

# Critical Thinking & Problem Solving

*Dr. Bektash Berdiev*

How to perform strategic analysis and  
assessment

# Domain of Strategy

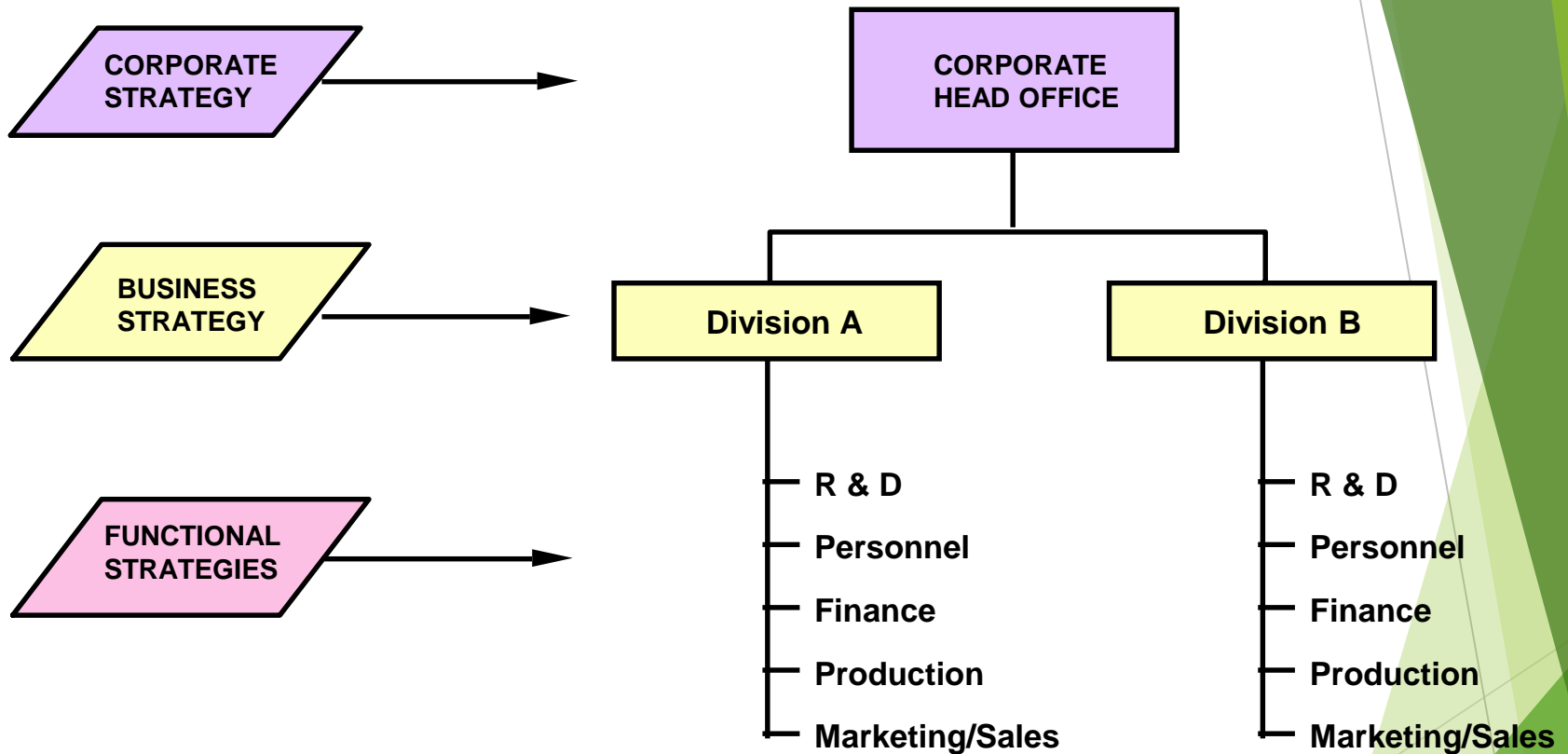
- ▶ strategic competitiveness and above normal returns
- ▶ concerns managerial decisions and actions which materially affect the *success and survival* of business enterprises
- ▶ involves the *judgment* necessary to strategically position a business and its resources so as to maximize long-term profits in the face of *irreducible uncertainty and aggressive competition*
- ▶ strategy is the linkage between a business and its *current and future* environment

# Definition

- ▶ The determination of the **long run goals and objectives** of an enterprise, the **adoption of courses of action** and the **allocation of resources** necessary for carrying out these goals

*Alfred Chandler, Strategy and Structure*

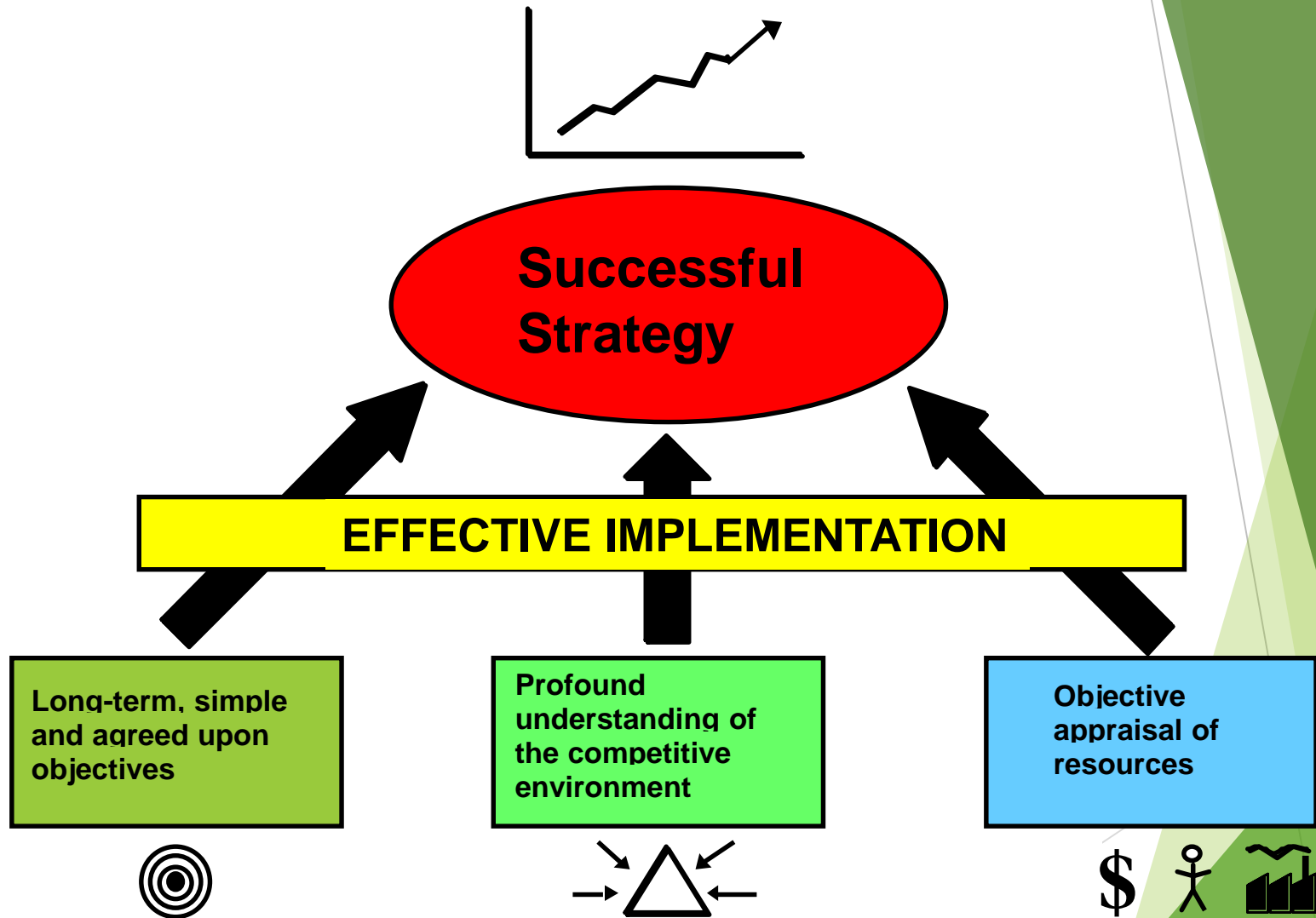
# Levels of Strategy



# Levels of Strategy

- ▶ **Corporate strategy**... defines the scope of the business in terms of the industries and markets in which it competes.
  - ▶ includes decisions about diversification, vertical integration, acquisitions, new ventures, divestments, allocation of scarce resources between business units
- ▶ **Business strategy**... is concerned with how the firm competes within a particular industry or market... to win a business unit must adopt a strategy that establishes a competitive advantage over its rivals.
- ▶ **Functional strategy**... the detailed deployment of resources at the operational level

# Common Elements in Successful Strategy



# Strategy as a Quest for Profit

► The stakeholder approach : The firm is a coalition of interest groups—it seeks to balance their different objectives

▪ The shareholder approach : The firm exists to maximize the wealth of its owners (= max. present value of profits over the life of the firm)

*For the purposes of strategy analysis we assume that the primary goal of the firm is profit maximization.*

*Rationale:*

- 1) Boards of directors legally obliged to pursue shareholder interest
- 2) To replace assets firm must earn return on capital > cost of capital (difficult when competition strong).
- 3) Firms that do not max. stock-market value will be acquired

Hence: Strategy analysis is concerned with identifying and accessing the sources of profit available to the firm

# From Profit Maximization to Value Maximization

Profit maximization an ambiguous goal

Total profit vs. Rate of profit

Over what time period?

