The Critical Path

The Critical Path

Building strategic performance through time

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Introduction

The defining challenge facing business leaders is to develop and drive performance into the future. For commercial firms, this generally means building profits and growing the value of the business. Although their focus may be on non-financial outcomes, public services, voluntary groups, and other not-for-profit organizations share the same central challenge. When the causes of performance through time aren't understood, management has difficulty making the right decisions about important issues. Worse, entire organizations are led into ill-chosen strategies for their future.

To overcome these problems, leaders need the means to answer three basic questions:

- Why is business performance following its current path?
- Where are current policies, decisions, and strategy leading us?
- How can future prospects be improved?

These questions are the starting point for this book.

The key to achieving business success is the ability to develop and sustain critical resources and capabilities, leveraging what we have today to grow more of what we will need tomorrow. The Critical Path is the journey your organization takes though time as it builds this portfolio of vital resources. The book provides innovative ideas that enable readers to answer the three questions and develop a sustainable winning strategy.

The Critical Path is based on strategy dynamics, a rigorous, fact-based method of analyzing business issues. Strategy dynamics explains why the performance of an organization has changed through time in the way that it has, provides estimates of where it is likely to go in the future, and allows management to design strategies and policies to improve that future path. It achieves this by building an integrated fact-based picture of how the resources of your business are developing through time, driven by mutual interdependence, management policies, external opportunities, and constraints.

The book has been written in a compact and easy-to-read style to help managers quickly understand the underlying causes of strategic challenges so that they can take action to improve performance. It uses clear examples to show how things can go well if managers have a firm grasp of the changing resources in their business, or badly if this perspective is missing. It describes practical techniques for developing a dynamic, time-based picture of a range of challenges. It includes:

- A clear overview at the start of each chapter setting out the issues and techniques to be explained.
- Action checklists highlighting practical considerations to help ensure that the approach is applied successfully.
- Worked examples, diagrams, and sections focused on doing it right, showing how the techniques and ideas can be implemented to uncover new insights and benefit your entire organization.

Travelling the critical path to organizational success is a challenging but fascinating journey. This book provides a practical, in-depth guide to help you along the way. If you would like to understand and discuss these techniques in more detail, we would be delighted to hear from you. Simply log on to *www.strategydynamicssolutions.com* for more information.

Chapter one
Performance through time

Overview

The biggest challenge facing business leaders is to understand and drive performance into the future, while improving long-term profits. Executives in non-profit organizations have performance aims too, though they may not be financial. To tackle this challenge, leaders need good answers to three basic questions: why the business's performance is following its current path; where current policies and strategy will lead; and how the future can be altered for the better. This chapter will:

- **Clarify these questions** and explain the contribution that a sound approach to strategy can make.
- **Explain why performance through time is so critical.**
- **Outline some limitations of existing strategy tools** that explain why few senior managers use them.
- **Give you practical techniques** for developing a time-based picture of the challenges you face.

The challenge for business leaders

Your organization's history is fundamental to its future. What you can achieve tomorrow depends on what you have today, and what you have today is the total of everything you have built up, and held on to, in the past. This is true even for new ventures when the entrepreneur brings experience, credibility, and contacts to bear on creating the new business.

It also holds true for non-profit activities: voluntary groups, government services, and non-governmental organizations. They too can only achieve what is possible with their current resources, and if more resources are needed then existing ones must be used to get them. A charity won't appeal to many new donors, for example, unless it has built a reputation.

When the causes of performance through time aren't understood, organizations make poor choices about their future. They embark on plans they can't achieve, and fail to assemble what they need in order to achieve even those plans that *might* be feasible. The catalog of failed initiatives, in every sector and through all time, would make a thick book indeed. These failures are costly not only in money but also in terms of wasted and damaged human potential. The better news is that organizations are often capable of far *more* than they imagine, if only they choose objectives well and can piece together the necessary elements.

Improving an organization's performance is not just a matter for top management. Given the right tools, everyone with influence over the way in which any part of their enterprise functions can make a difference. Challenges may be focused on an individual department or span the whole organization; they may range from very small to truly huge; and they may call for urgent measures or a long-term approach.

The importance of time

The following cases illustrate organization-wide challenges with long-term implications, but short-term imperatives for action. The scale of each issue is important, and the cases highlight the time path over which strategic challenges evolve and resources develop or decline. Ensuring that these changes play out at the right speed is vital.

Example 1: Retail banking

Confronted with growing competition as well as a mature market and internal management crises, Banco Bilbao Vizcaya (BBV) faced a major challenge to improve performance in the mid-1990s.[1] In the event, BBV transformed its failing branch-based retail banking business into one of the most successful in Spain within 1,000 days.

It accomplished this feat by means of astute, determined management of strategic resources: in particular, getting the right information to people in the branches and enabling them to cross-sell its products successfully. A new customer relationship project was implemented that provided customer representatives with an easy-to-use and intuitive IT interface; clear information about customer segments, sales targets, and company performance; and team-building incentives that developed an open culture emphasizing teamwork and action. The strength of BBV's approach was that it understood how people, information, and technology – the most important, expensive, and valuable resources – could be combined to benefit customers.

The problem BBV faced was immense: failure to secure its position would have led to huge losses. Timing was also critical. BBV's ability methodically to target priority areas meant that it could generate cash flows from its investments to fund further developments.

