CHAPTER 1

PERFORMANCE THROUGH TIME

KEY ISSUES

- Business value reflects future earnings.
- The management imperative: building performance into the future.
- Nonfinancial performance measures, especially in public service and voluntary organizations.
- Appropriate objectives: achievable, but developing the full opportunity.
- Inappropriate performance measures: ratios, market share, percentage growth rates.
- Multiple and conflicting objectives.
- Choosing appropriate timescales, depending on the issue of concern.
- Functional challenges and choice of objectives.
- Implications for information needs.

Worksheet 1: Performance Objectives over Time.

This chapter makes connections to the following concepts: economic profit, free cash flow, value based management, sustained competitive advantage.

THE PERFORMANCE IMPERATIVE

Before trying to develop tools and frameworks for understanding and improving strategic performance of firms and other organizations, it is helpful to clarify the question we need answered—that is, what exactly *is* the "performance" that we want to improve? Popular writing on strategy, whether in management journals or books, avoids this question entirely and moves directly on to offering recipes, frameworks, checklists and general advice. Yet it will be difficult to have confidence in such advice if it is not clear what outcomes are expected, or how exactly the recommended actions lead to those outcomes.

FINANCIAL PERFORMANCE

Strategy textbooks, which are largely devoted to commercial business situations, generally take some indicator of financial performance as the measure of concern. The large financial values involved in the commercial sector create an understandable incentive for academics, consultants and executives to develop strategy tools for such cases. However, as a result, the strategy concerns of public sector, voluntary, and other not-for-profit organizations are somewhat neglected. Ideally, we need tools and frameworks that are helpful to management in all cases, not just for business. Furthermore, many strategic issues in corporate situations, while they will ultimately affect financial performance, primarily concern nonfinancial issues: poor marketplace reputation, rapid loss of staff, business lost to competitors, and so on. Nevertheless, since the financial performance of firms is helpfully clear, as well as highly valued, we will start with these concerns before widening the question to encompass other kinds of objectives.

A wide range of financial measures are featured in firms' reporting, controls and objectives, but the overriding concern with the interests of investors has led to the choice of one specific measure—economic profit—as the basis for assessing performance for any particular time period. The rationale for this choice is extensively explained in other textbooks, so it will only be summarized briefly here.[1]

Two elements of profit must be distinguished. First is the "normal" profit that investors would expect to receive for the use of their capital, given the level of risk they are taking on by investing in a particular type of business. This leaves a second element, the "economic profit", which is the surplus that remains after the costs of *all* inputs (including the cost of capital) have been paid out, so:

Economic profit = *operating profit* minus *taxes* minus *cost of capital*

This has become more than just a theoretical concept, with economic profit or the closely related "economic value added" (EVA) being adopted as a management tool by many large corporations.[2,3]

An exclusive focus on current profit poses a rather obvious problem. We can nearly always boost profits *now*, by simple changes such as pushing up prices or cutting expenditure, although shareholders will not thank us for these actions if we damage *future* profits. Historical and current profits are therefore only relevant insofar as they provide important clues to what profits will likely be in the coming years. This severely limits the value of any strategy approaches or frameworks based on explanations for profitability in a single period, no matter how persuasive the statistical significance of those explanations.

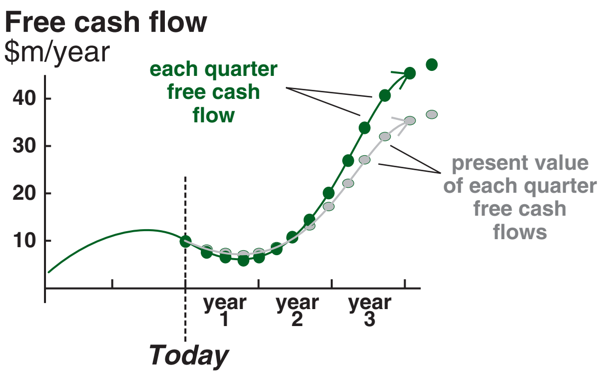


Figure 1.1: Future free cash flows and their present value.

The money available to distribute to shareholders in future years will be the cash flow generated by the company's operations, minus any additional capital input required to make that operating cash flow possible. So another measure that receives attention is "free cash flow." Current period profits include an allowance for writing off the past expenditure on fixed assets, known as depreciation. This depreciation needs to be added back and replaced by the actual expenditures on fixed and working capital. This results in the following measure of a firm's free cash flow:

Free cash flow = operating profit + depreciation − taxes − change in fixed and working capital

The value of a firm to its investors reflects the expected stream of all *future* free cash flows,[4] but is not simply the sum of these amounts. Cash received today and in the near term is valued more highly than the cash that may be received far in the future, due to the increasing uncertainty involved and the fact that the money invested has alternative uses. Each period's cash flow is therefore discounted by the firm's cost of capital to arrive at its "present value" (Figure 1.1), and the firm's total value is the sum of all those values out into the future.[5]

To evaluate a firm's strategy, we therefore need a way to estimate the *future trajectory* of cash flows, not just a single period. Furthermore, since strategic management concerns *improvements* in performance, we need a way to estimate what impact on that cash flow trajectory may arise from any actions or decisions we may be considering. Such changes may be relatively minor, such as a price reduction intended to accelerate sales growth, or major, such as the acquisition of another substantial business.

In Figure 1.2, Strategy B should be preferred because it delivers a greater total discounted present value than Strategy A, even though it involves lower cash flows in year one.[6] Outcome B could, for example, arise from entering a new market or

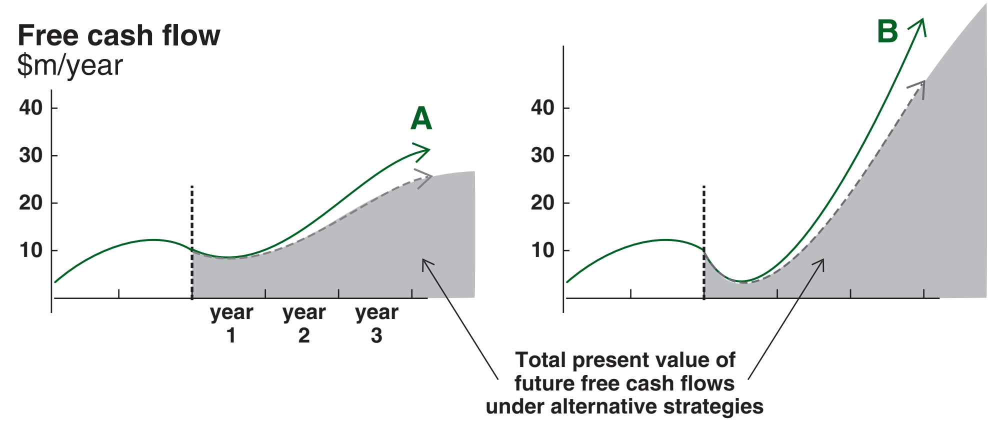


Figure 1.2: **Total value of a firm under alternative strategies.**

launching a new product, either of which would incur short-term costs but with the prospect of enabling additional growth thereafter. Management will, of course, face the challenge of convincing investors to share their confidence in option B!

The principles outlined to this point provide the overriding focus for this book:

Strategic management is about building and sustaining performance into the future.

This is not a novel idea in the strategy field, but goes back to seminal work in the 1950s by Edith Penrose,[7] who pointed out that superior profitability is neither interesting in itself, nor sustainable in any but the most exceptional circumstances. Rather, management should be concerned with growing future economic profit.[8]

To illustrate the idea that shareholders value future cash flows, even if money has to be invested in the short term, Figure 1.3 shows the profit history for Amazon.com.

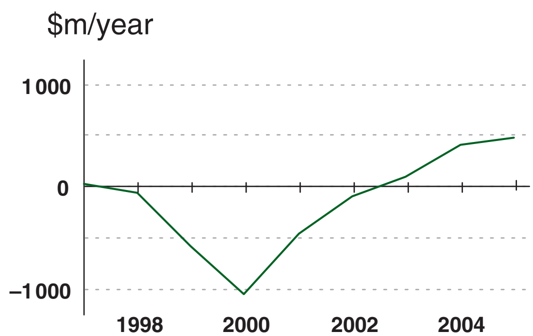


Figure 1.3: **Profit history at Amazon.com.**

In the years up to 2001, the company repeatedly delivered only losses (and heavily negative cash flows). Investors nevertheless ascribed value to the firm because of the prospects that profits would arise in due course. Indeed, those early losses were often greater than investors had previously expected, yet they still valued the company positively since each new level of loss arose from additional spending to develop ever more sources of sales and thus future cash flows. (Note that this is not a story many firms can credibly copy, since few face the burgeoning new opportunities that Amazon.com enjoyed.)

From this point on, we will assume that the appropriate translation between operating profit, economic profit, and free cash flows can be properly carried out by finance professionals. Our task in developing and evaluating strategy is to provide a confident estimate of what those top-level profits are likely to be. We will therefore generally refer to operating profit or cash flow when discussing the financial performance of commercial firms.

NONFINANCIAL PERFORMANCE OBJECTIVES

The purely financial view implied by this approach to valuing firms need not be inconsistent with other objectives, or with concerns for wider issues, such as social responsibility. Indeed, lack of attention to such issues can easily create problems that ultimately damage long-term profits and business value.

Management often sets targets for measures that are not expressed in financial terms—customer growth, market share, staff numbers, and so on. Some companies even set aims for intangible measures, such as reputation. This is not to say that they ignore bottom-line financial performance. Rather, they focus on these other factors because they *drive* financial performance. Investors, analysts and other outside commentators also pay attention to firms' performance on such measures, so nonfinancial aims and progress towards them are often made quite public. Airlines report passenger volumes, cellphone operators report on subscriber numbers, fast-moving consumer goods (FMCG) firms report market shares, and so on.

Skype, the voice-over Internet protocol (VoIP) telephony service, is a well known situation where management and outsiders alike watched progress with keen interest. As Figure 1.4 shows, attention focused on the quarterly growth in the number of registered users. Having registered subscribers is not especially

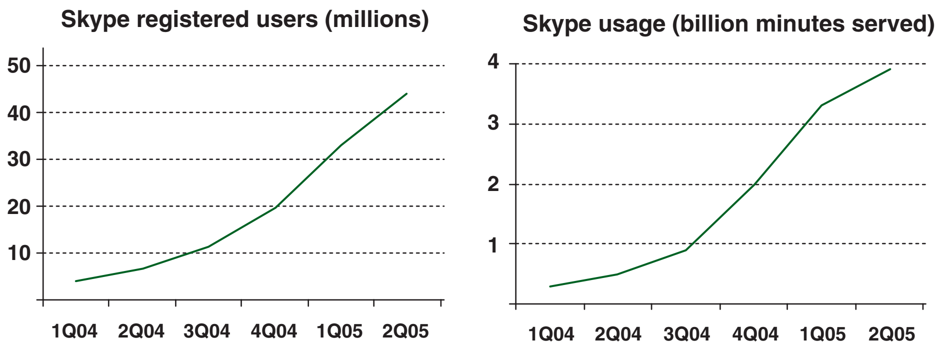


Figure 1.4: Early growth in registered users of Skype VoIP, and usage of the service.
Source: Company reports.

useful, however, unless they are *using* the service, so a secondary indicator is actual usage. As at the end of the second quarter, 2005 (2Q05), management might have been somewhat disappointed to see that usage growth had dipped below growth in user numbers. However, it is possible that VoIP, like other new technologies, won the keenest users first, so this was not necessarily a cause for concern. These nonfinancial indicators do not make financial performance unimportant, of course, and Skype seeks to earn revenues from add-on services, such as "Skype-in" and "Skype-out", which connect calls in from, and out to, normal phones.