What measure of profit?

Accounting profit *versus* economic profit (e.g. Economic Value Added: Post-tax operating profit less cost of capital)

***Maximizing the value of the firm:***

Max. net present value of free cash flows:  $\max. V = \sum_t \frac{C_t}{(1+r)^t}$

Where: V market value of the firm.  
C<sub>t</sub> free cash flow in time t  
r weighted average cost of capital

# The World's Most Valuable Companies: Performance Under Different Profitability Measures

COMPANY	MARKET CAP. (\$BN.)	NET INCOME (\$BN)	RETURN ON SALES (%)	RETURN ON EQUITY (%)	RETURN ON ASSETS (%)	RETURN TO SHARE- HOLDERS (%)
Exxon Mobil	372	36.1	19.9	34.9	17.8	11.7
General Electric	363	16.4	10.7	22.2	14.7	(1.5)
Microsoft	281	12.3	40.3	30.0	18.8	(0.9)
Citigroup	239	24.6	22.0	21.9	1.5	4.6
BP	233	22.3	9.9	27.9	10.7	10.2
Bank of America	212	16.5	27.0	14.1	1.2	2.4
Royal Dutch Shell	211	25.3	14.7	26.7	11.6	11.8
Wal-Mart	197	11.2	5.5	21.4	8.1	(10.3)
Toyota Motor	197	12.1	10.7	13.0	4.8	(22.1)
Gazprom	196	7.3	28.1	9.8	7.1	n.a.
HSBC	190	15.9	23.0	16.3	1.0	(11.8)
Procter & Gamble	190	8.7	17.3	13.7	6.4	7.2

# Shareholder Value Maximization and Strategy Choice

## *The Value Maximizing Approach to Strategy Formulation:*

Identify strategy alternatives

Estimate cash flows associated with cash strategy

Estimate cost of capital for each strategy

Select the strategy which generates the highest NPV

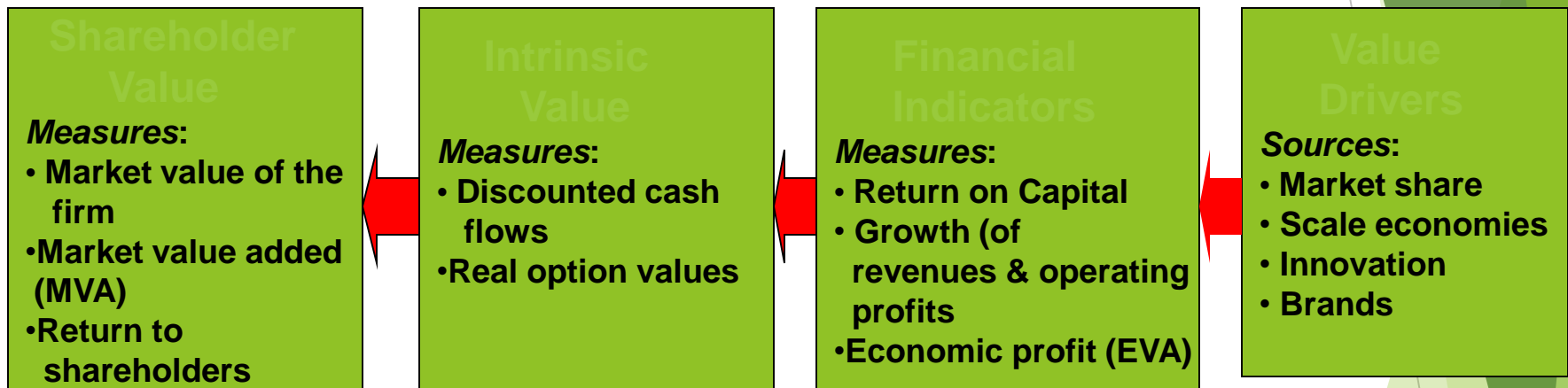
## *Problems:*

- Estimating cash flows beyond 2-3 years is difficult
- Value of firm depends on *option value* as well as DCF value

## *Implications for strategy analysis:*

- Some simple financial guidelines for value maximization
  - a) On existing assets—maximize after-tax rate of return
  - b) On new investment—seek rate of return  $>$  cost of capital
- Utilize qualitative strategy analysis to evaluate future profit potential

