10 Generating strategic options

OBJECTIVES

This chapter addresses the generation of strategic options based on the analysis covered in previous chapters. Chapter 18 covers the evaluation and selection of options.

The discussion of the generation of strategic options is approached in three steps:

- The basis for achieving competitive advantage (Michael Porter's generic strategies).
- Exploring alternative strategic directions.
- Alternative methods to employ in pursuit of a strategic direction.

This methodical approach suggested by Garry Johnson and Kevan Scholes has been adapted by the authors and is shown in Chart 10.1. Chapter 18 also explains the linkage between the portfolio and matrix analysis covered in Chapter 8 and in this chapter.

Chart 10.1 **Generating strategic options**

Source: Adapted from Johnson, G. and Scholes, K. *Exploring Corporate Strategy*, Prentice-Hall, 1989

LINKAGE TO PORTFOLIO AND MATRIX ANALYSIS

The industry maturity-competitive position matrix, the growth-share matrix, the directional policy matrix and the GE business/industry attractiveness screen not only analyse the position of products or strategic business units, but also provide recommendations as to the strategic directions in which strategic business units (SBUs) should be developed.

For example, the recommendation for a problem child SBU is either to develop it by means of heavy investment or to withdraw it before it becomes a dog. In other words, there are two strategic options. The GE business/industry attractiveness screen with a three-by-three matrix is even more prescriptive, suggesting only one strategic direction is suitable in some cases.

Matrix analysis is therefore a useful tool in helping to generate strategic options and understand the cash flow implications of strategic decisions for a portfolio of products. The advantage is that the strategies for several products or SBUs are looked at not in isolation but in the context of a business with limited resources, which should be allocated to the products or SBUs that produce the greatest return on investment.

BASIS OF COMPETITIVE ADVANTAGE

Generic strategies

Michael Porter[1] identified three generic strategies: cost leadership, differentiation and focus. The focus strategy has two variants: cost focus and differentiation focus (see Chart 10.2).

Chart 10.2 **Generic strategies**

		COMPETITIVE ADVANTAGE	
		Lower cost	**Differentiation**
COMPETITIVE SCOPE	**Broad target**	1. Cost leadership	2. Differentiation
	Narrow target	3a. Cost focus	3b. Differentiation focus

Source: Porter, M.E., *Competitive Advantage*, Free Press, 1980

Cost leadership

Cost is of overwhelming strategic importance. This is implicit in many of the portfolio or matrix models. Cost leadership strategy aims to reduce the firm's costs at all stages of the value chain. This will allow it to earn a higher return on investment.

In the early stages of the product life cycle, experience-curve-driven reductions in costs are important for attaining cost leadership. For a cost leadership strategy to work in the longer term, volume is usually important. This means that products must address a wide market. Products are often standardised to bring down prices and appeal to a wide market. In industries where scale economies matter, market share will be a key objective. In terms of the growth-share matrix, a cost leadership strategy is an option for stars and cash cows.

In industries with high fixed costs, capacity utilisation has to be maximised. For example, a cellular mobile phone operator usually has to cover a whole country, so driving up customer numbers is of overriding importance in order to increase utilisation and bring down average costs. In the airline industry, low-cost carriers that apply yield-management techniques with the objective of full capacity and short turnaround times are more profitable than traditional full-service airlines.

True cost leadership can only be achieved by one firm in the industry. However, given the law of diminishing returns, once volumes exceed certain levels, cost differences among leading businesses will be small. In other words, once a certain scale has been reached no further cost advantages may be available. The scalability of a business is therefore an important issue.

Differentiation

A differentiation strategy is based on equipping a product or service with some perceived or tangible unique attribute that cannot be easily replicated by competitors. Perceived differentiation can be achieved, for example, through branding. High quality is a commonly used way to differentiate a smaller supplier from a volume-driven supplier. Again, the differentiation strategy must be applied consistently at all stages of the value chain. A quality product can lose its reputation if delivery and installation are shoddy, or if distribution is only through stores that are located in downmarket areas. In order to be of value, the cost of differentiation must be lower than the premium buyers are prepared to pay for the differentiated product.