PERFORMANCE CONCERNS IN NONCOMMERCIAL SETTINGS

Nonfinancial performance aims are understandably common in public sector, voluntary, and nongovernmental organizations (NGOs). One such case concerns the increasing prevalence and cost of diabetes in affluent societies.[9] In the United States, for example, the number of people with diabetes more than doubled between 1980 and 2003, from 5.8 million to 13.8 million (Figure 1.5).

Now there *is* a financial objective in this case: to limit the cost of treating diabetes and the various unpleasant illnesses that it can cause. The total costs of diabetes in the United States in 2002 were estimated at $132 billion, with $92 billion of that amount in direct medical expenditures and the other $40 billion in indirect costs due to disability and premature mortality.[10] But since those costs flow strongly from the number of people with the complaint, it is entirely reasonable that attention should focus on this nonfinancial indicator.

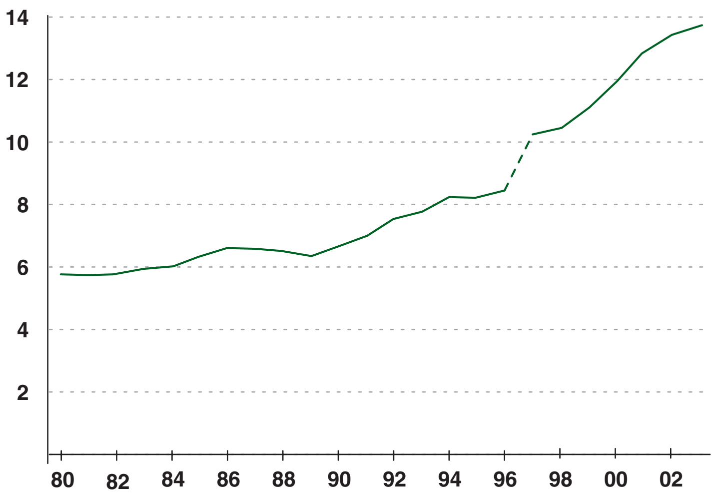


Figure 1.5: Prevalence of diabetes in the United States (millions). Source: This chart gives numbers of diagnosed cases – total cases are approximately 25% higher. Reproduced by permission of the US Centers for Disease Control and Prevention (change in measurement between 1996 and 1997).

THE MANAGEMENT CHALLENGE: IMPROVING FUTURE PERFORMANCE

We have established that the time path of future performance is central to the concerns of investors in commercial firms, as well as to stakeholders in public policy and nongovernmental organizations. Disappointment with strategic performance defined in these terms is widespread,[11] so it is important to examine the issue in more detail. There are three distinct, but related questions lying behind the issue of how businesses and other organizations perform through time:

- **Why** has our historical performance followed the time path that it has?
- **Where** will the path of future performance take us if we carry on as we are?
- **How** can we improve that future performance?

The first question may not be relevant in every case—a new venture start-up has no history, for example. However, in most cases, history is highly relevant to the likely trajectory of future performance. To see why these three questions are important, and how widely they vary in character between different situations, consider the example of Amazon.com in more detail.

Amazon.com is an outstanding growth story, as the company expanded from the online sale of books by offering an increasingly wide range of other

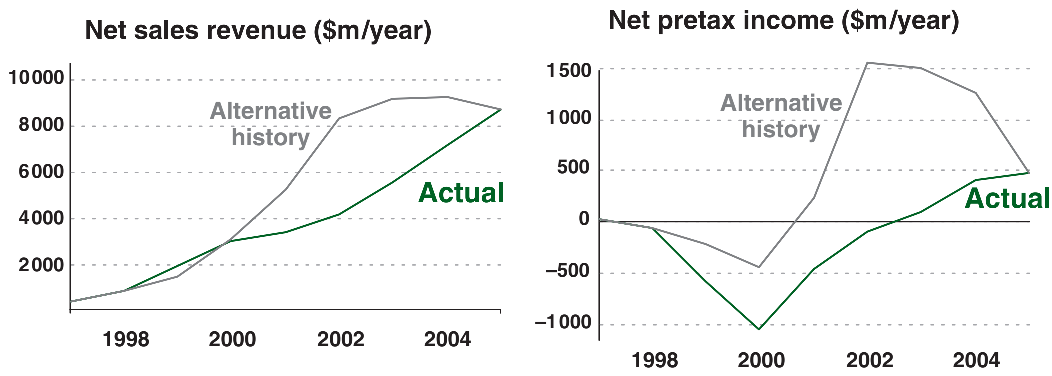


Figure 1.6: A hypothetical alternative sales and profit history of Amazon.com.

high-value/small-size consumer goods. Since its founding in 1994, the company has promised and delivered growth in its business although, as explained above, it took until 2002 to translate increasing sales volume and revenue into profitability.

So how do our three questions apply to Amazon.com?

Why has our historical performance followed the time-path that it has? Sales have grown strongly as consumer uptake of online purchasing has spread and as Amazon.com has extended its product range and entered new geographic markets. Earnings have bounced back from heavy losses into positive profitability, as early expenditure generated the sales growth and gross profits to more than cover the continuing costs of serving customers' demand.

However, the company's development need not have followed the same path, even if it ended up at the same point in 2005. Figure 1.6 compares the company's actual record with an alternative, fictional history. In this other world, the answers to our first question would be quite different. The company might conceivably have grown its revenues still more strongly between 1999 and 2002 than it actually did, due to an even faster penetration of online shopping by consumers or extension of its product range and services. From 2002 to 2005, sales growth could have slowed and reversed, perhaps due to saturation of the potential market, the emergence of strong competitors, or a slowdown in the company's expansion of its offerings. The alternative income line is more worrying still, and explanations might include reduced margins due to competitive activity, poor cost control, or deliberate increases in spending in an effort to restart growth.

Where will the path of future performance take us if we carry on as we are? This second question shows the importance of answering the first. The two alternative histories *must* imply very different prospects for the future, even though the 2005 endpoint is identical. Figure 1.7 extends the time horizon beyond 2005, and offers a plausible

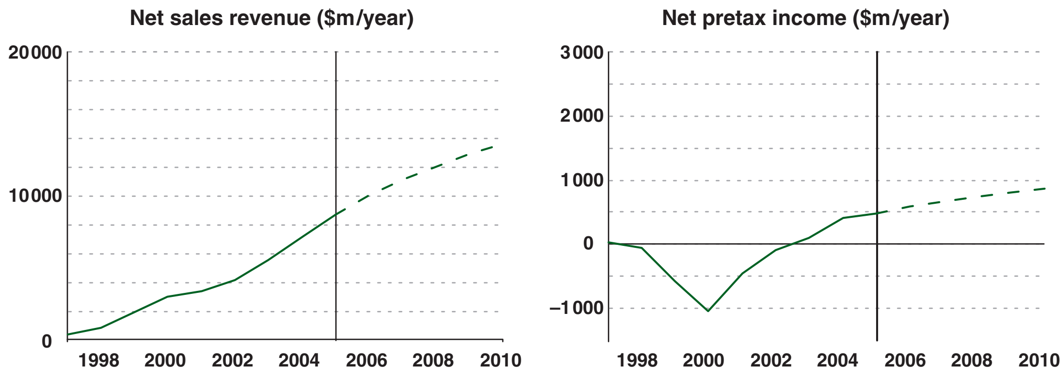


Figure 1.7: Plausible sales and profit prospects for Amazon.com, reflecting its actual history to 2005.

future for Amazon.com's sales and profits, given the company's actual history. Sales continue to grow for much the same reasons they have in the past—more consumer use of online shopping and extended coverage by the company of product and geographic markets. As a result, profits continue to grow.

But the answer to "where might we be heading?" would likely be very different, had the alternative history occurred (Figure 1.8). Now we are worried that the slowdown in sales could become a serious downturn, especially if the recent history had reflected progress by powerful rivals. If this were to come about, the profit forecast could be very disappointing, with the company slipping into losses as it struggles to contain costs that it has built up to support a growing sales rate.

How can we improve that future performance? Amazon.com's actual history to 2005 offers encouraging prospects for sales and profit growth thereafter, so in reality,

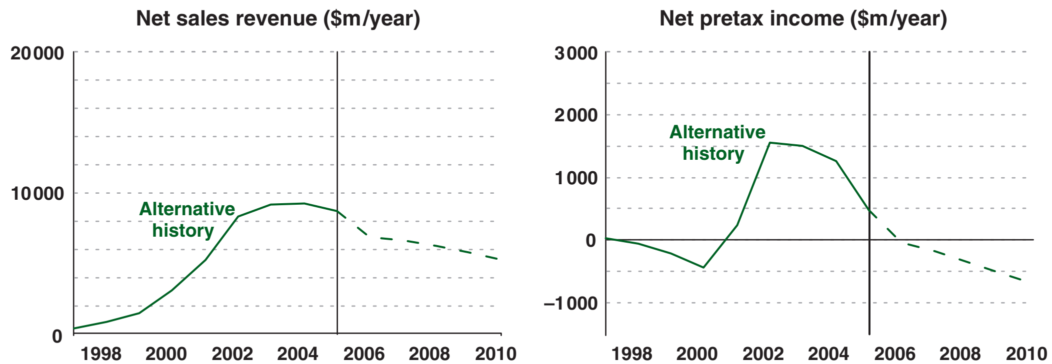


Figure 1.8: Sales and profit prospects for Amazon.com reflecting a fictional alternative history.

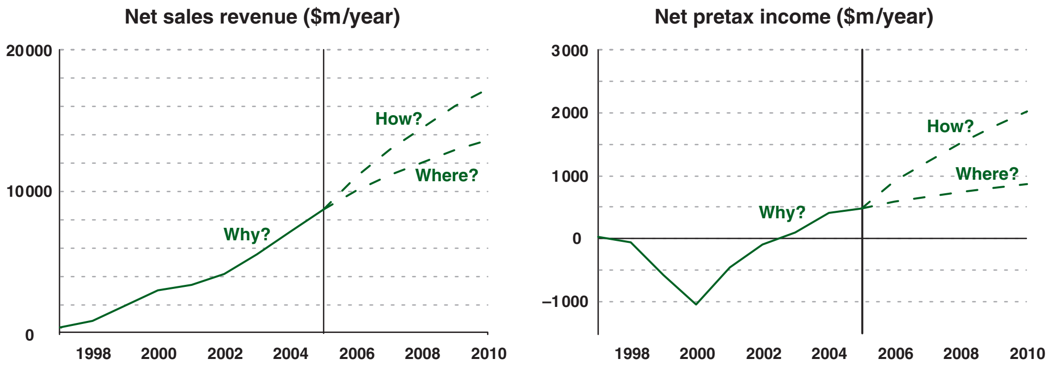


Figure 1.9: Plausible improvements to sales and profit prospects for Amazon.com, given its actual performance history.

answers to this third question focus on pushing growth just a little faster, while not risking damage to the business system that supported its performance to date. Perhaps further product and service development would drive additional growth, and this could plausibly lead to still higher profits (Figure 1.9).