# A Comprehensive Value Metrics Framework



# Sources of Superior Performance

**Above Normal Profits**  
(in Excess of the Competitive Level)

**Avoid Competitors**

Attractive Industry

Entry Barriers

Attractive Strategic Group

Mobility Barriers

Attractive Niche

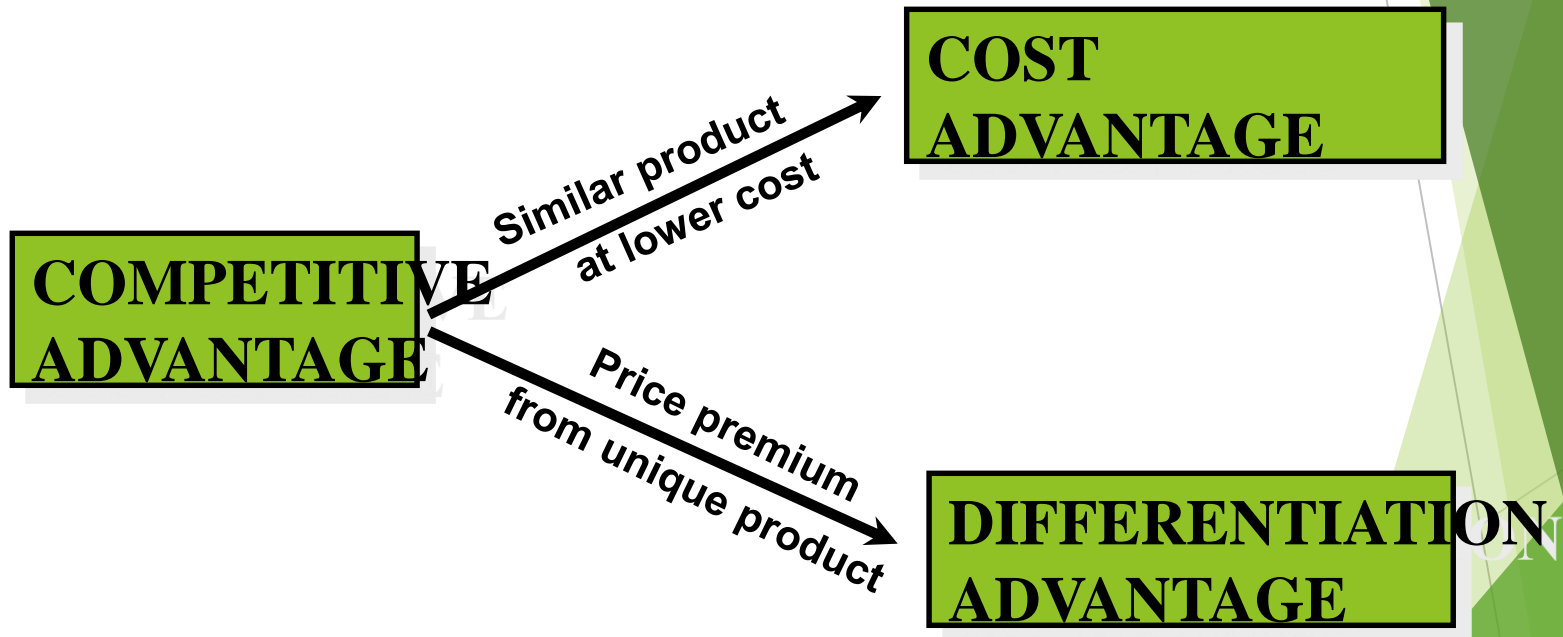
Isolating Mechanisms

**Be Better Than Competition**

Cost Advantage

Differentiation Advantage

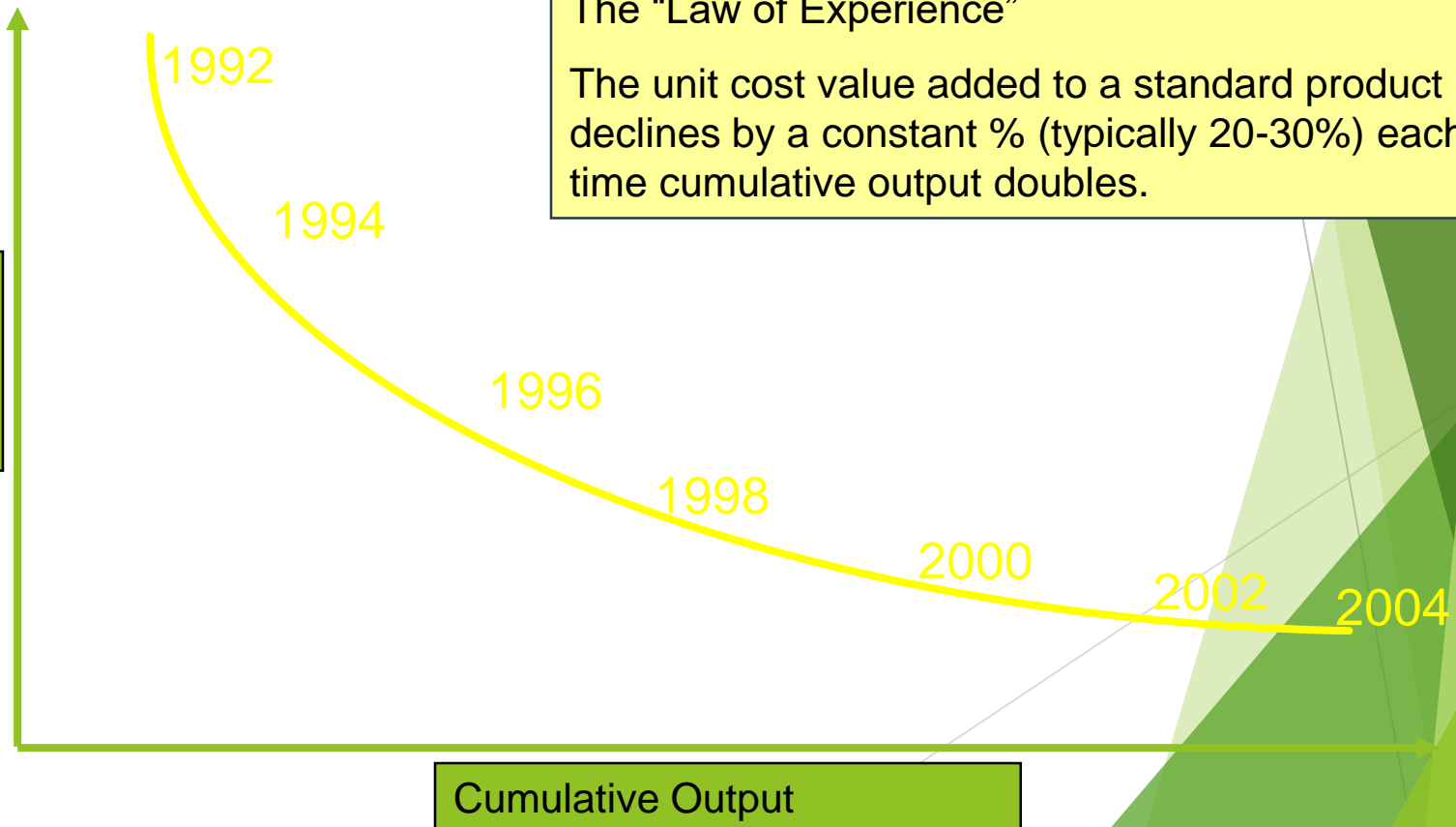
# Sources of Competitive Advantage



# The Experience Curve

## The "Law of Experience"

The unit cost value added to a standard product declines by a constant % (typically 20-30%) each time cumulative output doubles.

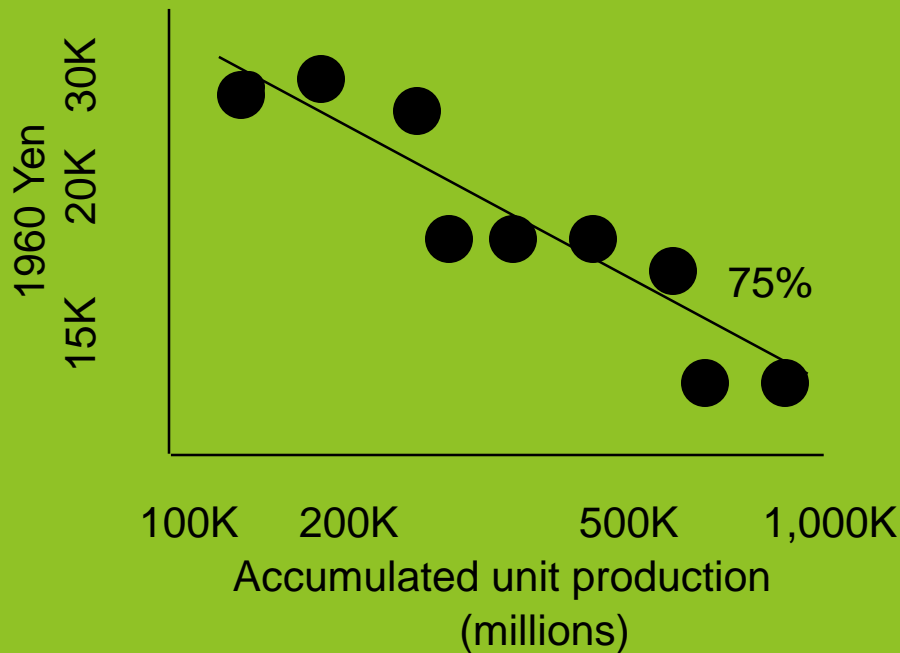


Cost per unit of output (in real \$)