Differentiation is a strategic option for followers, rather than for market leaders. For example, if a product is a problem child, the firm could invest to catch up with the leader. This strategy is more risky than investing to differentiate the product for two reasons. First, the market leader probably has a cost advantage, which will make it more difficult for the follower to catch up. Second, a differentiation strategy does not directly challenge the market leader and therefore reduces the chances of a damaging competitive response, such as cutting prices.

Focus

The objective of a focus strategy is to gain competitive advantage by building on advantages of segment-specific specialisation, such as a better understanding of the requirements of buyers in that segment and the ability to respond to particularities of buyers. It is also referred to as a niche strategy. Pursuit of a niche strategy amounts to choosing a competitive playing field where competitive advantage can be achieved. In pursuing this niche strategy, for this special group of buyers the firm aims to be the “best” supplier. Within the chosen segment, the firm can achieve competitive advantage either because it is the cost leader or because it offers a differentiated product. Hence the two variants of the focus strategy.

Skills required to pursue generic strategies

Depending on the characteristics of the firm, industry and markets, not all strategies may be a realistic option. In other words, the resources and the environment condition the ability of a firm freely to select its strategy. Porter produced a list of resources and organisational requirements commonly required to pursue the generic strategies (see Chart 10.3 on the next page).

Chart 10.3 **Strategies and required skills and resources**

Generic strategy	Required skills and resources	Organisation requirements
Overall cost leadership	◪ Substantial capital investment and access to capital ◪ Process engineering skills ◪ Intense supervision of labour ◪ Products designed for ease in manufacture ◪ Low-cost distribution system	◪ Tight cost control ◪ Frequent, detailed cost-control reports ◪ Incentives based on meeting strict quantitative targets
Differentiation	◪ Strong marketing abilities ◪ Product engineering ◪ Creative flair ◪ Strong capability in basic research ◪ Corporate reputation for quality or technology leadership ◪ Long tradition in the industry or unique combination of skills drawn from other businesses ◪ Strong co-operation from channels	◪ Strong co-ordination among functions in R&D, product development and marketing ◪ Subjective measurement and incentives instead of quantitative measures ◪ Amenities to attract highly skilled labour, scientists, or creative people
Focus	Combination of the above policies directed at the particular strategic target	Combination of the above policies directed at the particular strategic target

Source: Porter, M.E., *Competitive Strategy*, Free Press, 1985

Risks associated with generic strategies

For a strategy to be successful (that is, increase value), it must be sustainable. If other businesses can copy the strategy, the competitive advantage will be lost and returns will decline to the industry average. Depending on the strategy chosen, managers must carefully monitor what factors can challenge the business position.

For example, if a strategy of cost leadership largely succeeds because of volume production, the firm is particularly exposed to technological changes. A competitor with much lower volumes may be able to enter the market using new technology, whereas the incumbent would have to make massive investments to convert existing capacity to the new technology. In this situation, the incumbent may use its financial strength to acquire the newcomer and gradually introduce the new technology. Indeed, the new entrant may consider this the best option because expanding businesses are often financially vulnerable.

The risk of differentiation is that products become commoditised and customers no longer perceive or care about differences. This means there is no value in differentiation; the competitive advantage is lost. It may also be possible for volume-based manufacturers to use some aspects of their products to achieve a significantly lower cost base for differentiated products. For example, volume car manufacturers generally use the same platform for high-value, low-volume models and share research and development costs across the whole product range. As a result, many luxury car brands are now owned by volume manufacturers.

Focus brings with it the risk of specialisation. Highly specialised businesses may live profitably in their chosen niche. However, as businesses become more adapted to serve their niche market they also become less flexible. Small changes in demand or the competitive environment may lead to rapid failure. Other risks include imitation and a narrowing of differences between the niche and the general market.

ALTERNATIVE STRATEGIC DIRECTIONS

The alternative strategic directions for a business are to grow the business (that is, embark on a development strategy), do nothing or withdraw. Generally, you would be making a business plan in order to develop a business. However, among a portfolio of products or SBUs, it may be best to withdraw some problem children or dogs in order to concentrate resources on stars. This is also addressed in Chapter 8.