The answers to this third question would have appeared very different if the company had reached 2005 by the alternative path (see Figure 1.10). Instead of asking how the firm might safely push for even faster growth, it would instead be worrying about how to stop sales revenue slipping backwards, and then how to restart growth. Such a turn-round would likely be costly, so the time path of recovery might well show an even worse profit performance in the next year or two than the "do nothing" projection.

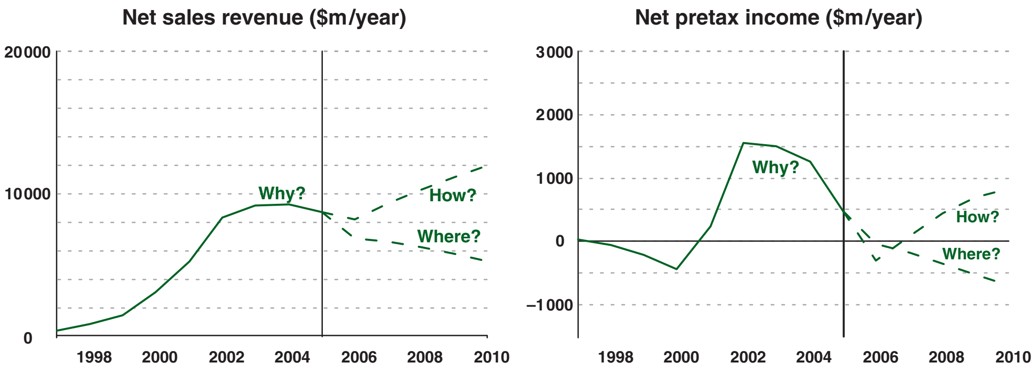


Figure 1.10: Desired sales and profits improvements for Amazon.com, following an alternative history.

SETTING APPROPRIATE OBJECTIVES

Failing to understand these three questions of performance through time can make it difficult for management to determine an appropriate performance goal. Two types of errors are common. Objectives may be set that are completely beyond the scope of the business to accomplish. Alternatively, management may significantly underestimate performance that might be possible, if it were to pursue policies that would allow the business to fulfill its potential.

Figure 1.11 shows overly ambitious targets for an international group in the IT and communications industry that was intent on capitalizing on the emerging opportunity for integrating mobile communications with corporate information systems. The opportunity was genuine, very large, and developing rapidly, driven by new technology and the efforts of some large competitors. Top management set a target of multiplying the business fourfold in four years. Unfortunately, this required three times the number of technical specialists that the company had in its sales and customer support teams. Very few such people existed in the industry and they were in high demand. It would take at least two years to develop existing staff, and the business was declining rather than growing. The goal was entirely unrealistic.

It is important not to confuse this error with the setting of "stretching" goals, which can energize an organization toward what may appear a daunting ambition.[12]

Doing it right: history matters!

There is often a reluctance to examine the history of an organization's performance—immediate results naturally get the most attention, followed perhaps by concern with the medium to long term. But there are two key reasons for examining history.

- performance reflects how complex business systems interact, so history contains considerable information about these relationships that has important implications for what may happen in future
- much of the future is *already determined* by occurrences in the past, so the trajectory of performance over recent history has important implications for what is about to happen in the short to medium term

No amount of analysis of current business, financial numbers or ratios alone, at whatever level of detail, can tell us how the company's future performance will develop.

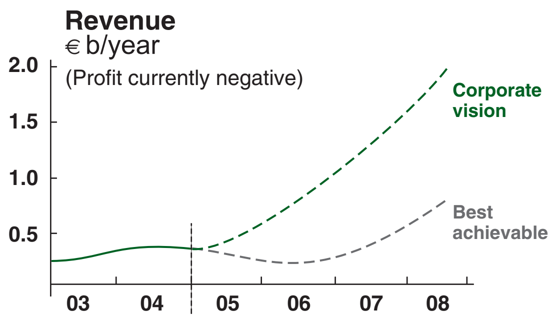


Figure 1.11: Revenue growth aims in a new market for an IT/communications firm.

Companies frequently establish a future vision and most standard strategy texts offer examples of vision or mission statements that set the tone for an organization's progress toward outstanding achievements. However, that is not what is being described here, which is a specific financial target that clearly cannot be hit due to the basic physics of the business system. Setting targets like this destroys credibility in any vision that management may articulate, undermining, rather than assisting in its achievement.

The contrasting case in Figure 1.12 concerns the credit card business of an East European bank. The firm had an overall corporate goal to achieve 15 % annual growth in profits. Given the attractive opportunity in the market, it set a "stretch goal" of 22 % growth. On examination, it became clear that the opportunity was already many times greater than this bank or its rivals had appreciated. None had

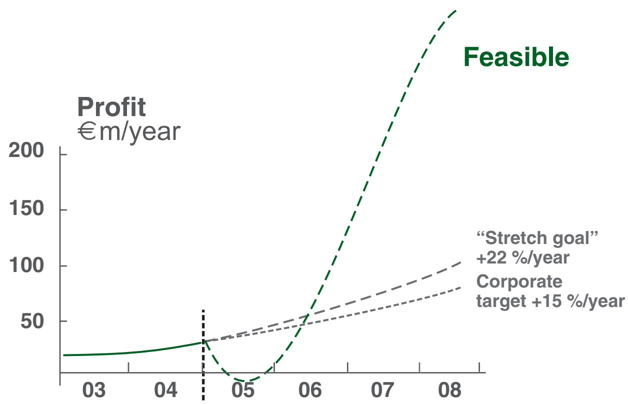


Figure 1.12: Profit growth opportunity for the East European credit card business of a major bank.

assembled the resources or capacity to develop the opportunity nor had they undertaken the necessary marketing to capture the potential. This division could readily multiply profits by many times over the next few years, provided that it immediately committed sufficient resources.

INAPPROPRIATE PERFORMANCE MEASURES

FINANCIAL RATIOS

This chapter's initial explanation of investors' financial concerns emphasized the importance of the future stream of cash flows, rather than any particular ratios at a point in time. It also pointed out that financial ratios can be easily manipulated in the short term, to the detriment of future profits. In general, then, when looking at strategy, management should be giving higher priority to how profits will grow over time, rather than to these ratios.

This is *not* to say that financial ratios are unimportant. If they are not healthy, or cannot be expected to move to healthy levels, then management will not be able to deliver on its strategy goals. Nevertheless, we argue strongly that management should switch from being driven by financial ratios to taking control of the absolute scale of financial results.

This implies that profit margin, return on capital or any other financial ratio should *never* be chosen as the metric on these performance-over-time charts. Instead, the charts should be populated with absolute values of profits or revenues (e.g. $m/month), or with absolute values of business activity, such as sales volume (e.g. 1000 units/month) or factors that drive that activity. In many businesses, customer numbers are an obvious choice. Certain sectors have rather particular business drivers. Construction companies, for example, need to anticipate the number of future projects and oil companies focus on how their oil reserves will change as existing fields are depleted and new discoveries are made.

Care is needed, though, if the strategy focus is on revenue growth or its drivers. This implicitly assumes that the costly supply side of the business will be fine—that it will be soundly developed to be affordable and sufficient to win and support revenue aspirations. If this might not be the case then attention should probably be moved to the revenue *and* cost prospects, i.e. to likely profit results.

In nonbusiness cases, too, a natural starting place is with likely future activity rate, or with the factor that drives that activity—e.g. the number of diabetes sufferers mentioned above, which drives activity rates for various medical services. Voluntary organizations supporting disadvantaged groups will focus on the likely future rate of demand for their services, driven by the number of people served. Police and armed forces will be concerned with the likely rates of criminal or hostile activity and therefore with the numbers of criminals or enemy forces driving those rates.

Again, this is not to say that financial viability is unimportant or that financial ratios should not be tracked to ensure an organization's viability. However, this is not the strategic focus—an organization's financial health should serve its purpose, rather than being its master.

MARKET SHARE

In some industries, management is focused—sometimes seemingly obsessed—with market share. There are a number of problems with this measure as a basis for strategy. First there is the rather simple point that you will enjoy larger sales with 25% of a $100 million/year market than with 50% of a market that is only $20million/year in total.

Secondly, market share is merely a coincidental ratio between sales and the total market, so a company has no decision levers that connect directly to this ratio. It is *sales* that any decisions or policies will affect—by winning customers and persuading them to buy more. The same applies to your competitors, so when you track market share, you are mixing up the consequences of both your own choices and those of your rivals.

Thirdly, seemingly small movements in market share can disguise big underlying changes. This may delude management into thinking nothing much is happening and that nothing much *can* happen. In the case of a mature pain-relief product, market shares were changing very little while, in relation to the company's sales rate, many new customers were acquired and others lost. A new focus on reducing customer loss rates highlighted the potential for real sales growth that the company had not seen for years. Market share did increase as a result of developing a clear picture of how sales might grow, but no amount of attention to this ratio, or the tiny fractions by which it had changed from year to year, revealed anything useful about what the company should do.

A competitor's achievements or failings also contain important information—such as successful acquisition of new customers or the failure of a marketing campaign to boost customer purchases. Your market share may have gone up or down by a percentage point or two during a particular year, while a large competitor has lost 20% and a new rival has won a significant share. Both those changes contain much more useful information than the marginal shift in your own situation. Your strategy should incorporate learning from the things that the new rival is doing and avoiding whatever difficulties the loser experienced.

PERCENTAGE GROWTH RATES

The growth rate for a market or business is another common indicator that can be highly misleading. Again there is the simple observation that 10% growth in a \$100 m market is more actual business than 50% growth in a \$10 m market.

The limited relevance of this percentage measure is highlighted particularly as new markets emerge or new businesses develop. At some point in their history, Skype and Amazon.com alike probably hit a level for their customer base that was three times the previous year, so their growth rates were 200% per year. However, this percentage contains no useful information. Absolute numbers, on the other hand, are critical—specifically, the number of new customers and their future revenue potential.

When markets are developing, market growth rates and market share measures both mislead management into ignoring the *potential* customers, sales and profits that will become available as this potential develops. This has led to the sound suggestion that "opportunity share" is a better issue to track.[13] Skype's market share of the 2005 VoIP telephony demand was much less significant to its future prospects than was the fraction of potential demand that it had captured.

