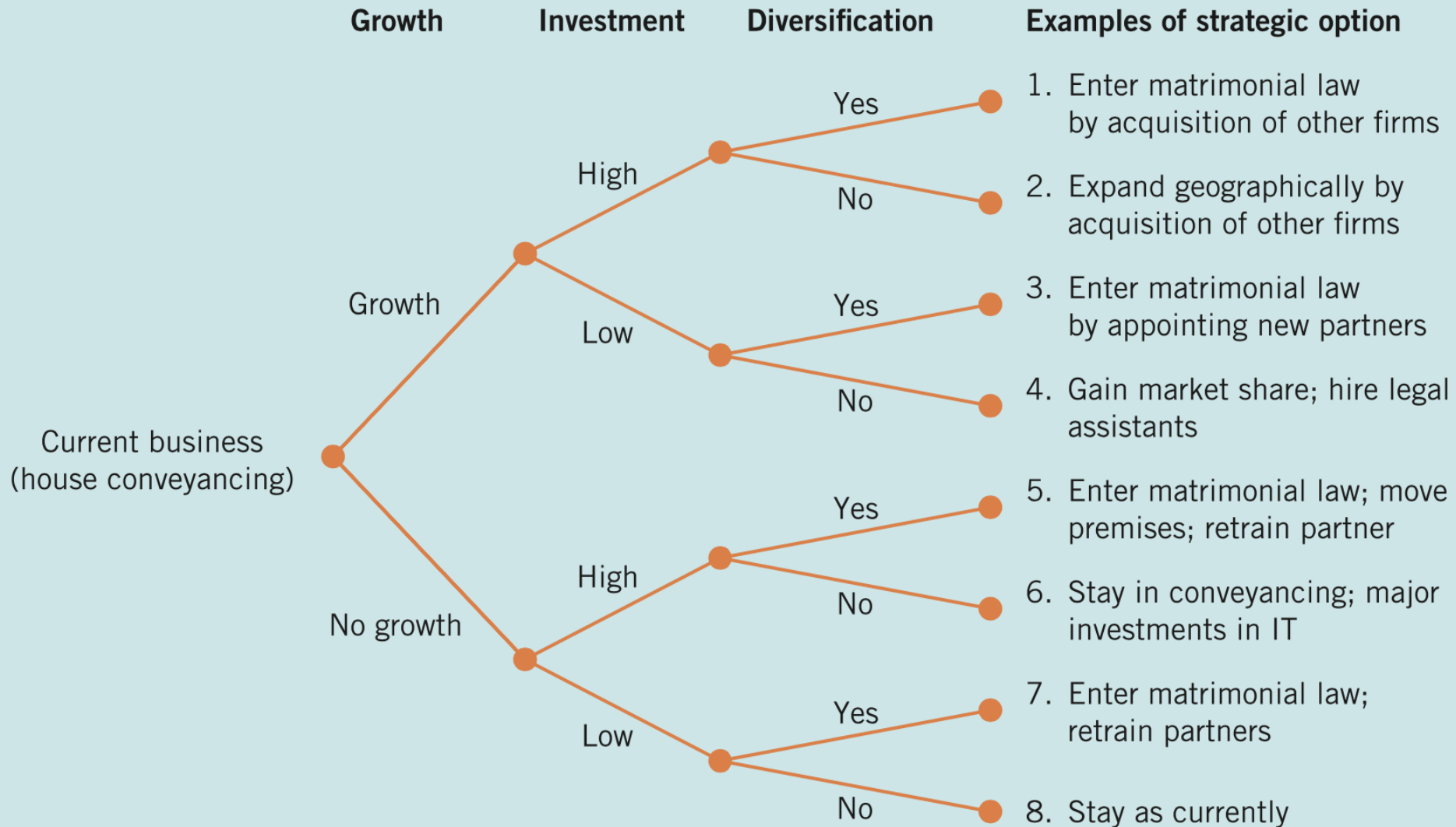
Strategic option	Why this option might be suitable in terms of:	
	Macro, industry and sector environments	Resources and capabilities
Directions		
Retrenchment	Withdraw from declining markets Maintain market share	Identify and focus on established strengths
Market penetration	Gain market share for advantage	Exploit superior resources and capabilities
New products and services	Exploit knowledge of customer needs	Exploit R&D
Market development	Current markets saturated New opportunities for: geographical spread, entering new segments or new uses	Exploit current products and capabilities
Diversification	Current markets saturated or declining; new opportunities for expansion beyond core businesses	Exploit strategic capabilities in new arenas