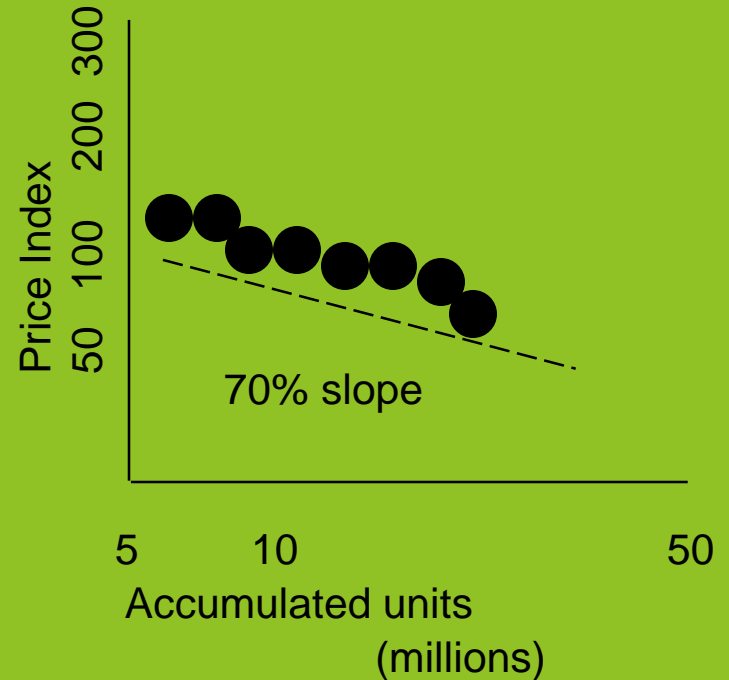
Cumulative Output

# Examples of Experience Curves

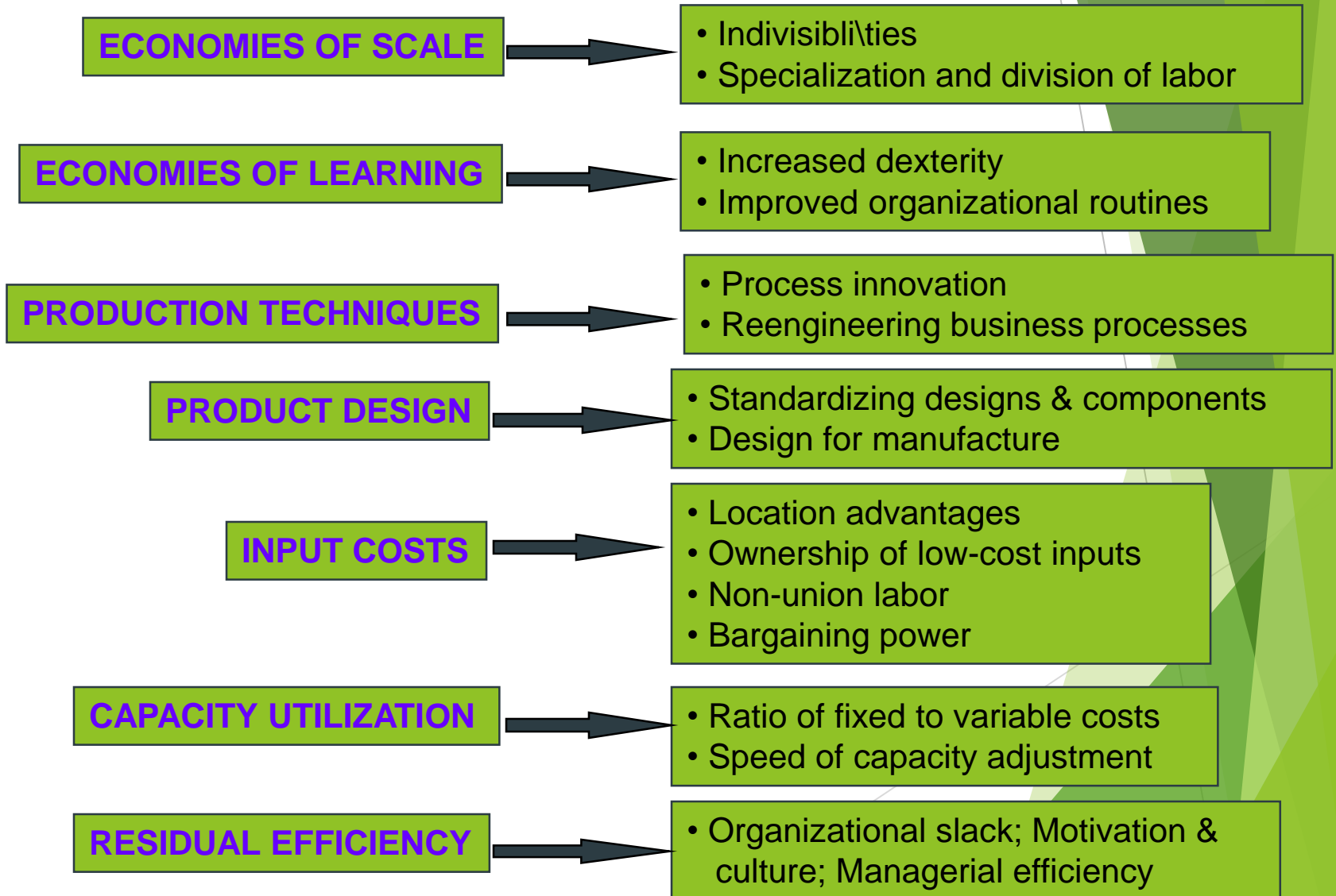
Japanese clocks & watches, 1962-72



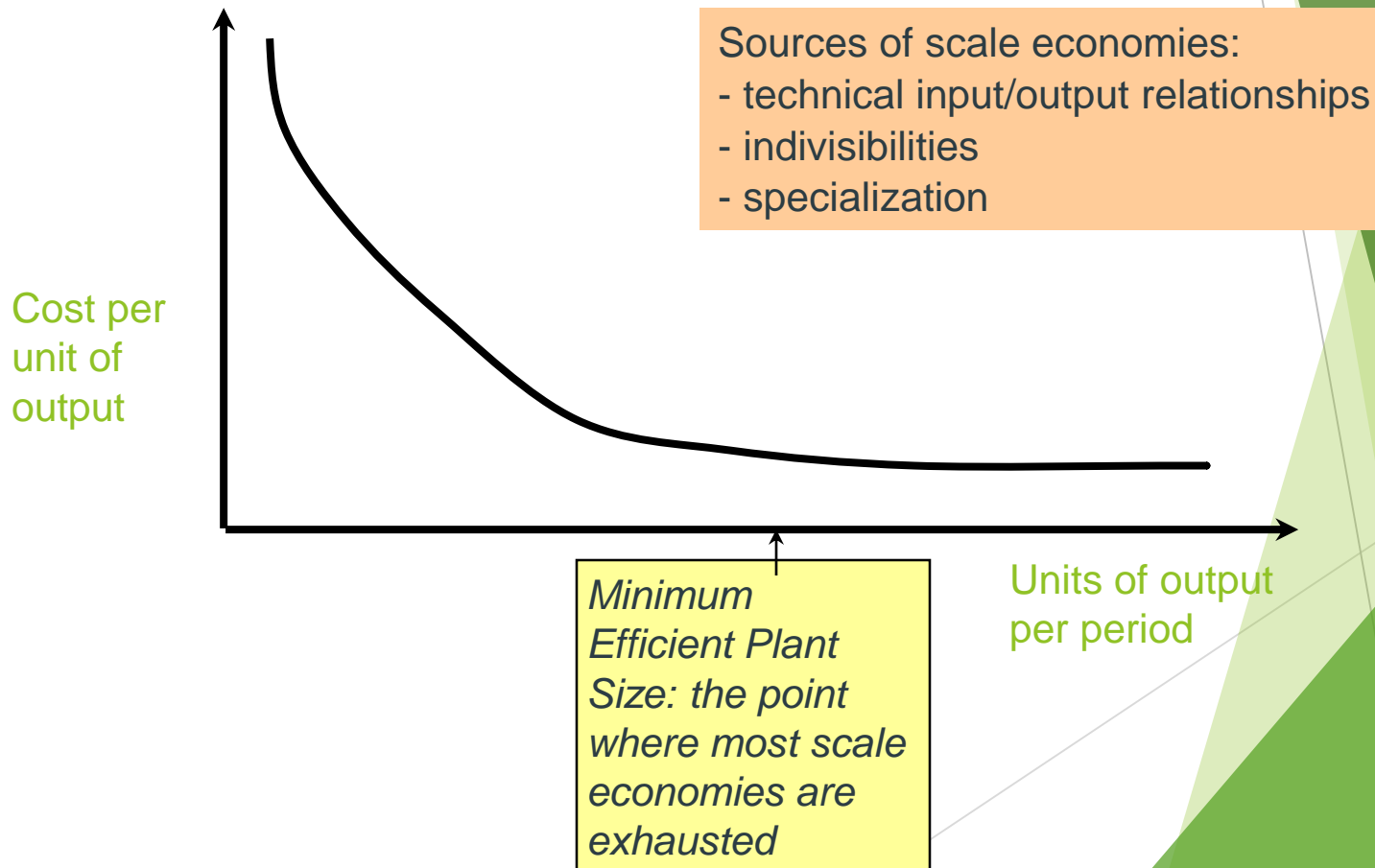
UK refrigerators, 1957-71



# Drivers of Cost Advantage

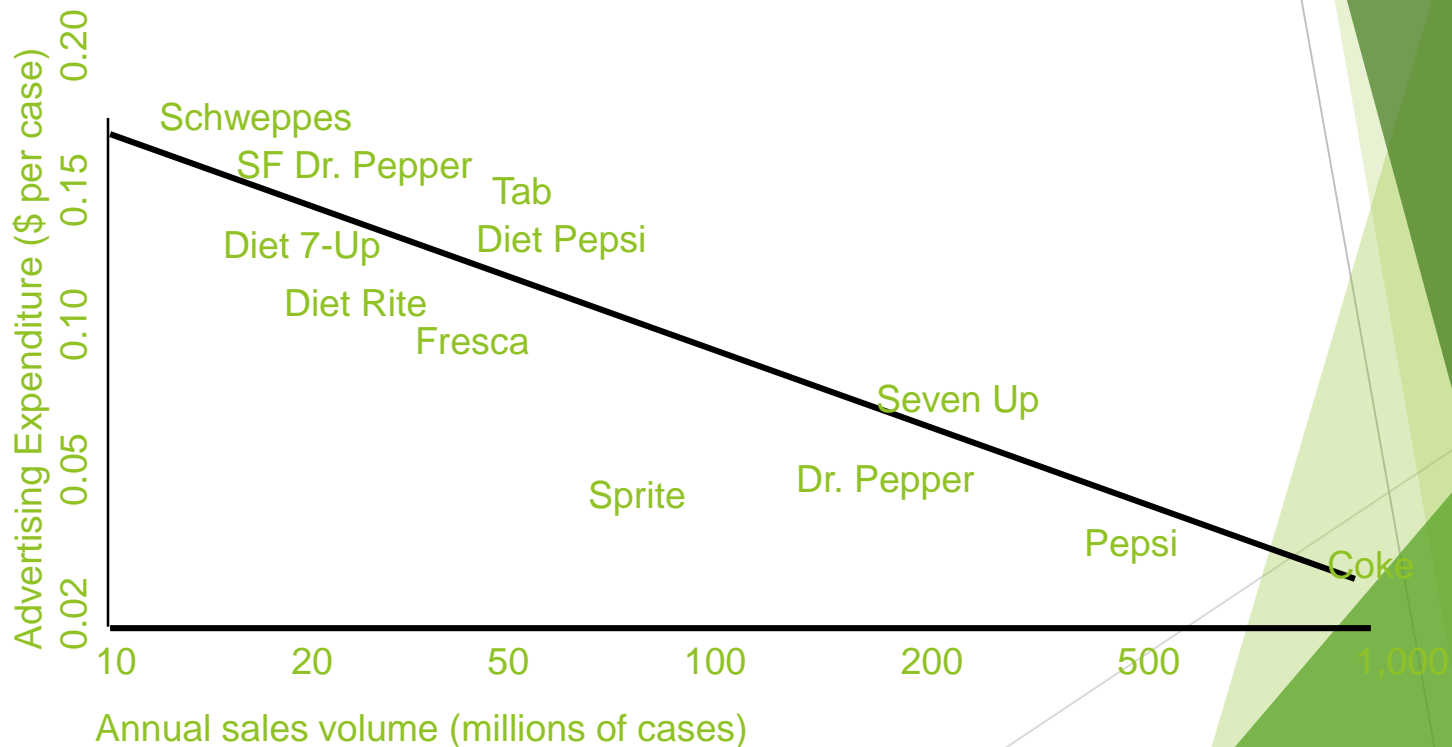


# Economies of Scale: The Long-Run Cost Curve for a Plant



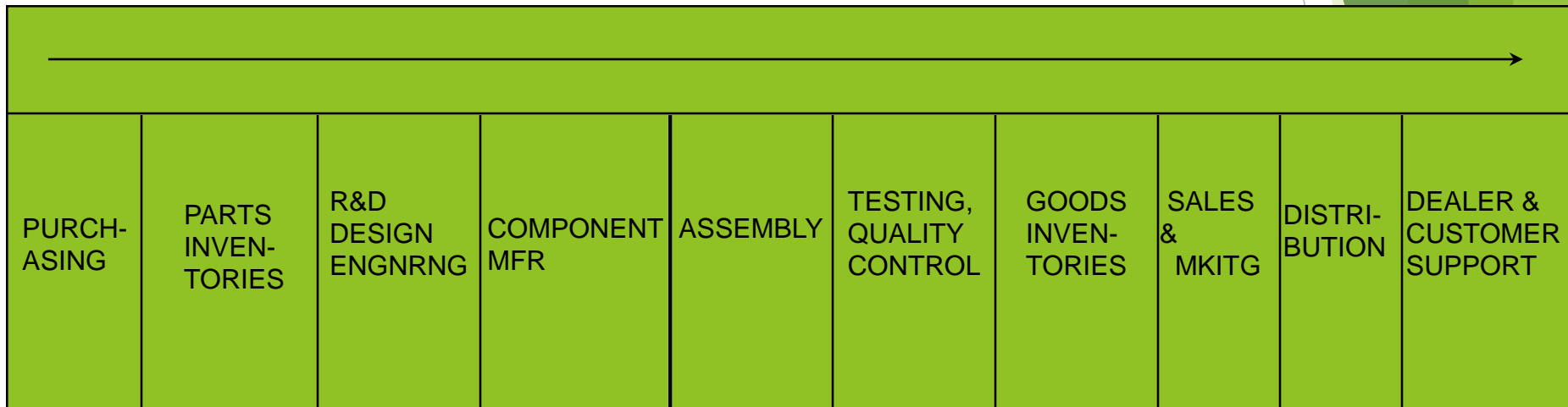
# Scale Economies in Advertising: U.S. Soft Drinks

Despite the massive advertising budgets of brand leaders Coke and Pepsi, their main brands incur lower advertising costs per unit of sales than their smaller rivals.



# Applying the Value Chain to Cost Analysis: The Case of Automobile Manufacture

## **STAGE 1. IDENTIFY THE PRINCIPLE ACTIVITIES**

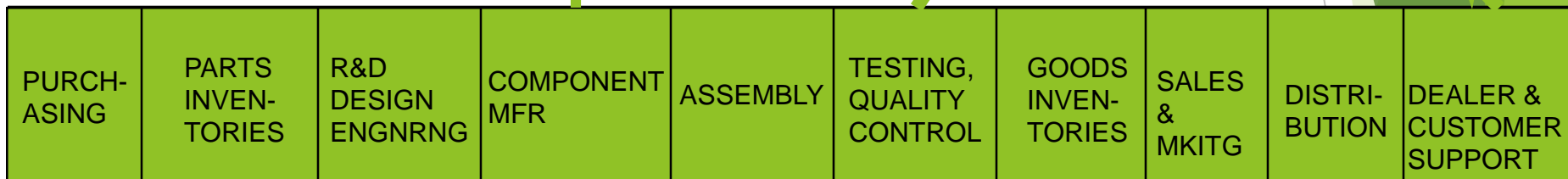