The importance of opportunity share is not limited to new technology industries. In 2004, the Chinese insurance market was worth 150 bn yuan (\$18 bn) and growing at a reasonable, if not spectacular, rate. As China opens its markets to foreign participation, large insurance companies are scrambling to grab a share, often by acquiring local distributors. The real prize, however, lies with the vast numbers of customers who are currently uninsured but likely to become available as income levels rise. Ill-advised attention to current market share is leading some to sign up poor quality business, where salespeople move from firm to firm, taking their clients' business with them.

BENCHMARKS

Something of an industry has grown up for research organizations that survey firms in a sector and sell back to them anonymous performance rankings for all the firms on various measures. Individual companies can then compare their performance on a specific issue with "benchmarks"—the best performance to be found among their competitors.

Benchmarking may help to ensure firms are with the pace on key measures of operating performance, like quality levels and productivity. This may be fine when you are comparing like with like, for example car makers with similar product ranges, but it can be dangerous when firms are operating with significant differences.

One oil company participated in a benchmarking study that included comparisons of maintenance spending. This company's expenditure per unit of production was somewhat greater than the "best in class", and the gap represented huge potential savings. Sure enough, by pursuing this benchmark, costs were reduced and profits boosted—for a while. Five years later, the company's equipment was in such a poor state that breakdowns and emergency repairs soared. There were even worries about safety being compromised. Spending had to be raised far above the original rates just to stop things from continuing to decline. Even if you are comparing yourself with similar competitors, the danger is that the allegedly best-in-class competitor may itself be making a mistake.

MULTIPLE AND CONFLICTING OBJECTIVES

Most organizations discover that it can be risky to focus on one performance measure alone. Pursuing profit growth might be achieved at the expense of losing sales and market share, if it is achieved by raising prices, which could lead to losing customers. Consequently, many companies have an eye on both profits and sales volume (or less advisedly, market share). Conversely, some companies focus on market share believing that profitability will follow. This assumption received strong support from research in the 1960s and 1970s, which seemed to show that firms with higher market shares were typically more profitable than firms with less. This encouraged many companies to pursue increased share at almost any cost, neglecting the true reasons why larger firms were more profitable. While the correlation may have been statistically significant, it did not follow that market share *caused* profitability. More successful firms generally had better strategies and management of their operations, resulting in both growing sales volume *and* profitability.

Few firms today pursue profitability or sales growth alone—or any other single measure. Most pursue a balance between these two items, and often more, recognizing that it would be foolish to ignore the factors necessary for the sustained health of the business. Those factors often include "soft" issues, such as reputation, service quality or product appeal. The observation that firms need to track and manage performance on multiple dimensions has led to the widespread adoption of "balanced scorecard" systems,[14] which lay out a range of mutually consistent performance measures covering customer-related, organizational, financial and operational factors.

In practice, organizations cannot avoid simultaneously tracking several measures. Therefore, our analysis of strategy dynamics will always track multiple measures, even when it starts from a single primary indicator of how performance is changing into the future. This will enable management to see how conflicting aims are changing in relation to each other, and to make appropriate trade-offs continually as the future unfolds.

TIMESCALES

Most examples of performance challenges discussed so far have played out over recognizably strategic timescales—several years at least. However, not all strategic situations have such long-term horizons.

The example of Skype already illustrates a situation that is evolving rapidly. For the organization to simply watch progress from year to year would be far too casual. "Strategic" does not equal "slow!" Even though concern is with future performance, short-term conditions and events can have a big impact on longer term outcomes.

An issue, decision, opportunity or challenge is "strategic" if it is likely to significantly alter the trajectory of future performance.

Take the case of a pharmaceuticals company facing an attack by its largest competitor. The general manager of this €250 m/year business unit discovered he had four weeks to prepare for a major competitive onslaught. Why the urgency, and why is this short episode strategically important?

The market in question is travel vaccines, so sales build strongly during the pre-vacation period of May through June. There are five to six major diseases covered by the available vaccines, such as hepatitis A and B and typhoid. The market in the region where this attack is about to break out is worth approximately €500 m/year and is growing.

This company has 50 % of the market, and the major rival has about one-third, with the rest being served by smaller firms. Both of the large companies have an almost complete range of vaccines, except that this firm has the only vaccine approved for one major disease, a product that generates €50 m/year of the company's revenue and one-third of its profits.

The threat arises as the major rival announces its own alternative—a near-identical molecule that has just been approved. Doctors are delighted, because the competitor has a track record of undercutting on price by at least 15 %. The competitor's salesforce of 50 is excited, because they have long suffered resistance from doctors due to this gap in their product range. Their company inundates the medical journals and doctors' surgeries with advertizing and promotional literature. One year ago, this same rival successfully stole 40 % of the company's sales on another product within three months of a similar launch.

While this situation will play out over a few months, it is *still* a strategic issue. Losing a substantial fraction of this critical market threatens the cash flow that supports the salesforce, R&D and marketing expenditure. Failure will demoralize the company's salesforce, and encourage many to leave—most likely to the competitor! The company has historically sustained higher prices by offering better customer support, but this is costly, and the price premium that funds this service is threatened by the competitor's low-price positioning. Overall, this single episode could be the start of an unstoppable decline for the whole division. Figure 1.13 shows two versions of this division's short-term sales.

As things turned out, this company was able to fend off the attack by its competitor without even having to reduce prices. The defense included exploiting inaccuracies in the competitor's claims for its product, loading the doctors' inventory with their own product, and undermining the morale of the competitor's salesforce and their commitment to the new product.

Even though many organizations operate in environments that move quickly, senior management is still surprisingly committed to annual planning systems that have no capacity to respond to such rapid changes.[15] Budgets are set, say, in December for the coming 12 months and managers are held to those numbers regardless of unforeseen events. This results in errors of two kinds. As the year progresses, unforeseen difficulties arise—a competitor launches a better product for example—but the company still carries on as though the original sales target for the year was correct. Alternatively, things may turn out better than expected—perhaps customer adoption accelerates well ahead of forecast—but sales and marketing budgets that were chosen on much more cautious assumptions are immovable.

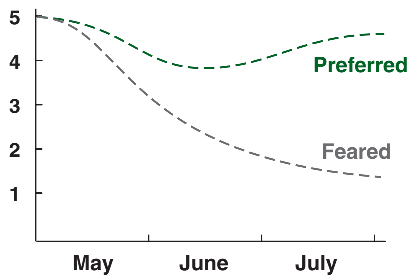


Figure 1.13: Sales projections for pharmaceuticals firm facing new threat—000 packs per month.

PERFORMANCE AIMS IN DIFFERENT CONTEXTS

The Amazon.com example features the pleasant challenge of sustaining growth that is already strong. Not all organizations are so fortunate as to be concerned only with how quickly they can keep growing.

STABILITY

Many firms, particularly in developed economies, operate in markets that long ago went "ex-growth", with every customer who might be interested in taking the product or service already doing so. Examples include utilities such as power or water supply, fast-moving consumer goods (FMCG) such as cleaning materials or food and drink products, and well-established services such as hairdressing.

There is a difficult balance to achieve in such cases. On the one hand, operating in a low-growth or no-growth market is not sufficient reason to assume that no growth is possible. On the other hand, efforts to pursue growth that are not realistically attainable can be badly damaging.

One possibility for driving growth in mature markets is to challenge the reasons that are assumed to be preventing growth. This occurred in the cinema industry in the 1970s. Until then, it had been widely assumed that movie going was doomed by the growth of TV and other home entertainment. Investment by film studios led to a stream of new, big-budget movies, and cinema operators developed much-improved cinemas, which brought the industry back into growth.

Even if the industry is irretrievably mature, growth in sales and profits can often be taken from competitors or substitutes (products that serve the same customer need, without being directly competing products). Firms in such markets are often satisfied to take small points of market share from their competitors and, if sustained over a long enough period, such creeping progress can indeed lead to a significant change.

However, more substantial performance may be possible, as the earlier example of the pain-relief product shows. For this brand, simply slowing the churn rate among consumers would allow sales to grow, which could be achieved with a more focused marketing strategy than previously employed. As a result, the renewed sales growth could be initiated with a *reduced* marketing budget, leading to a disproportionate increase in profits (Figure 1.14).

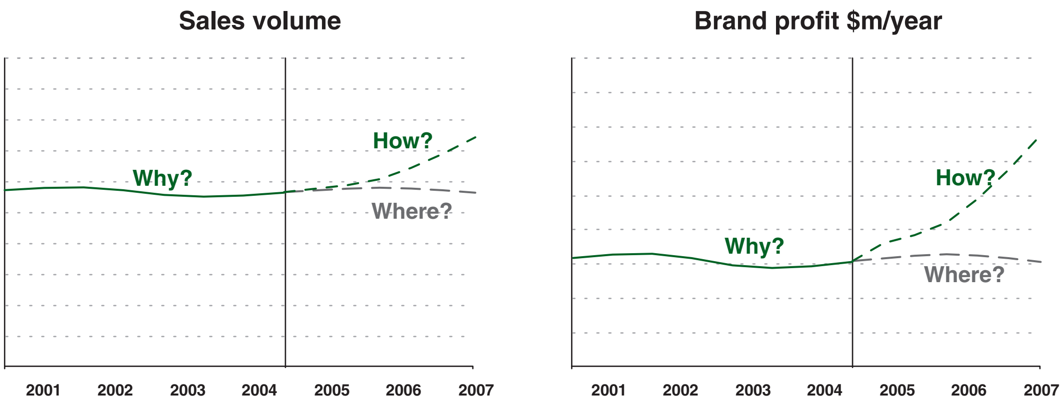


Figure 1.14: Profit opportunity for a product in the low-growth painkiller market. (Actual data are confidential.)

While it is important to seek opportunities for profitable growth in low growth industries, it is also essential to avoid pursuing growth that will damage the business. One company that encountered this danger at least once in its history is McDonald's (see box).

In spite of declaring a *lower* target for earnings growth, the net income of McDonald's actually rose from $893 m in 2002 to $1 471 m in 2003 and $2 279 in 2004. Nor did it take long for investors to recognize the realism of this new strategic focus. The stock price, which had fallen from over $29 to $15 by the end of 2002, recovered to $24 by the end of 2003 and climbed to $34 by late 2005. All of these activities occurred during a time of immense pressure on the company from public concern with the health effects of its products.

Blockbuster Inc., the global rental store chain for in-home movies and games, also has to sustain performance in mature markets. The company boasts more than 9 000 stores throughout the Americas, Europe, Asia and Australia. It built its business by renting videos during the boom in consumer purchases of video recorders in the 1990s. Although it has since moved on to renting out DVD films and video games, it is constantly threatened by substitutes for its service, such as the increasingly wide range of movie transmissions by cable and satellite TV, or postal distribution of rental DVDs from the likes of Netflix and Amazon.com.

THE GROWTH-TO-MATURITY TRANSITION

The contrast between the strategic imperative facing firms in high-growth markets and those in more mature sectors comes into sharp focus when industries

Extract from letter to McDonald's Shareholders from the Chairman and CEO, included in 2002 Financial Results

... Over the past several years, McDonald's has lost momentum ... and lost what it takes to make customers feel special. We have struggled to grow our business in the face of weak and uncertain economic conditions around the world. The result has been disappointing financial performance. This is not acceptable.