Johnson et al. (2008)

There are, however, also a number of **screening techniques** that can be used to assess the suitability of proposed strategies by reviewing their relative merits against key opportunities and constraints

- **Ranking:** possible strategies are assessed against key factors relating to the strategic position of the organization and a score (or ranking) established for each option
- **Screening through scenarios:** useful where a high degree of uncertainty exists. Suitable options are ones that make sense in terms of the various scenarios. As a result of such analysis it may be that several strategic options need to be 'kept open', perhaps in the form of contingency plans
- **Screening for bases of competitive advantage:** whether it is likely to draw on the organization's bases of competitive advantage, e.g. VRIO
- **Decision trees:** options are 'eliminated' and preferred options emerge by progressively introducing requirements that must be met (such as growth, investment or diversity)

Decision trees: example for a law firm



Johnson et al. (2008)

- **Acceptability** is concerned with **whether the expected performance outcomes of a proposed strategy meet the expectations of stakeholders.**
- These can be of three types, the '3 Rs':
 1. Risk
 2. Return
 3. Stakeholder Reactions

1. **Risk concerns the extent to which strategic outcomes are unpredictable, especially with regard to possible negative outcomes.**
 - Chosen strategies should be within the limits of **acceptable risk** for the organization
 - Developing a good understanding of an organization's **strategic position** is at the core of good risk assessment. However, the following tools can also be helpful in a risk assessment
 - **Sensitivity analysis**: *what-if* analysis that allows each of the important assumptions underlying a particular strategy to be questioned and challenged
 - **Financial risk** refers to the possibility that the organization may not be able to meet the key financial obligations necessary for survival
 - **Break-even analysis** is a simple and widely used approach which allows variations in assumptions about key variables in a strategy to be examined. It demonstrates at what point in terms of revenue the business will recover its fixed and variable costs

2. Return is a measure of the financial effectiveness of a strategy. In the private sector, investors and shareholders expect a financial return on their investment

- An assessment of the **financial effectiveness of any specific strategy** should be a key criterion of acceptability
- Techniques:
 - Financial analysis: ROCE, payback period, discounted cash flow
 - Shareholder value analysis
 - Cost-benefit analysis

3. Reactions of stakeholders

- There are many situations where stakeholder reactions could be crucial
 - *Owners'* financial expectations have to be taken into account
 - *Bankers* and other providers of interest-bearing loans are concerned about the *risk* attached to their loans
 - *Regulators*
 - *Employees*
 - *Customers*

- **Feasibility is concerned with whether a strategy could work in practice**
- An assessment of feasibility is likely to involve two key questions:
 - Do the resources and capabilities currently exist to implement a strategy effectively?
 - And if not, can they be obtained?
- Financial feasibility:

Life cycle phase	Funding requirement	Cost of capital	Business risk	Likely funding source(s)	Dividends
Start-up	High	High	High	Personal debt; Equity (angel and venture capital)	Zero
Growth	High	Medium	High	Debentures and equity (growth investors)	Nominal
Maturity	Low/medium	Low/medium	Low/medium	Debt, equity and retained earnings	High
Exit/Decline	Low/negative	Medium/high	Medium	Debt, retained earnings	High

- People and skills
- Integrating resources

Option	Suitability criteria	Acceptability criteria	Feasibility criteria	Comment
A				
B				
C				
D				
E				