## **STAGE 2. ALLOCATE TOTAL COSTS**

# Applying the Value Chain to Cost Analysis: The Case of Automobile Manufacture (continued)

## STAGE 3. IDENTIFY COST DRIVERS

- |   |  |  |
|---|--|--|
| <ul style="list-style-type: none"> <li>-- Plant scale for each component</li> <li>-- Process technology</li> <li>-- Plant location</li> <li>-- Run length</li> <li>-- Capacity utilization</li> </ul> | <ul style="list-style-type: none"> <li>-- Level of quality targets</li> <li>-- Frequency of defects</li> </ul> | <ul style="list-style-type: none"> <li>-- No. of dealers</li> <li>-- Sales / dealer</li> <li>-- Level of dealer support</li> <li>-- Frequency of defects under warranty</li> </ul> |
|---|--|--|



Prices paid depend on:

- Order size
- Purchases per supplier
- Bargaining power
- Supplier location

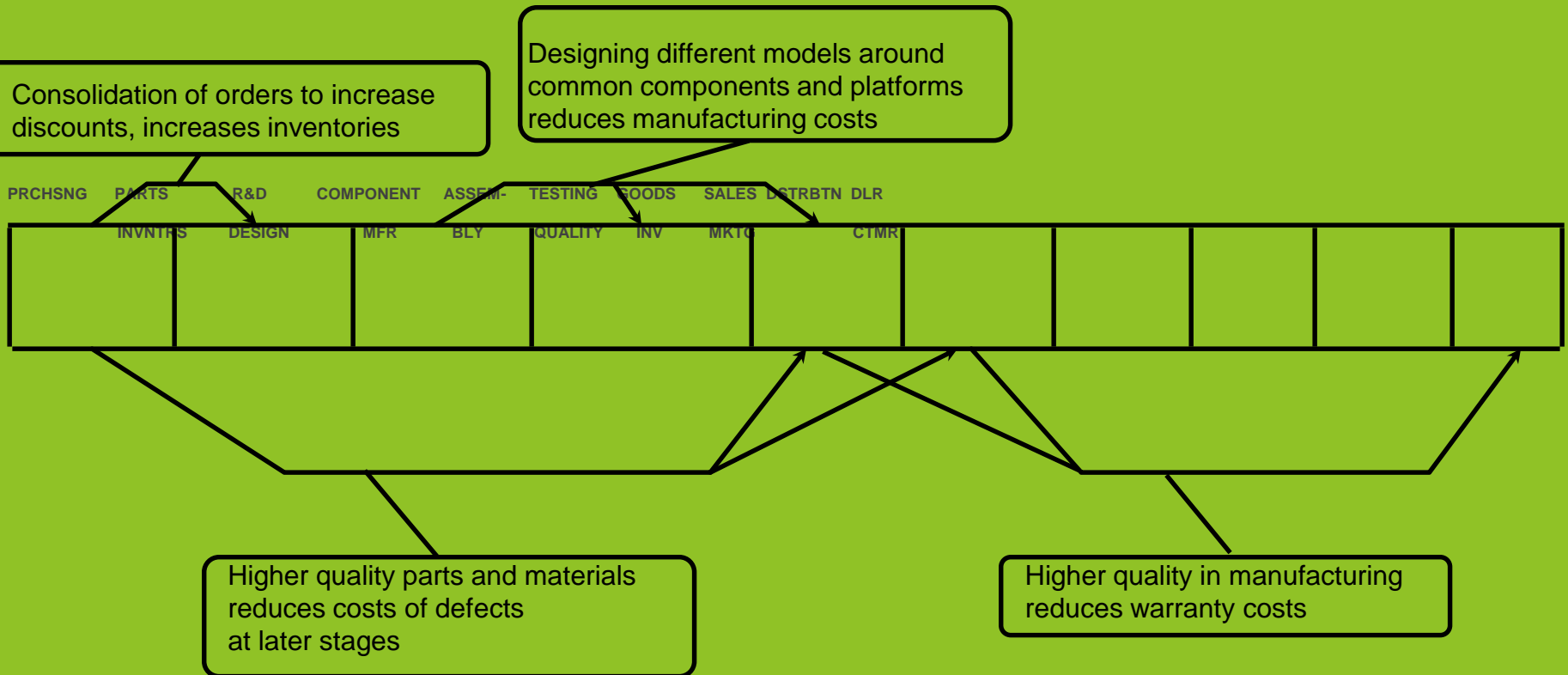
- Size of commitment
- Productivity of R&D/design
- No. & frequency of new models