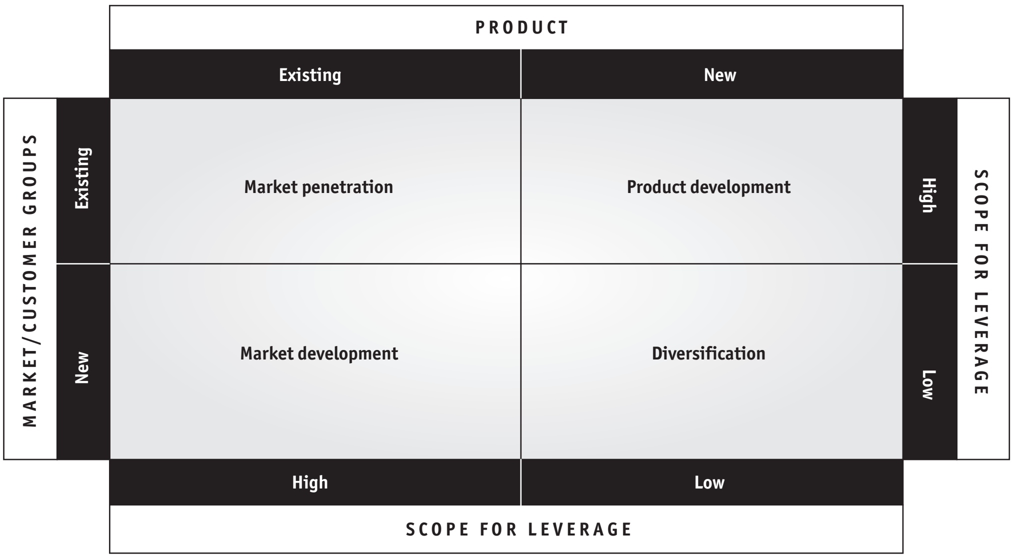
Development strategies

A business can be developed in four possible directions (see Chart 10.4):

- Market penetration – sell more of the same to the same market.
- Product development – sell new products to existing customers.
- Market development – seek out new markets for existing products.
- Diversification – sell new products to new groups of customers.

With all development strategies, the question of leverage of core competencies or resources is crucial. The scope for leverage is highest for a market penetration strategy and lowest for an unrelated diversification strategy.

Chart 10.4 **Alternative strategic directions for business development**



Market penetration

Selling more of an existing product to the same customers or market is generally regarded as the easiest development strategy. Products and markets are well known, and this strategy potentially provides the best scope for leveraging existing skills and assets.

In growing markets, all competitors to a greater or lesser extent pursue penetration strategies; they are jointly expanding the total market. Because market penetration increases overall volumes, the strategy is particularly relevant in industries with high fixed costs and low marginal costs, such as hotels, railways and utilities.

In markets that are in the maturity stage of the product life cycle, the pursuit of a market penetration strategy becomes more difficult. At its simplest, increased market penetration is a fight for market share, but this can be costly. However, increased market penetration can be achieved by selling more to existing customers or retaining customers longer.

- The rate of product innovation can be increased, inviting customers to upgrade more often. For example, Microsoft, which already dominates the PC operating-systems market, regularly brings out new operating systems, which leads to sales to customers who already have the previous version. Subsequently, application software such as Microsoft Office also has to be upgraded.
- The rate of use can be increased, for example increasing the visits to a cinema by people who are already cinema-goers. Also getting customers to buy double the quantity of a food product generally does not mean that it will take twice as long to consume, and the overall sales volume per buyer increases. Another example is telephone companies that encourage customers to make more calls.
- The uses or applications of a product can be multiplied, such as promoting cornflakes not just as a breakfast cereal but also as a snack to be eaten at any time of the day. Cable TV subscribers can be encouraged to use an existing cable subscription more by making it interactive so it can be used for shopping or by offering video on demand. The interesting point about using the TV for shopping is that increased revenue does not come from the shopper but from the retailer.
- Customers can be induced to trade up; instead of buying the standard version of a product they buy an enhanced version. This technique is commonly applied in restaurants, where diners are asked whether they would like extra toppings for a pizza or the waiter recommends an expensive wine. Another prime example is cars. The basic versions have a relatively low price to get customers interested, but optional extras often account for a disproportionately high share of the final sales price.
- In mature markets, it is particularly important not to lose customers. As long as a business retains customers and adds just a few more, market penetration increases. It generally costs far less to retain a customer than to acquire a new customer. For example, magazines seek to retain customers by inviting them to renew their subscription early, offering a higher discount for two- and three-year subscriptions, and encouraging automatic renewal by direct debit.