It didn't take me long to realize that some difficult—albeit necessary—decisions had to be made. To start, we are ***targeting a lower earnings growth*** *rate. Given the nature and size of our business,* ***the prior earnings per share growth target in the 10 percent to 15 percent range is no longer realistic****. Yet, we are committed to returning the Company to reliable, sustainable annual sales and earnings per share growth. We also have decided to lower our capital expenditures compared with recent years until we achieve significant improvements in sales, margins and returns at our 30 000 existing McDonald's restaurants.... McDonald's is in transition from a company that emphasizes "adding restaurants to customers" to one that emphasizes "adding customers to restaurants."*

(Bold type added for emphasis.)

move rapidly from growth to maturity. Management has to switch from driving exploitation of the emerging opportunity to conserving what has been accomplished and extracting sustainable value into the future.

The cellphone industry exhibits this transition clearly. As markets developed, cellphone operating companies engaged in a race to sign up new subscribers, offering generous handset subsidies and reseller incentives. However, as penetration of cellphone ownership approached 100 %, marketing strategies began to demonstrate a significant shift.

First, operating companies tried to persuade subscribers to switch from competitors' services to their own. It did not take long, though, for cellphone operators to realize that stealing each others' customers was ultimately a zero-sum game. With the costs of signing up a new subscriber often more than the full-year income that each might generate, with usage charges falling and with churn rates (the fraction of customers leaving each year) hitting 25 % or more, the financial case for such ferocious competitive efforts quickly became marginal. Most recently, then, the marketing efforts of major operators such as Vodafone and Verizon Wireless have changed once again. They now focus on raising usage by existing subscribers, both for phone calls and for additional services, rather than on enticing subscribers to switch.

Not all companies recognize this need to change strategy as growth slows. The dotcom boom of the late 1990s saw many casualties of this error, one example being Exodus Inc.,[16] a provider of Web site hosting and related services (Figure 1.15).

The company persisted in employing large numbers of people and spending large amounts of money despite industry research showing that the remaining potential for its services was approaching zero. The cooling love affair with everything e-based in 2000 saw the demise of some of its main customers and this, combined with the company's relative inattention to supporting its *existing* customers, raised customer churn to a rate that matched its win rate. The cost of pursuing unachievable growth quickly overwhelmed the company's revenues, leading to a collapse in earnings, and the bankruptcy that ended its existence as an independent entity.

The United Kingdom satellite broadcasting company, British Sky Broadcasting PLC (BSkyB, see www.sky.com), is another firm facing the challenge of this growth-to-maturity transition. As its name implies, the company broadcasts digital TV from satellite, and offers a very wide range of channels for viewers who subscribe to its service. The uptake of this service grew strongly from 4.5 million at the end of 2000 to 8 million at the end of 2005 (Figure 1.16). With a total of 26 million homes, the market appeared still to offer ample opportunity for further growth, especially since, unlike in the United States, penetration of cable TV was low (3.8 million) and showing little growth. The company therefore committed to still higher penetration, promising investors that it would acquire 10 million subscribers by 2010.

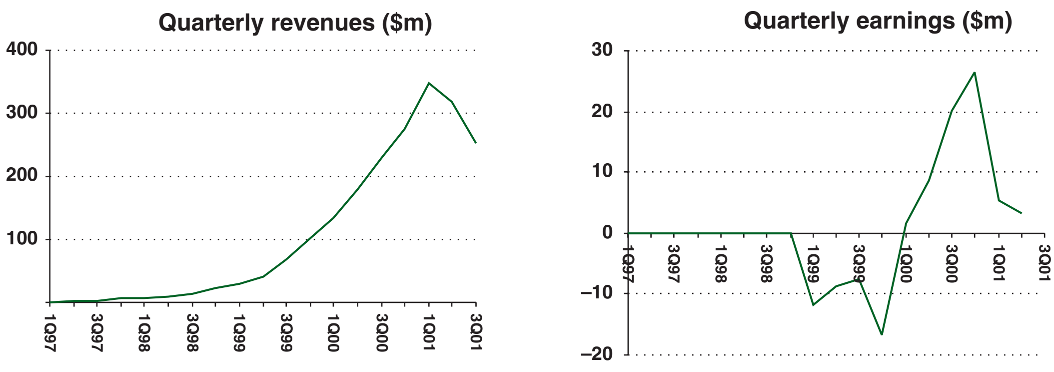


Figure 1.15: Revenue and earnings history for Exodus Inc. 1997–2001.

Unfortunately, reaching this objective presented a number of challenges. First, 2005 saw the strongest growth yet in penetration of "Freeview" services—digital TV broadcast direct-to-home (DTH) from terrestrial transmitters, provided free of charge, though with a limited range of channels. Viewers of this service hit 4.6 million in 2005, an increase of over 1.5 million from the previous year. At the same time, churn rates amongst Sky's own subscribers continued rising, exceeding 11 % or nearly 0.9 million per year. Nevertheless, the company persisted in its growth efforts, with costly increases in marketing spend and discounting of its services. The curious feature of this situation is that no one actually asked the company to make the promise in the first place.

Notice that Figure 1.16, like the chart for the vaccine's sales above, shows two alternative outcomes—a "preferred" projection, which reflects how management would like to see the future turn out, and a "feared" view of what might happen if things do not work out. This pair of projections is not simply a comparison between high and low growth. Notice, for example, that the feared future starts out on much the same trajectory as the preferred. Rather, each projection depicts a coherent story of plausible events. In this case, the preferred forecast arises if viewers are slow to take-up the Freeview alternative, leaving plenty of potential for Sky to win new subscribers. In the feared alternative, take-up of Freeview is rapid, so although Sky initially keeps winning new subscribers who really want the full range of channels, the remaining potential quickly drops, so that the rate of new subscribers soon approaches zero.

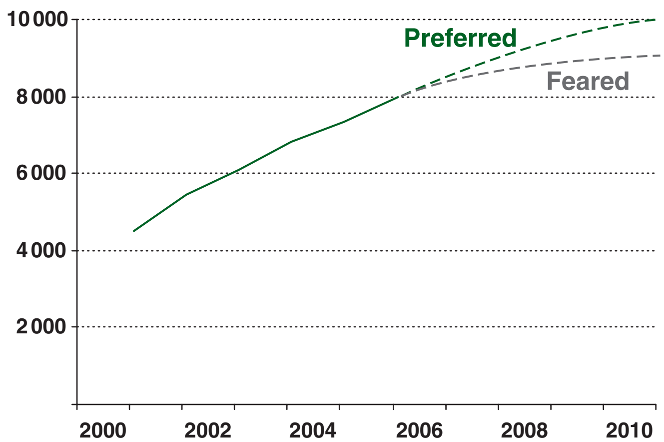


Figure 1.16: Subscribers to BSkyB at year end.

DECLINE

Other firms find themselves facing conditions that are still more challenging than mere maturity in their industry—some sectors experience inexorable decline. The people who head such organizations are rarely recognized with the heroic status accorded to leaders of exciting growth businesses. Yet any success they achieve is no less important to their investors, and often requires considerable skill and determination.

A current example concerns the switch from photo-film to digital cameras. According to PMA Marketing Research, consumer photographic print volumes in the United States fell from about 30 billion in 2000 to less than 19 billion by 2005, as uptake of digital cameras made the use of traditional photo film increasingly obsolete. Retail travel stores face a tough time as travelers switch to the online purchase of holidays and other travel, and newspapers face declining advertizing revenues as advertizers switch marketing budgets to online channels. Not all such challenges are driven by changes in technology, however. Firms in the European defense industry faced dramatic falls in demand for military hardware following the collapse of the former Soviet Union.

The pain of industry decline need not, however, be equally shared by all. Strong strategic management enables businesses to thrive at the expense of their competitors. Even as the switch to digital photography began to bite between 2000 and 2003, Kodak's arch rival Fuji captured market share, worsening Kodak's difficulties. In the European defense industry, BAE Systems PLC saw revenues rise between 2000 and 2004 from £12.2bn to £13.5bn as its strategy took business away from weaker rivals. In many cases industries see widespread rationalization as those weaker participants close down or sell out to the stronger survivors. This is further evidence that there can be substantial strategic opportunity in apparently difficult industry conditions.

We should not leave the issue of performance in declining situations without a word about organizations whose purpose is in effective to *accelerate* decline, even to the point of putting themselves out of business. Many voluntary organizations aim to eliminate some hardship or problem, such as reducing homelessness, drug use or domestic violence. "Success" for such organizations would mean achieving zero rates for their key indicators of harm, at which point the organization's purpose would cease.

Many public sector and nongovernmental organizations also recognize success in terms of eliminating the need for their work. In December 2005, the United Nations (UN) was able to announce the conclusion of one of its largest missions ever to eliminate civil conflict, as it planned the withdrawal from Sierra Leone of the last of its peacekeepers—a force that had once numbered 17 500.[17] The force had been deployed in 1999 to restore government control and to disarm and demobilize fighters. The UN's intervention was prompted by a further escalation in an eight-year conflict that had killed 20 000 and left thousands more badly injured. Essentially, the "performance objective" was to reduce to zero the rate of deaths and injuries (Figure 1.17).

Note that this chart again makes explicit both a preferred and feared future from the point in time at which the situation is being assessed, each of which reflects a plausible story of how the future may develop.

Fulfilling those aims had not been without difficulties. In early 2000, more than 700 UN peacekeepers were abducted and later that year 11 British troops were taken hostage by the militia group, the West Side Boys. This event, however, prompted a sweeping rescue operation that all but eliminated that militia, sending a powerful signal that the UN force was serious about its intent. Over the subsequent five years, 72 000 combatants were disarmed and demobilized, and over 30 000 arms were destroyed. By 2002, the major conflict was effectively over, with virtually no casualties being reported.

FUNCTIONAL PERFORMANCE OBJECTIVES

Concern with improving performance over time is not limited to organizations' overall strategic aims, but may also arise on issues concerning just a part of the organization—staffing, marketing, product development, information systems, etc. Success in these specific functional areas may support a wider improvement in overall performance, but they often deserve attention in their own right.

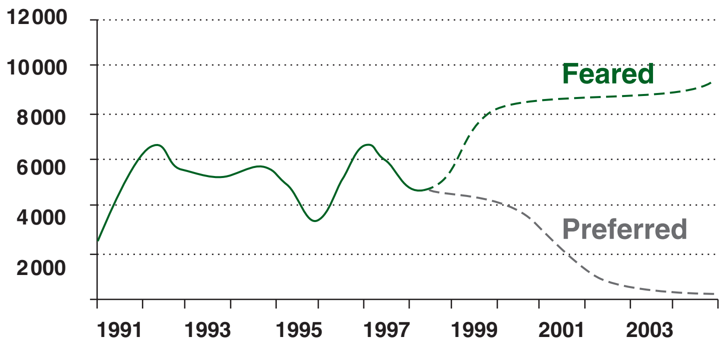


Figure 1.17: The estimated number of deaths and serious injuries from civil conflict in Sierra Leone.