- Plant scale
- Flexibility of production
- No. of models per plant
- Degree of automation
- Sales / model
- Wage levels
- Capacity utilization

- Cyclicity & predictability of sales
- Customers' willingness to wait

# Applying the Value Chain to Cost Analysis: The Case of Automobile Manufacture (continued)

## STAGE 4. IDENTIFY LINKAGES



## STAGE 5. RECCOMENDATIONS FOR COST REDUCTION

# The Nature of Differentiation

**DEFINITION:** “*Providing something unique that is valuable to the buyer beyond simply offering a low price.*” (M. Porter)

➔ **THE KEY IS TO CREATE VALUE FOR THE CUSTOMER**

## TANGIBLE DIFFERENTIATION

Observable product characteristics:

- size, color, materials, etc.
- performance
- packaging
- complementary services

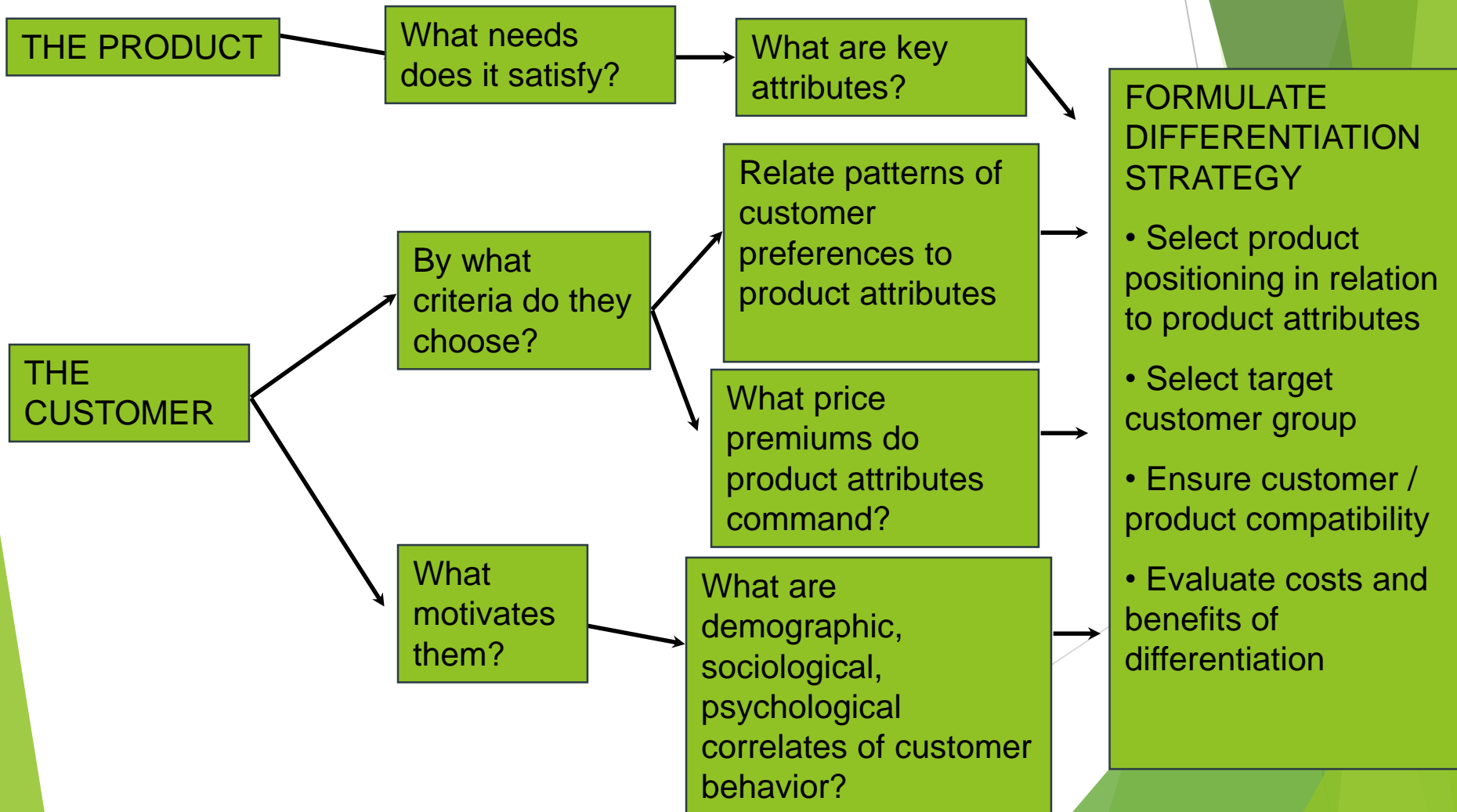
## INTANGIBLE DIFFERENTIATION

Unobservable and subjective characteristics that appeal to customer’s image, status, identity, and desire for exclusivity

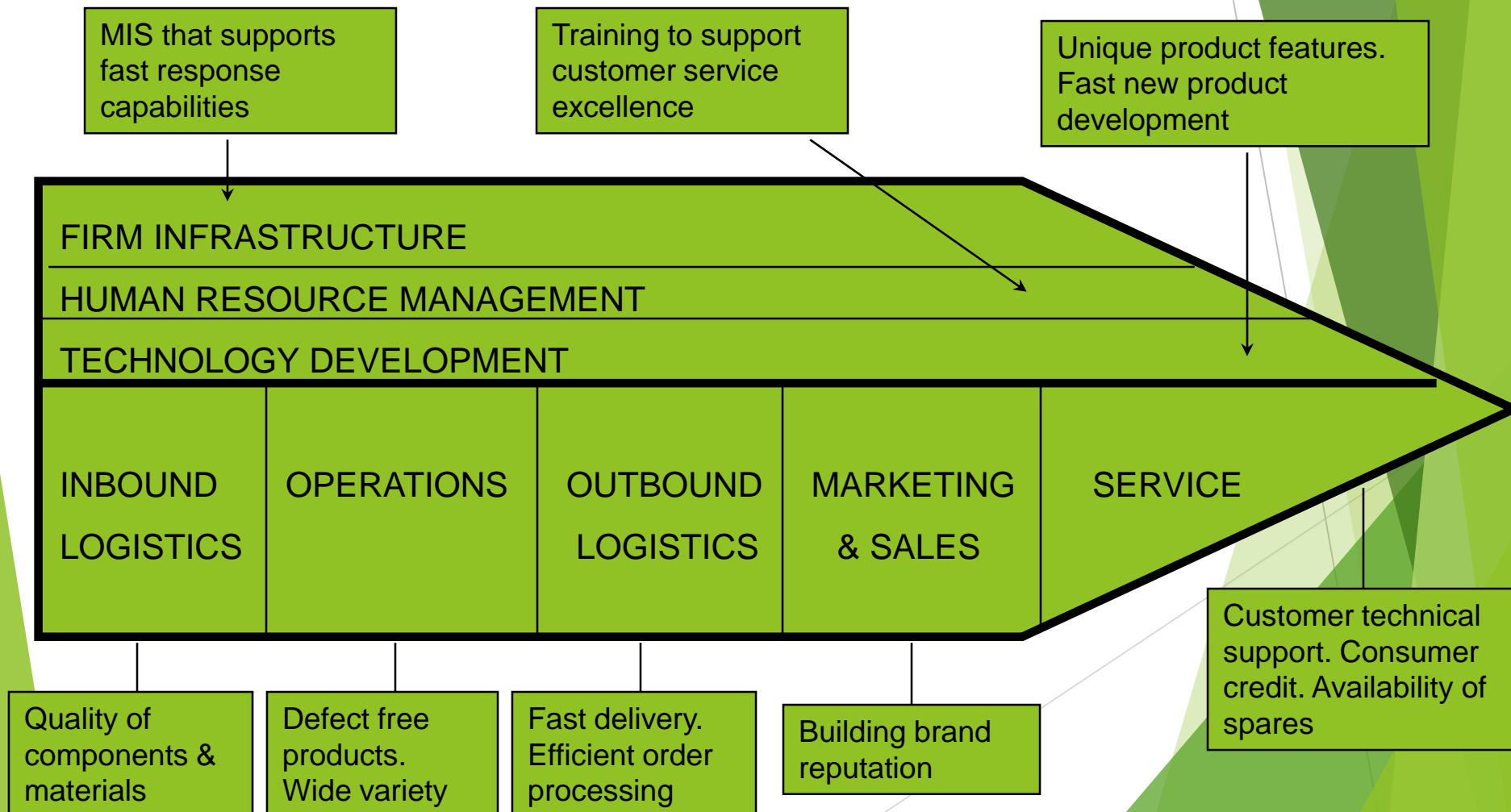
## TOTAL CUSTOMER RESPONSIVENESS

Differentiation not just about the *product*, it embraces the whole *relationship* between the supplier and the customer.