Product development

The basis of a product development strategy is to sell new products in addition to existing products into the same market or to the same customer groups. The term "new products" is used here to describe genuinely new products that satisfy different needs and generate incremental sales, not enhancements or new versions of existing products. Because the new products are sold into existing markets or to existing customers, some aspects of the value chain can be leveraged, notably distribution and customer knowledge. It may also be possible to leverage other aspects of the value chain such as manufacturing or warehousing.

If there is no possibility of further growth for an existing product, product development may be the only way to achieve growth. Because new product sales leverage existing assets, a contribution is earned and this reduces the cost base for existing products. This increases the competitive position for existing products, thus reinforcing a cost leadership strategy.

- Product development strategies are particularly relevant where a firm has acquired extensive market knowledge or has an established customer relationship. A prime example is database marketing. Profiling of customers on the basis of past purchases may allow the business to target new products at particular customer groups. Such methods achieve much higher conversion rates than generalised sales campaigns. For example, a firm selling car insurance may develop other products, such as home or travel insurance.
- Retailers continually extend their offerings, not only to meet the changing tastes of customers but also to induce customers to increase the average sales value per store visit. Some supermarkets are now selling credit and telephony services.
- A brand can be extended to new products, say Ferrari branded watches and men's toiletries. However, care must be taken not to overstretch the brand and dilute its value. In this case the strategy becomes merely a diversification strategy, which may lead to lower sales of existing products because the brand value has been diluted.

Market development

Here a business seeks to sell existing products to new markets or customer groups. A classic market development strategy is extending the geographic reach, either within the country or by exporting. This generally requires modifications to the marketing mix, such as adjustments to the products so that they appeal to new market segments, printing manuals in different languages and ensuring compliance with local standards.

- Many products are now sold globally. High R&D costs drive globalisation in industries such as electronics, cars and pharmaceuticals. In other cases, the engine for globalisation is the brand, for example Disney and of course Coca-Cola. In the media business, distribution can be the basis for globalisation. For example, the News Corporation satellite TV empire incorporates satellite platforms in Australia, Asia, Europe, the Middle East and the United States.
- Another way of developing the market is to extend reach by having a presence in more retail outlets or offering mail-order delivery to remote customers. A single-outlet sandwich bar can develop its market by offering delivery to offices that are not within walking distance. Adjustments as small as in-store shelf presence constitute market development. For example, an Italian sauce can be referenced in a supermarket's sauces and condiments section and in the pasta section.
- Market development can also mean targeting new market segments. For example, cosmetics companies now sell make-up targeted at men. Another common marketing theme of established products is to attract a younger clientele.

Diversification

Diversification offers the least scope to leverage existing competencies and resources. The strategy aims at selling new products into new markets. Diversification can be further distinguished into related or unrelated diversification.

Related diversification means that a business stays broadly within the industry but needs to acquire new competencies and resources:

- A firm can pursue a strategy of related diversification by means of vertical integration: extending the value chain backwards or forwards. For example, a manufacturing business can choose to make components rather than buying them from a supplier.
- A successful restaurant chain may decide to leverage its brand name to get into the frozen convenience-food business. The skills required to run a restaurant and manufacture ready meals for distribution in supermarkets are entirely different, but the brand and possibly some recipes or signature dishes provide the link between the two.

Unrelated diversification takes a business into a completely new field, a different industry. Because it is unrelated, it is often difficult to establish a strategic logic for such moves, other than perhaps a limited degree of synergy. Conglomerates are the archetypal diversified businesses, where a holding company manages a diverse collection of companies, acting almost like an investment fund. Although conglomerates and diversified companies do not find much favour with analysts and management gurus, they do have merits:

- The financial management and planning skills are core competencies of the head office, and this expertise can be applied to make portfolio companies in different industries more successful.
- Diversified companies are less affected by a downturn in one industry. For example, if a diversified company owns businesses in industries with opposing cycles, cash flow can be balanced between industries. The downturn in the telecoms industry in 2000 and 2001 adversely affected highly telecoms-focused companies such as Ericsson much more than it did diversified Siemens, which has substantial interests in telecoms, information technology, power generation and transmission, lighting, medical solutions, automotive technology, transportation systems and building technology.