Among the cases we have already discussed are some that naturally present challenges for the sales and marketing functions—growth in subscribers for BSkyB and sales for the painkiller, for example. In others, sales and marketing clearly have a major role to play, such as McDonald's recovery in earnings. Time charts for sales volume and revenue are an essential starting point for any strategy intended to improve these performance indicators. In many cases, this may be the major focus for improving profits, provided we can be confident that the cost elements are well managed.

Doing it right: properly defining a performance challenge as a time chart

If a chart of performance over time is to provide a strong foundation for subsequent analysis and development of strategy, it is important that it is constructed properly

- Include a clear numerical scale (sales volume, profit, customers, etc.).
- Specify the timescale over which the situation is expected to play out (e.g. eight quarters, 12 years, etc.).
- Include as much history as may be important to explain the current situation (last four quarters, last three years, etc.).
- Show the *time path*—how much and how fast the situation has changed over the past, and may change into the future.
- Include information for this time path with as much frequency as is necessary to display important changes—it is not good enough to show only annual numbers, for example, if profit or anything that has driven that profit has changed substantially from quarter to quarter or month to month.
- Show alternative futures, especially contrasting what may feasibly happen if the strategy is poor or the issue is not dealt with well, versus what might realistically be expected if a strong strategy is pursued or the issue is handled well.

Sales growth is not always an appropriate aim, and in some cases can even be a major error. As the Exodus Inc. case illustrates, many organizations may be better advised to hold on to good quality business—larger, high-value customers who generate high rates of gross profit, while being readily supported by affordable sales and service capacity—rather than scavenging for any growth they can find, regardless of whether it can be translated into profitable business.

Even when sales growth is the correct objective, it can be a mistake to leave *all* such problems at the door of the salesforce or marketing department. A number of failings in other functional areas of the business can compromise sales success—poor product quality or lack of capacity in production and distribution can undermine otherwise successful sales effort. It is also important to remember that sales growth is not only the result of what has been won, but reflects what has been lost too. Poor service quality can cause customers to leave, including even such apparently trivial issues as poor management of cash receivables (collecting money that customers owe) in the accounting function.

STAFF CHALLENGES

The earlier telecom company example has already shown how staffing difficulties alone can undermine achievement of otherwise quite plausible objectives. That company needed to develop a strategy to initiate and sustain rapid growth in the specialist staff it required. Staffing challenges are common sources of difficulty, and can be quite difficult to solve. A sound strategy for staff development can be particularly tough when business relies on highly skilled people, such as in consulting companies, law firms and other professional service organizations.

One mid-size law firm had grown successfully, providing specialist services to medium- to large-sized companies. Its reputation with the clients it had won over previous years was such that it was constantly being asked to do more for those clients, so had little need to seek new ones. The firm found itself losing talented people, which made it increasingly difficult to serve its clients' rising demands (Figure 1.18). Staff losses were concentrated amongst lawyers with 5–10 years' experience. This amplified the problem, since this group carried the burden of leading the work for client projects. Shortages at this level threatened the firm's ability to undertake work that had been sold by partners, or to complete that work to a high standard. This risked damaging established client relationships, ultimately threatening a fall in the firm's revenues, rather than furthering the growth it sought.

Ironically, the cause of this trouble was the firm's growth in the four to five years before 2003. A large number of young lawyers joined during this time and quickly progressed through to senior partner positions by winning new client relationships. They were well rewarded, so had no reason to move on at that time.

Exit interviews with the lawyers who were leaving suggested two problems. First, they were overburdened with the increasing volume of work coming from clients. Normally, such professionals put up with this pressure for the promise of substantial rewards when they achieve partner level. However, the second reason given was

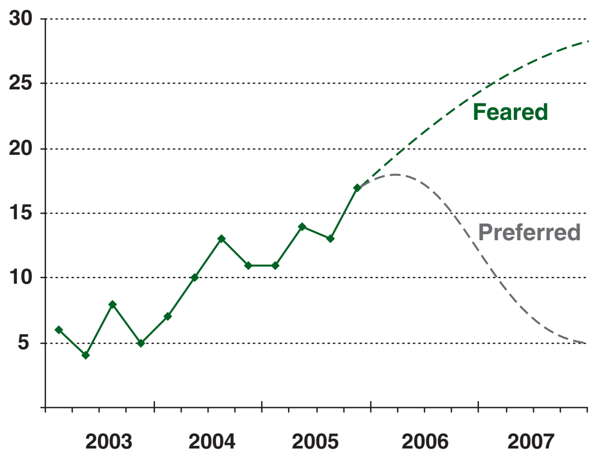


Figure 1.18: Quarterly staff losses at a mid-size law firm.

that they faced the prospect of being stuck at their grade, with limited opportunities to progress to partnership themselves. With little chance of progress, these talented people were choosing to pursue their careers elsewhere, leaving those who had joined the firm earlier and had reached more senior positions to cope with the client work themselves, which increased further the work pressure.

To take a more positive example, progressive improvements in staffing issues can be powerful drivers of performance. Not many people may know of Yum! Brands Inc. (www.yum.com), but they do know of the Kentucky Fried Chicken, Pizza Hut, and Taco Bell chains the company owns. Spun off from PepsiCo in 1997, Yum!'s management appreciated that treating its franchisees and staff well was vital if those people were to keep customers happy. By 2005, US restaurant employees were on average staying 12 months with the company, far longer than is typical for the industry.

Not all staff challenges are about obtaining the resources needed to drive growth. It is not often appreciated that a management hierarchy is a powerful system for "breeding" growth. As young people are brought in at junior ranks, others expect to be promoted to middle management. Existing middle managers hope for senior positions and ambitious senior people want the top jobs. Since there can be many times more people at any level than at the level above, only a small fraction can expect a promotion in any year.

For example, if there are 1 000 juniors and 100 middle managers, of which only 20 per year are leaving or being promoted, then only 2 % of juniors can hope for promotion in any year. There are only two solutions to this problem—either the organization must be growing (just 5 % growth per year means that 7 % of juniors can be promoted in this example), or else senior people must be moved out to make space for juniors. The flatter the organization, and the wider the span of control from one level of seniority to the next level, the more serious this issue becomes.

Certain additional factors can worsen this need to speed up the turnover of staff. In 2004, one large United States financial institution had the laudable aim to increase the proportion of people-of-color and disadvantaged staff amongst its senior management from 60, or 6% of that rank, to 200 by 2008 (Figure 1.19). Turnover amongst senior people was running at less than 5% per annum, and there were few experienced minority staff in the pipeline, so unless something else could be changed, the entirely well-intentioned objective could not possibly be met. This would be very serious for the company's reputation, causing potentially considerable damage to its *future* hiring needs, and even to its business revenues.

Incidentally, this challenge is dwarfed by that facing some South African businesses, where regulations require representation among all management grades for people-of-color to reach levels representative of the population as a whole within just a few years.

The special case of zero targets

Functional issues, like the overall objectives of certain noncommercial organizations, sometimes make it appropriate to "aim for zero." One example that has transformed business performance in many manufacturing industries is the pursuit of zero defects—"the only acceptable rate of product failure is zero, so wherever we are starting from, that is the target, and we will hit it by (date)." However, manufacturing is not the only setting in which zero may be an appropriate aim. Call center operations may aim for zero unanswered calls, and accounting departments may aim for zero errors.

Yet care is needed to avoid setting a zero target when this is not advisable, even though one may think it would be. It is not good in most cases to have zero staff turnover, either for organizations or for the staff who work for them. New ideas need to be brought in, people need to develop in ways the organization cannot fulfill, and so on.

Lastly, zero targets will frequently conflict with other performance aims. Whilst it may be highly desirable for a call center never to fail to answer a call, this may only be achievable at an unacceptably high cost.

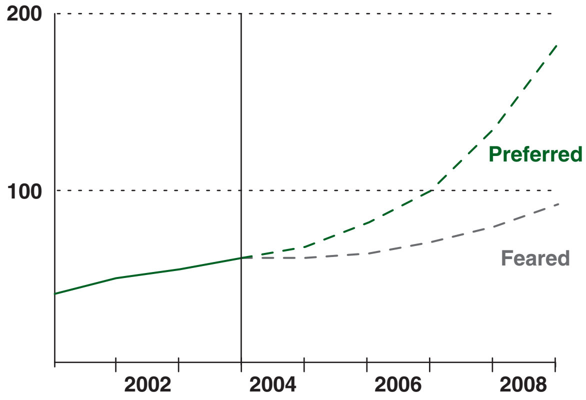


Figure 1.19: Number of minority staff amongst senior management at a large financial institution.

PRODUCT DEVELOPMENT

Major drugs companies provide a good example of how serious time-based challenges can be in research and development programs (R&D). These firms have grown to their present scale over several decades, on the back of a stream of major drug discoveries—highly effective treatments for widespread and costly ailments, such as heart disease, stomach ulcers, and depression. These so-called "blockbuster" drugs, with annual sales of $1bn, are so critical that firms pursue enormous R&D investments in an effort to discover more such drugs. The imperative to discover big revenue products is intensified by the limited patent life for drugs, which means that high prices and revenues can only be sustained for a limited number of years before sales are decimated by low-price generic products—essentially the same product, but without the brand name.

For these firms, the performance over time of concern is the rate of new product introductions that offer a high potential revenue stream. Unfortunately, having successfully developed drugs to treat the most widespread complaints through the 1980s and 1990s, companies are left only with complaints that are suffered by fewer people in developed economies, or more complex complaints for which wonder drugs are harder to find.

Controversially, the last large-scale opportunities for disease treatment are concentrated among the populations of the world's poorest countries. This has led to accusations that drug firms are ignoring the needs of the poor due to their inability to pay the high prices needed to justify the large R&D costs involved. In other industries, firms have found ways of serving the poor profitably,[18] an aim that many pharmaceuticals firms also pursue.

CAPACITY

Time-based challenges frequently arise in the building of capacity, whether for production, distribution or service.

Retailers of all kinds face this challenge—"capacity" in their case consisting of retail stores. We have already seen in McDonald's an example of such a company running out of good quality locations where they can expect strong incremental sales. Supermarket chains such as Wal-Mart in the United States, Tesco in the United Kingdom or Japan's Daiei also used up the best locations long ago and must work hard for new opportunities, either developing novel retail formats that can reach smaller markets, or else switching to emerging markets.

Manufacturing capacity can also pose strategic challenges. Roche Diagnostics is a major global producer of blood test meters for diabetics, under the Accu-Chek brand (www.accu-chek.com). As explained earlier, numbers of people with this disease are very large and growing quickly, although only a fraction of these are severe enough to need blood meters. During 2004–5, the company introduced two new products, which it hoped would extend the brand's uptake amongst meter users. In addition, the company's existing meter users would likely want the new products, since machines typically last just three years, and users are naturally interested in having the latest model. Since nothing exactly similar had occurred in the market before, at least on such a scale, the company faced great uncertainty regarding the likely rate of uptake for the meters, and therefore the capacity required to fulfill that demand (Figure 1.20).