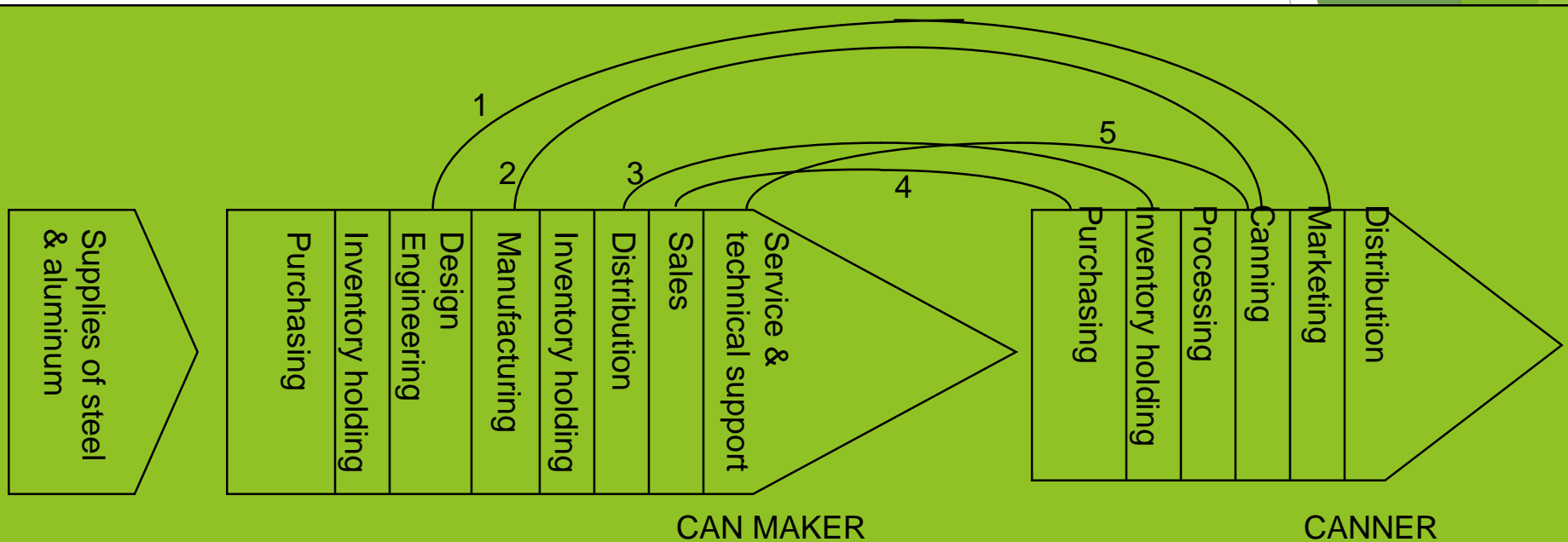
# Identifying Differentiation Potential: The Demand Side



# Using the Value Chain to Identify Differentiation Potential on the Supply Side

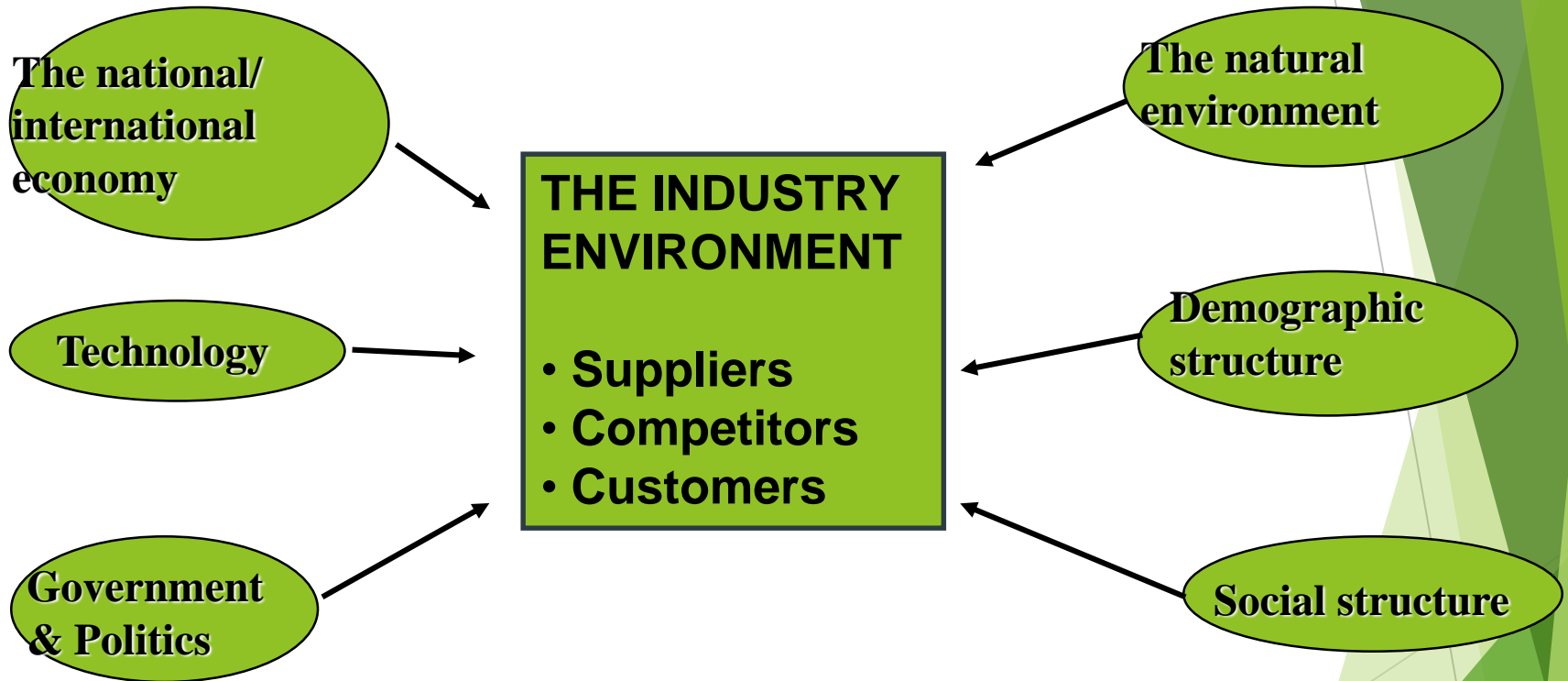


# Identifying Differentiation Opportunities through Linking the Value Chains of the Firm and its Customers: Can Manufacture



1. Distinctive can design can assist canners' marketing activities.
2. High manufacturing tolerances can avoid breakdowns in customer's canning lines.
3. Frequent, reliable delivery can permit canner to adopt JIT can supply.
4. Efficient order processing system can reduce customers' ordering costs.
5. Competent technical support can increase canner's efficiency of plant utilization.

# From Environmental Analysis to Industry Analysis



- *The Industry Environment lies at the core of the Macro Environment.*
- *The Macro Environment impacts the firm through its effect on the Industry Environment.*

# Drawing Industry Boundaries : Identifying the Relevant Market

What industry is **BMW** in:

World Auto industry

European Auto industry

World luxury car industry?