Do nothing

In a constantly changing world, "do nothing" could hardly be termed a strategy option. However, Johnson and Scholes[2] point out that this option provides the base against which other strategic options can be evaluated.

Doing nothing does not imply that a firm ceases all activity; it simply means that it does not develop in any new direction. But, generally, standing still is not a realistic option. In terms of portfolio strategy, doing nothing in a growing market means the product or SBU will rapidly lose market share. In a slow-growing market, doing nothing is similar to harvesting (see below). Thus merely to maintain market share and competitive position, a firm will have to keep pace with market development, which will probably entail some investment. The closest a business can come to doing nothing and standing still is perhaps as the dominant player in a mature, stable industry that is not declining.

Withdrawal

In a portfolio-based business, withdrawal should always be actively considered. Even for a single SBU, business withdrawal should not be ruled out. In terms of the growth-share matrix, withdrawal may be the only shareholder-value-increasing option for problem children and dogs. What makes this option different from others is that it affects vested stakeholder interests in an organisation, and there may be high political and social exit barriers. In some cases, withdrawal is a deliberate strategy:

- To save a company from bankruptcy severe measures may have to be taken, such as selling off divisions and making a large part of the workforce redundant. In the United States, companies under Chapter 11 protection often go through this restructuring process in order to salvage profitable bits of the company.
- Entrepreneurs and venture-capital companies have a specific target to exit the industry once they have turned a new business into a self-sustaining going concern.

Withdrawal can take three forms:

- Harvesting involves the gradual running down of an SBU. Market share will be lost but cash is generated. In a declining market, harvesting may be the best option because if buyers cannot be found, the only means of releasing shareholder value is to release cash flow.
- Divesting is the outright sell-off of an SBU. This is a strategy that may be applied to a problem child, particularly if there are other SBUs competing for limited resources. Ideally, a sell-off should take place while the business is still of value to competitors. This will maximise shareholder value.
- Disintegration is the opposite of the integration path described as one of the options in a diversification strategy. This route has been taken by some major electronics manufacturers, which now no longer make products but just develop and market them. Manufacturers in low-cost countries take up the production part of the value chain.

ALTERNATIVE METHODS OF STRATEGY IMPLEMENTATION

Johnson and Scholes[3] identified three alternative methods by which to implement a strategy once it has been selected: internal development, acquisition and joint development. They describe the choice between the methods as a trade-off between cost, speed and risk.

- Internal development of products or markets takes more time but means the firm is fully in control and develops a detailed understanding. In terms of product development, companies such as Sony have built a reputation for internal R&D, thus turning the business into a technology leader. In some cases, companies grew overseas operations from a small sales office into a virtually autonomous business unit.
- Acquisitions can be a quick route for product and market development. Established companies often acquire smaller businesses to gain control of new technology and hence new products. Also, once the decelerating growth or shake-out stage of the product life cycle is reached industries often consolidate. This is an opportunity to

increase market share through the acquisition of competitors. Overseas acquisitions are a well-established way of building a foreign presence.

- Joint development is a co-operative form of development by which risks and rewards are shared between partners. Forms include joint ventures, licensing, franchising and the use of agents. In many cases, joint development is the only suitable form of export market development because local laws prohibit or discourage foreign investment. In cases where a small firm has a patent but cannot exploit it fully, licensing is the best method for product and market development. Licensing is also an excellent way of staving off competition from substitutes, because potential competitors will find it cheaper to license than to develop substitute technology.

USES OF OUTCOMES IN THE BUSINESS PLAN

When the options have been generated they should be screened (qualitative filtering), and those that survive the screening process should be subjected to detailed financial analysis (quantitative ranking). This is covered in Chapter 18. You should opt for the strategies that produce the greatest return on investment.

References

1 Porter, M.E., *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Press, 1985.
2 Johnson, G. and Scholes, K., *Exploring Corporate Strategy*, Prentice-Hall, 1989.
3 Ibid.