Neither the replacement rate amongst existing Accu-Chek users nor the penetration rate among new users could be known exactly before the launch. The problem was exacerbated by uncertainty as to whether the two new products should

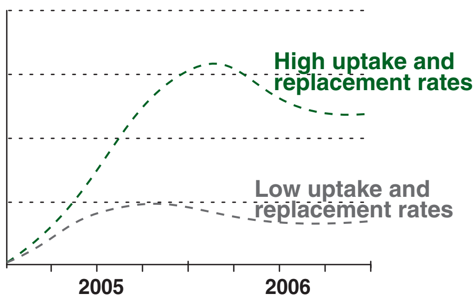


Figure 1.20: **Capacity requirement for Roche Diagnostics' new model blood test meters (actual data are confidential).**

be launched simultaneously and at the same time in many countries, or staggered over several quarters and different geographic markets.

This uncertainty posed a tricky question about how much production capacity to build for the new products—should initial capacity be sufficient to fulfill the highest likely rate of uptake, or be limited, leaving further expansion to be deferred until uptake rates became clear? If the latter course were adopted, what might be the value of potential sales that would be lost through inability to supply? Furthermore, what competitive risk might this pose that sales might be taken by the company's arch-rival, Johnson & Johnson, and other competitors?

Firms facing similar decisions risk making a subtle, but important strategic error. The business case for building higher or lower levels of capacity may take reasonable account of the medium-term trade-off between the higher cost of building plenty of capacity versus the loss of sales and profits from building too little. However, this is not the end of the story, since underprovision creates a serious strategic threat—in this case, the risk of medical advisors, retailers *and* end users all switching their allegiance to rival products. This would threaten not only immediate sales, but longer term business too. Yet such consequences are rarely factored adequately into such decisions for fear of missing quarterly earnings targets.

Another example requiring a strategy for capacity growth, this time from a public policy perspective, concerns the provision of biodiesel—an environmentally attractive alternative to diesel produced from petroleum. Although diesel is not a popular fuel for cars in the United States, it is widely used in Europe and elsewhere, and could potentially switch a large fraction of overall fuel consumption onto renewable sources. (Note, however, that if this shift were to occur on a large scale it would introduce a new problem, since the grain required to fill a large vehicle's tank would alternatively feed a person for many months.) Oil from crops, such as rape seed, and even old cooking oil, can easily be converted to motor diesel. It is already technically feasible for mid-scale diesel users, such as taxi firms, to operate their own small conversion plants.[19]

Since the technology is feasible and environmental benefits are so clear, why has this system of biodiesel production not swept the industry? Unfortunately, powerful forces are holding back growth in capacity. First, whilst purchase and use of a conversion plant may make economic sense at a particular point in time, fuel prices are volatile, driven both by the global supply–demand for petroleum and the short-term supply–demand balance for particular fuels. Unless tax policy is heavily skewed in favor of the new product, this uncertainty will likely continue, which makes investment in conversion facilities risky. The constraint on capacity is worsened by the impact of the same uncertainties for farmers who may be considering switching acreage on their farms to oil-producing crops. While they might see a good price for such crops in one particular year, these farmers cannot be sure when they are sowing crops that the same conditions will apply when it comes to harvest time. This adds further to the uncertainty facing firms wondering whether to install conversion capacity.

Equivalent issues apply to the addition of crop-based ethanol to gasoline in the United States and other markets.

For a government committed to raising the adoption of biofuel, a time chart of "the issue" would feature the historic growth in capacity (*why* have we come to be in the present situation), the likely future of capacity growth under current policies (*where* will we get to if we continue as we are), and an alternative higher growth aspiration (*how* we can drive growth at a higher rate, and to a higher level).

Functional challenges often need to be examined over short timescales. In fashion retailing, for example, the success of new product introductions is fundamental to the appeal of a store's overall product range. One such company operated a fast-test policy, in which it would test new product lines in selected stores for just two to three weeks before deciding whether to order large quantities for the whole chain. The company took on a new senior executive with much experience in the sector, who made a number of changes, such as reallocating floor space amongst product categories, and switching key product ranges to new suppliers because of better supply prices. Within weeks of these changes, the fraction of test products making the transition from trial to the core product range had fallen from 0.8 to 0.6 (Figure 1.21).

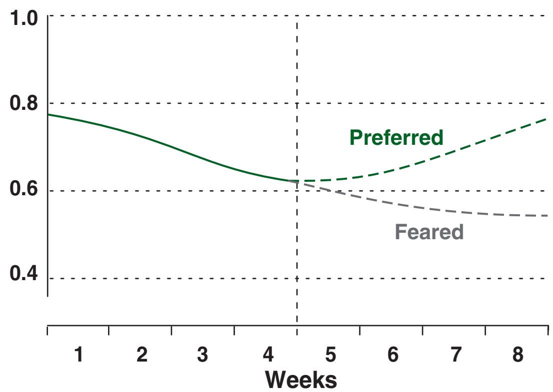


Figure 1.21: The fraction of fashion chain products successful enough to be added to the core product range.

The company faced a tough decision. It could try to reverse the changes, although it could not be certain which were most harmful, or whether some might, on their own, have been successful. They could also not be certain that all the original suppliers would be able to respond.

Again, though, why is such a short-term issue “strategic”? This seemingly isolated error hits several parts of the business. First, in addition to failing in the eyes of consumers, the changes led to the loss of other staff in the buying and merchandising group. Without these people, the company could not be certain of reestablishing good performance on this important issue. The reduced appeal of products sourced under the new arrangements also meant that those items that *did* make it to the core range suffered a faster fall-off in sales. Consequently, while discounted products previously featured little in the company’s stores, these came to represent a large fraction of both floor space and sales. Having previously been known for its high-appeal clothing, on which it could sustain high margins, consumers quickly came to associate the company with cheap goods at discount prices, making it difficult to reverse the changes. The particular market segment this company served is viciously competitive, with several similar chains fighting it out in most shopping areas. This company’s loss of position was quickly captured by rivals. Finally, if these problems were to continue for any length of time, they would make many of the stores uneconomic, resulting in closure and further loss of revenue and profit.

SUPPORT FUNCTIONS

A focus on performance over time is also a good starting point for functional departments whose primary role is to support other groups. Common examples arise in departments that provide information systems and finance/accounting services.

Sometimes such groups are run as profit centers—“selling” their services to other departments, to generate revenue, and managing their resources (largely people and equipment) to deliver adequate service at sufficiently low cost to make a “profit.” In other cases, these services are outsourced to independent firms, such as EDS Inc., CSC Inc. or providers from low-cost economies such as India, China or Eastern Europe.

When these functions are operated wholly or partly inhouse, their leadership is concerned with future levels of activity and providing the necessary resources to serve that activity. A starting point for establishing and running their strategy will be a time chart of projected activity rates and capacity, measured perhaps in full-time equivalent people, or person-hours per month.

Simply running the service for their customers is not the whole story for internal service functions. Such groups have the equivalent of a company’s “product range.”

This means they have to be concerned with product development, i.e. creating new services that the business may require. They may also offer project-based services to other parts of the business, creating the equivalent of an internal consultancy group. All such tasks add to the "demand" on their capacity, and ensuring that these tasks will be well implemented requires a time chart of expected future project numbers and the labor requirement these will bring.

Customer satisfaction is another factor that internal service functions share with businesses. In the case of business customers, poor service can lead to such customers deciding to switch to competitors. This is not necessarily so easy for internal users of service functions, but service department management is nonetheless keen to keep service quality high. Any drop can result in removal of support by their users for any spending they may need to make, and in extreme cases, poor service quality can drive internal customers to seek service from third-party suppliers—the equivalent of "losing customers." It is therefore vital for management of these service departments to track service quality over time.

INFORMATION NEEDS

An important implication of the time-based start point for functional objectives concerns the availability of the necessary information, especially when attention is focused on the time path of what is happening. Companies need to know: *why* have we come to be in our current situation?

Most companies can readily provide historic information on sales, revenue, costs or profits. Organizations are often less well informed, though, about important functional factors. The law firm suffering rising staff turnover described above is a rare case of a business that could lay its hands immediately on the staff loss numbers, quarter by quarter, not just for the firm as a whole but for any specific group. More often, while management may be aware that staff losses are increasing and that something needs to be done, it does not have such information routinely available and regularly scrutinized.

To illustrate the point, consider an example from the mutual fund industry, where highly skilled investment analysts and fund managers are vital. (These are the people who decide to invest or disinvest money in particular stocks, bonds or other investments.) Yet in the case of one such large firm, there was no routine tracking of staff movements. Consequently, when staffing was identified as the major issue constraining its future prospects, the only way to identify the seriousness of the challenge was to retrieve and analyse old payroll records from its archives.

Later chapters will expand on this issue of information needs, but for now it is sufficient to note that top-level performance factors need to be tracked, over time, their likely future trajectory needs to be assessed, and feasible improvements estimated. Moreover, this needs to be done with accurate, quantified measures—even for soft factors like service quality—and displayed and scrutinized in the form of frequently updated time charts.

CASE EXAMPLE: PERFORMANCE OF RYANAIR, THE LOW-FARE AIRLINE

The diagnosis of performance dynamics can best be understood by following a single example through the various stages of the analysis, starting with the principle of focusing on performance through time. The case developed through this chapter and later ones concerns the European low-fare airline Ryanair (www.ryanair.com). This case has been chosen for three reasons. First, it is a clear business model with which readers will be familiar. Secondly, very similar businesses operate in all regions of the world, and continue to be started, so the analysis can be readily replicated for similar airlines in North America, Asia, or other parts of the world. Finally, this business and others like it are well documented, with long histories of published data on key factors needed to complete the analysis.

Figure 1.22 shows the history of Ryanair's sales volume, revenue and profit, and two alternative futures. (This analysis examines profit at the level of earnings before interest, tax, depreciation and amortization(EBITDA).) The measure of sales volume is *passenger-journeys booked* (millions)—a key indicator reported by all airlines. This sales volume drives revenue, both through the fares paid for flights and various ancillary revenues, such as inflight food and drink sales and ground transportation. Profit arises from this sales revenue, minus the airline's costs, including those for aircraft, staff and marketing, as well as other costs driven by operating airports and routes.

The charts observe some important rules. There is a clear definition of each item, e.g. "passenger-journeys booked," not just "passengers." There is a specific scale on each item, and a clear timescale over which performance is examined. As in the earlier examples, the two alternative futures are not simply "best" versus "worst" cases. Each arises from a specific story of the future.