Key criterion: ***SUBSTITUTABILITY***

On the demand side : are buyers willing to substitute between types of cars and across countries

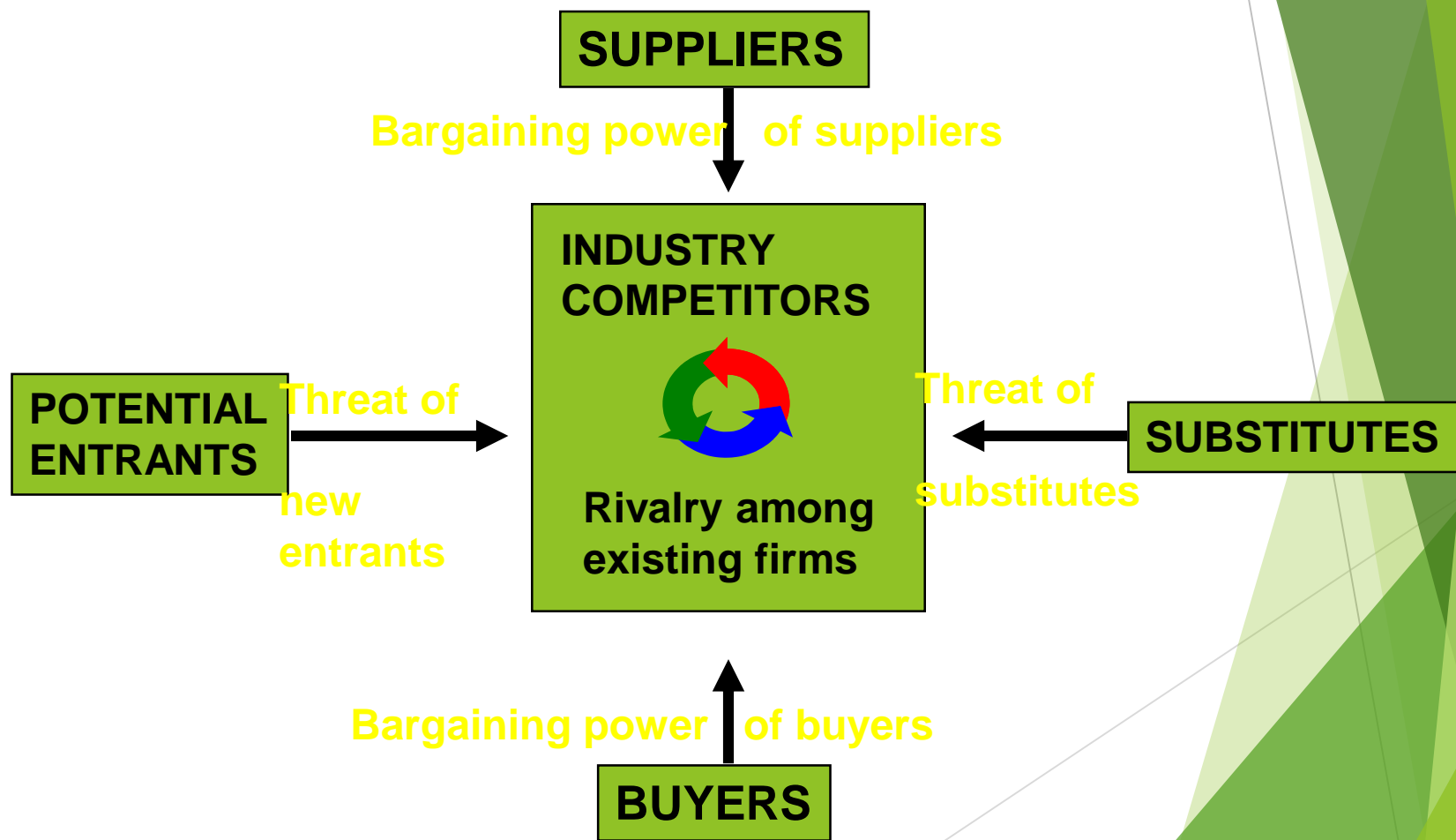
On the supply side : are manufacturers able to switch production between types of cars and across countries

We may need to analyze industry at different levels of aggregation for different types of decision

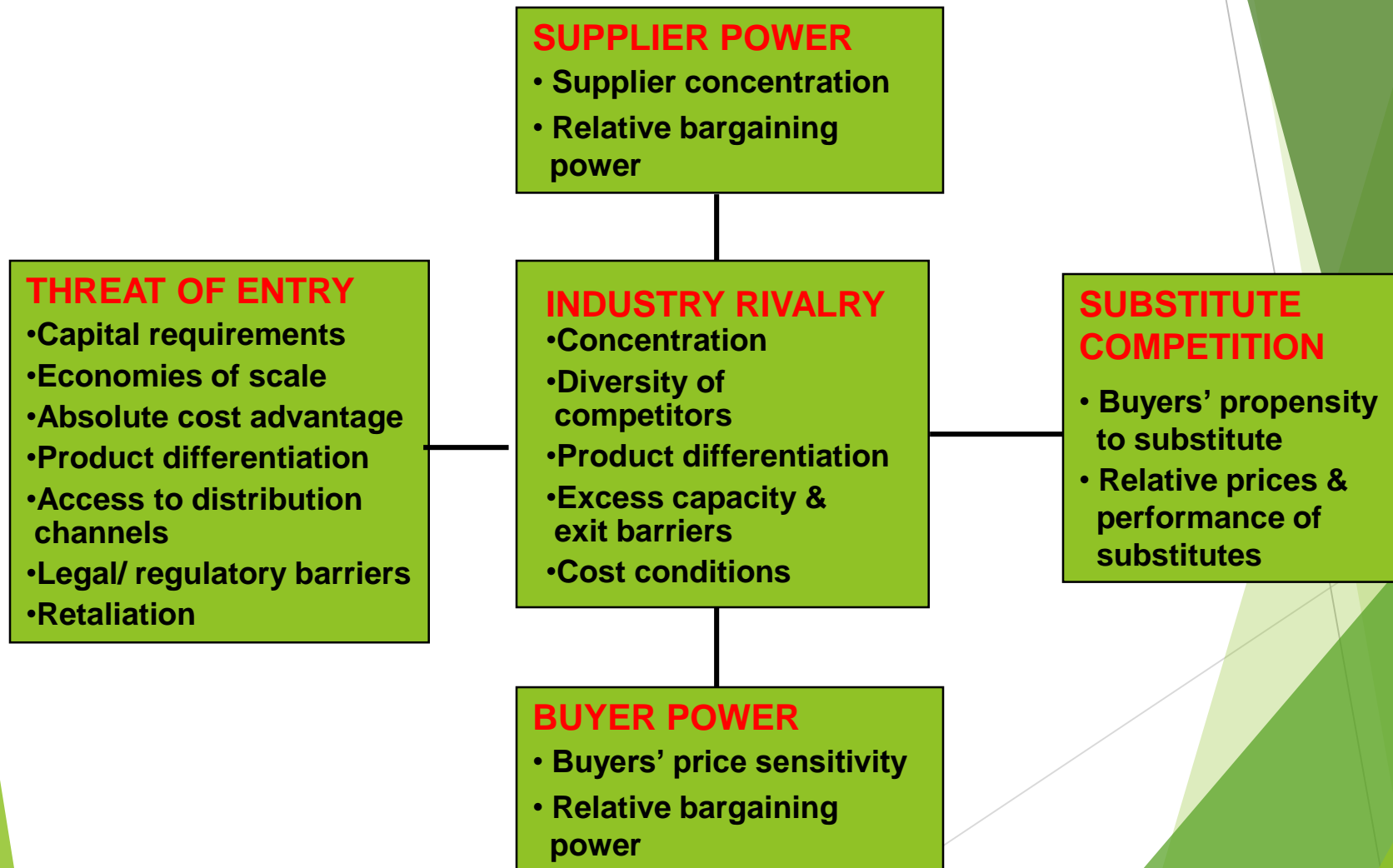
# The Spectrum of Industry Structures

	<i>Perfect Competition</i>	<i>Oligopoly</i>	<i>Duopoly</i>	<i>Monopoly</i>
<i>Concentration</i>	Many firms	A few firms	Two firms	One firm
<i>Entry and Exit Barriers</i>	No/Low barriers	Significant barriers		High barriers
<i>Product Differentiation</i>	Homogeneous Product	Potential for product differentiation		
<i>Information</i>	Perfect Information flow	Imperfect availability of information		

# Porter's Five Forces of Competition Framework



# The Structural Determinants of Competition



# DRUG INDUSTRY (ROE=22%)

**SUPPLIER POWER**  
*LOW*

**THREAT OF ENTRY**  
*LOW*

- economies of scale
- capital requirements for R&D and clinical trials
- product differentiation
- control of distribution channels
- patent protection

**INDUSTRY COMPETITIVENESS**  
*LOW*

- high concentration
- product differentiation
- patent protection
- steady demand growth
- no cyclical fluctuations of demand

**THREAT OF SUBSTITUTES**  
*LOW*

No substitutes.  
(Changing as managed care encourages generics.)

**BUYER POWER**  
*LOW*

Physician as buyer:  
Not price sensitive  
No bargaining power.  
(Changing with managed care.)

# Applying Five-Forces Analysis

## *Forecasting Industry Profitability*

Past profitability a poor indicator of future profitability.

If we can forecast changes in industry structure we can predict likely impact on competition and profitability.

## *Strategies to Improve Industry Profitability*

- What structural variables are depressing profitability
- Which of these variables can be changed by individual or collective strategies?

# Reference and sources

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