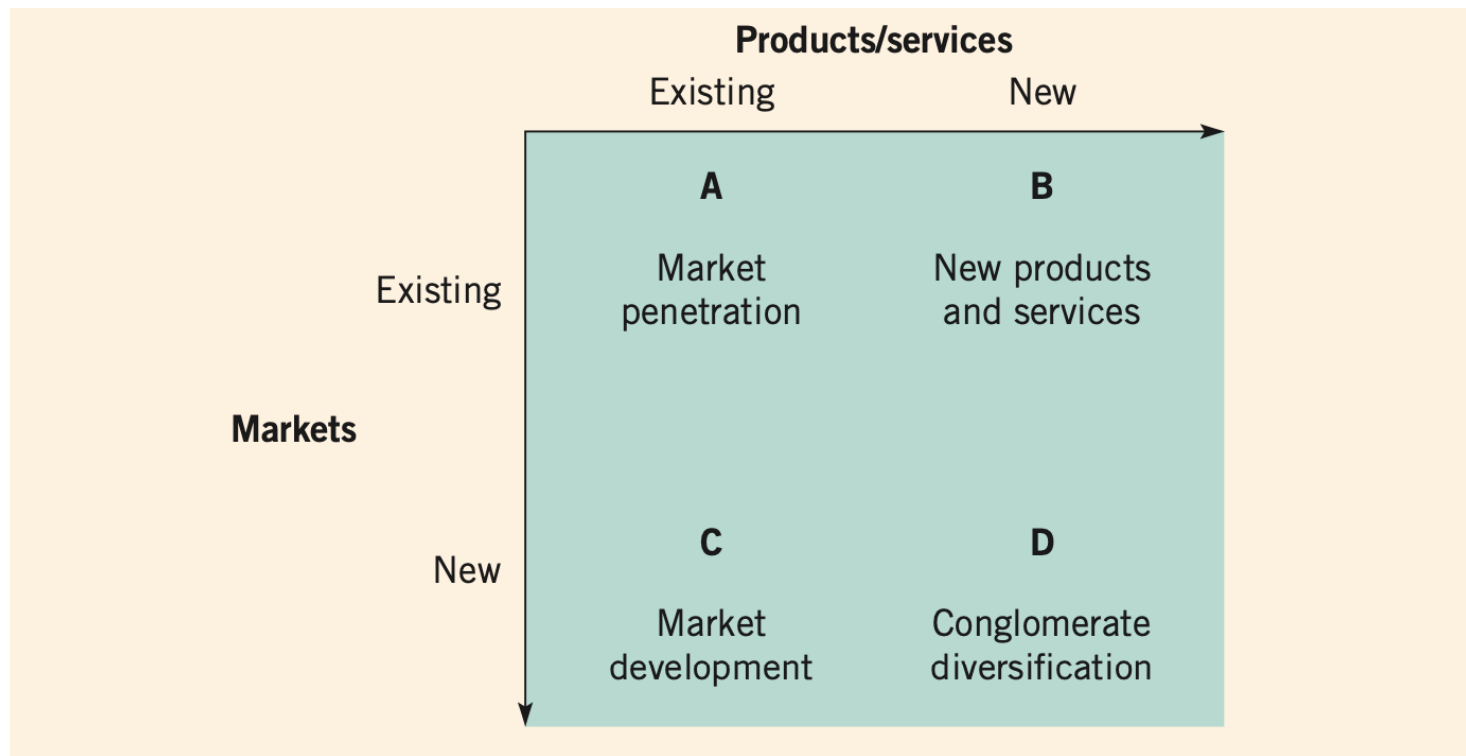
- Considering the analysis you have done, **complete an assessment of the strategic options you have considered above**
- You can use the other template at the same [LINK](#). Fill it in and upload a PDF (one per team, including all names of people involved)



OTHER EVALUATION TOOLS



- The Ansoff matrix is used to categorize generic product and market **growth options** available to the organization
- In practice there is often **gradual movement from one area into another**
- Although presented as a corporate level choice, in practice this involves choices and has implications at both **corporate and business unit level**



Ansoff (1988)

The **BCG** matrix uses market share and market growth criteria for determining the attractiveness and balance of a business portfolio