- In the preferred future, Ryanair continues to be able to find large numbers of new airports, between which enough passengers wish to fly for many additional routes to be economically viable. It remains sufficiently stronger

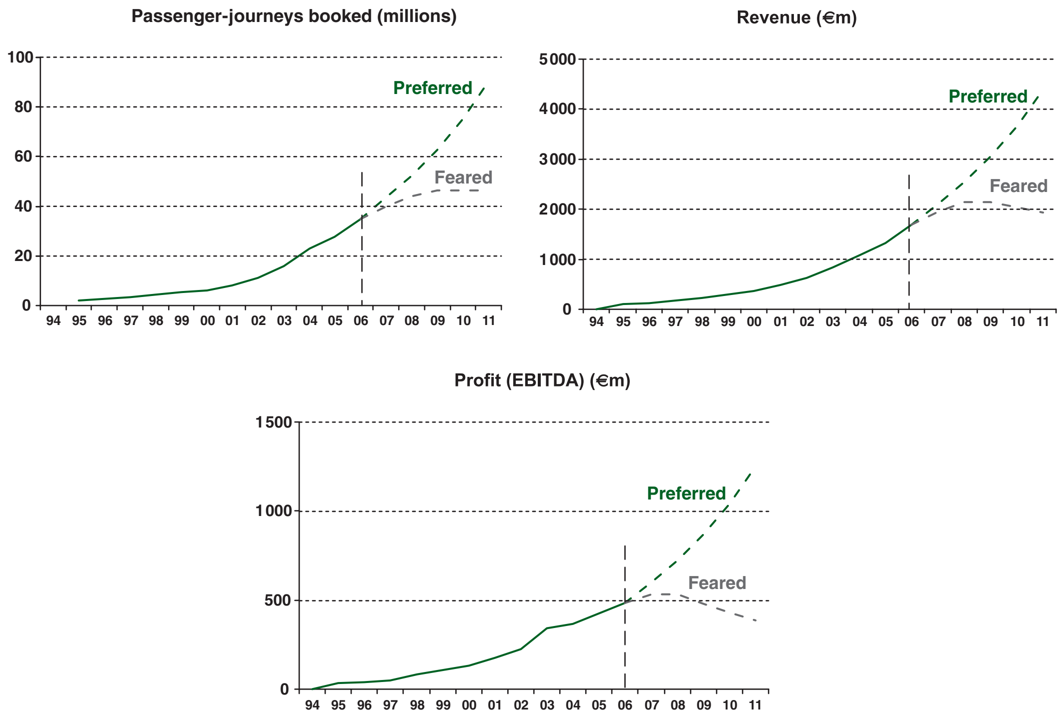


Figure 1.22: Historic and potential performance for Ryanair.

than competitors that it can fill its aircraft on those routes without excessively low fares, and continues to be highly efficient in delivering its service.

- In the feared future, it becomes increasingly difficult to find routes that are popular enough to deliver sufficient passenger volumes. Competitors capture many potential new routes before Ryanair can develop them itself, and competitive pressure on existing services hits passenger volumes and puts downward pressure on average fares. Although the airline continues to be operationally efficient, this is not sufficient to make-up for the slowdown and reversal of sales growth, leading to reduced profits.

Chapter 2 will also discuss this case example, and show how to trace out a causal analysis of these sales and profits time paths. Chapters 3 and 4 will then examine how the underlying resources of the airline have developed up to 2006, how they may develop into the future, and the interdependencies that explain why performance has progressed as it has, and might develop into the future. Later sections of the book will add to this core analysis by examining how competitive rivalry works, and show how to deal with important attributes of the business (e.g. the varying levels of demand on different routes) and "soft" issues, such as reputation.

Summary of Chapter 1

Investors in commercial businesses are concerned with the likely future growth in free cash flow, rather than with current financial ratios.

Investors and executives alike share a concern *to improve performance over time*. The same applies to stakeholders in voluntary organizations, public policy and other noncommercial cases, although the key performance measure may not be financial.

The history of performance up to now is important because it determines the trajectory on which future performance is heading.

Three key questions need to be answered in order to develop and sustain a sound strategy (Figure 1.23):

(1) *Why* has our performance to date followed the path that it has?

(2) *Where* is that performance heading into the future under likely conditions and current strategy?

(3) *How* can strategy be changed to improve that future performance path?

Figure 1.23: Three generic questions about performance over time.

Absolute values should be adopted as the top-level aims—cash flow, sales, customers—rather than ratios. Multiple measures may need to be pursued e.g. profit *and* sales, even though they may conflict.

Performance aims need to recognize the reality of the context in which an organization finds itself—e.g. a growing market versus maturity or decline. Decline may even be an objective for organizations whose purpose is to eliminate harm.

Large departments or functions of an organization may have challenges to "improve performance over time," as well as the organization as a whole.

SUGGESTED QUESTIONS AND EXERCISES

1. What are shareholders expecting when they invest money in a company?
2. What are the advantages and disadvantages of looking at market share and other ratios for a company when assessing its strategy?
3. Why can the percentage growth rate of a company's sales be a poor indicator of how well it is performing?
4. What are the three key questions concerning an organization's performance over time that management needs to answer? Under what circumstances might one of these questions not be relevant?
5. Give examples of nonfinancial measures that might be tracked by three different companies to indicate successful progress in their strategy.
6. Give examples of nonfinancial measures that might be tracked by three different noncommercial organizations to indicate successful progress in their strategy.
7. Give examples of nonfinancial measures that might be tracked by three different departments within a company to indicate successful progress in their strategy in a particular functional area.
8. Select an organization for which good information is publicly available (e.g. from case studies, newspapers or journals, or the Web). Use Worksheet 1, below, to sketch a time chart of both their historic and plausible future performance on one principal measure, observing all the rules for constructing such charts. Add a second time chart for a supporting indicator that might be important to track because it is fundamental to achieving progress on the principal measure.

USING WORKSHEET 1

A worksheet that can be used for the first stage of a strategy dynamics analysis is provided below.

Following the guidance provided in this chapter, the larger chart on the left can be completed with a time chart for the principal measure of performance of concern, whether that is an overall outcome (e.g. sales, profits or quantity of service delivered), or an indicator of functional performance (e.g. staff turnover, new product development rate, or error rate).

The smaller chart on the right is optional, and can be used to display some important supporting indicator to the principal objective, such as sales volume, which will enable a revenue or profit objective.

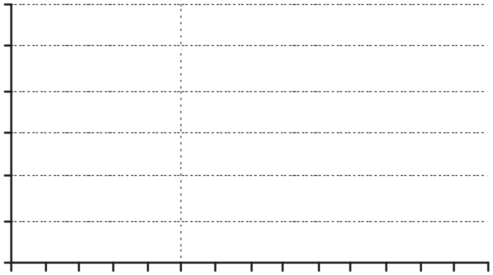
It is important to observe the discipline required to make these objectives usable:

1. Specify a numerical scale for each chart, sufficient to include the hoped-for upper value of the principal objective. For example, if profits have grown over the last three years from −$2.5 million to +$3.4 million, and you hope by five years in the future to reach $10 million, then the vertical scale should run from −$3 million to + $10 million
2. Define the timescale and time periods over which the objectives are to be achieved—to continue this example, the timescale runs from year −3 to year +5, or, if you are doing this in 2007, from 2004 to 2012.
3. The vertical dashed line on each chart shows “today”, and this point in time should be specified: 2007 in this example. Include as much history for each chart as is necessary to give a clear picture of why today’s values have come about (not relevant for new ventures).
4. Include both a “preferred” future, for the most positive scenario—external conditions are favourable and your management of the situation is successful—and a “feared” future that might result if conditions are challenging and the company is less successful than hoped.
5. Use the table at the bottom of the page to record the numerical values for each objective, both as they stand today and that you hope to reach by the end of the timescale on the charts. You can also usefully write these values on the charts.

WORKSHEET 1: PERFORMANCE OBJECTIVES OVER TIME

Principal objective: ………………………………

[Scale]



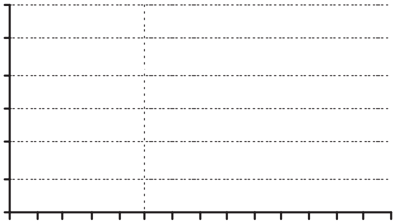
Preferred

Feared

[Time periods] ....

Supporting objective: ....

[Scale]



Preferred

Feared

[Time periods] ....

SUMMARY

Insert values in the table below to show today's value for the principal and supporting measure, and preferred and feared future values at a target date.

	Today date …………………	Future date ……………………	
Principal objective ………………………………			Preferred
			Feared
Supporting objective ………………………………			Preferred
			Feared

NOTES

1. Many strategy textbooks explain the rationale for the choice of financial performance measures. See, for example, Grant, R.M. (2005) *Contemporary Strategy Analysis*, 5th edn, Blackwell, Oxford, pp. 37–57. For a more extensive discussion of the theoretical foundations underlying economic profit, see Barney, J. (2007) *Gaining and Sustaining Competitive Advantage*, 3rd edn, Prentice Hall, Upper Saddle River NJ, Chapter 2.
2. For a clear, non-technical explanation of EVA, see Ehrbar, A. (1998) *EVA: The Real Key to Creating Wealth*, Wiley, Chichester.
3. Martin, J.D. and Petty, J.W. (2000) *Value-based Management*, Harvard Business School Press, Boston MA.
4. For an eloquent explanation of why free cash flow should be of overriding concern to investors, rather than reported profits, see the letter to shareholders that opens the 2004 Annual Report from Amazon.com (http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-reportsAnnual).
5. For an explanation of the principles of valuation, see Copeland, T., Koller, T. and Murrin, J. (2005) *Valuation—Measuring and Managing the Value of Companies*, 4th edn, Wiley, Chichester.
6. Rappaport, A. (2006) Ten ways to create shareholder value. *Harvard Business Review*, **84**(9), 66–77.
7. Penrose, E.T. (1959) *The Theory of the Growth of the Firm*, Oxford University Press, Oxford.
8. This perspective has been reviewed in Rugman, A.M. and Verbeke, A. (2002) Edith Penrose's contribution to the resource-based view of strategic management. *Strategic Management Journal*, **23**(8), 769–780.
9. I am grateful to Drew Jones of the Sustainability Institute and his colleagues for contributing this example.
10. Jones, A.P., Homer, J.B., Murphy, D.L., et al. (2006) Understanding diabetes: population dynamics through simulation modeling and experimentation. *American Journal of Public Health*, **96**(3), 488–494.
11. See, for example, Mankins, M.C. and Steele, R.C. (2005) Turning great strategy into great performance. *Harvard Business Review*, **8**(7), 64–73.
12. Collins, J. and Porras, J. (1996) Building your company's vision, *Harvard Business Review*, **75**(5), 65–72. Enhanced edition available, February 2000, from Harvard Business Online: http://harvardbusinessonline.hsbp.harvard.edu.
13. Hamel, G. and Prahalad, C.K. (1994) *Competing for the Future*, Harvard Business School Press, Boston MA, Chapter 2.

14. Kaplan, R. and Norton, D. (1996) *The Balanced Scorecard*, Harvard Business School Press, Boston MA. See also www.balancedscorecard.org.
15. Mankins, M.C. and Steele, R. (2006) Stop making plans: start making decisions, *Harvard Business Review*, **84** (1), 76–84.
16. I am indebted to Vitorrio Raimondi of Vanguard Strategy Ltd. for this example (see www.vanguardstrategy.com).
17. See www.irinnews.org.
18. Prahalad, C.K. and Hammond, A. (2002) Serving the World's poor, profitably. *Harvard Business Review*, **80** (9), 48–57.
19. I am grateful to Mike Chmielewski for this example.