Contrast this with the position of another retail bank facing the challenge of rationalizing its branch network. If it closed branches too slowly, it would suffer uncompetitive cost levels. Too fast, and it would erode its customer base. Similarly, cutting back on staff risked leaving branches with too few people to serve the remaining customers.

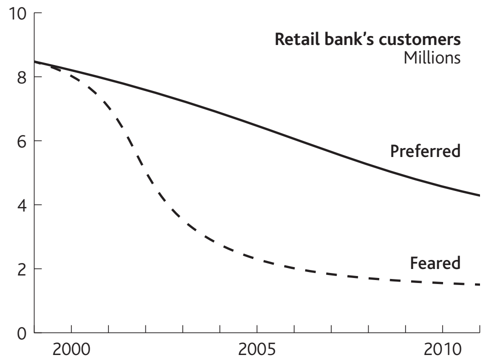
The starting point for the approach that we will develop in later chapters is shown in Exhibit 1.1. This is a time chart that displays three important characteristics:

1. A numerical scale (customers).
2. A time scale (expected to be more than 10 years).
3. The time path (how the situation changes over that time scale, showing both "preferred" and "feared" futures).

These three features ensure that the chart provides a clear view of the problem, and allow further details to be added later. This particular example happens to focus directly on a critical resource, customers, and clarifies the absolute numbers: much more useful than derived ratios such as market share, or abstract notions such as competitive advantage. Often, management's concern will be directed at the financial *consequences* of future developments – in other words, sales and profits.

1 Notes appear at the end of each chapter.

Exhibit 1.1
Time chart of potential implications of bank rationalization



Understanding the history of decisions that have already been taken is essential, as they are driving the bank's trajectory into the future. Past branch closures have already caused many customers to leave and customer losses would continue even if closures stopped, partly because of competition but also because of previous decisions by the bank.

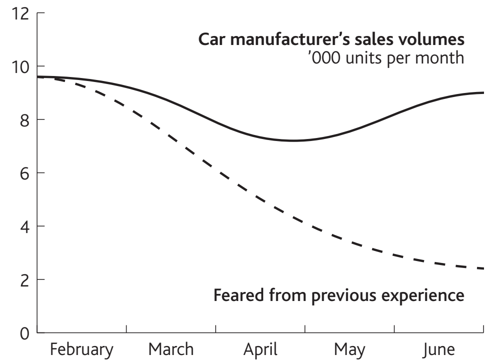
Example 2: Automobile rivalry

The second example concerns a car maker. Competing manufacturers frequently target new models at segments already developed by others. Innovative manufacturers have pioneered sports utility vehicles, people carriers, and so on, only to see others invade the market they developed. Consequently, the launch of a new competing model is a tense time for any car maker. What it would *prefer* is that the competitor's launch goes badly, with early buyers being disappointed, dealers losing commitment, and so on. Any impact on its own sales will then be small and unsustained. What it *fears* is that the newcomer gets an enthusiastic reception from motoring journalists and buyers alike, leading to sustained loss of its own sales.

As with the retail bank, this challenge is of strategic importance ("strategic" here simply means "with significant implications for the organization's medium- to long-term performance"). A failed response could undermine the brand and devastate sales revenue. This hits *future* prospects as the company is denied the cash to develop its own new models.

Exhibit 1.2 again shows preferred and feared outcomes. Timing is even more pressing in this example than with the retail bank, because the rival is likely to target the most profitable customers and regions first. Deciding whether to react on price or to launch a marketing campaign to head off

Exhibit 1.2
Effect of rival's attack on the position of a car maker



the new rival (and *how much* of either reaction to deploy) are time-critical issues that need careful evaluation.

The implications of this one episode are far reaching. As this model represents a substantial share of the car maker's cash flow, even a small loss of sales volume would not only hit short-term cash flow but also demoralize the sales force, perhaps even leading dealers to switch to competitors. The competitor, on the other hand, will enhance its cash flows, its sales force performance, and possibly its dealership network, boosting its future reputation and ability to encroach on other products. The car maker's reaction to this predicament is thus critical to its future performance.

Problems with existing strategy tools

Given that the problem of managing performance through time is universal, it is astonishing that time charts like those in our exhibits are almost completely absent from business books and management literature. Try looking for yourself next time you find yourself in a business bookstore. So what tools do managers actually use to help them decide what to do?

A regular survey by consultants Bain & Company identifies a long list of management tools.[2] However, few of these have won much confidence among managers, with the result that they come and go in popularity like fashions in clothing. The tools fall into several categories:

- Simple principles open to wide interpretation, such as vision statements and strategic planning.
- Substantial changes to business configuration, such as re-engineering and outsourcing.
- Approaches to controlling performance, such as value-based management and the balanced scorecard.
- Problem-solving methods, such as the five forces, real options, and customer segmentation.

A wide-ranging study by another consulting company, McKinsey,[3] found that there were few strategy tools with sound methodological foundations beyond the industry forces and value-chain approaches set out by Michael Porter in the early 1980s.[4] The many qualitative methods available seemed to work well only in the hands of their developers, and were limited in their ability to provide robust, fact-based analysis.

To understand the potential value of a sound approach to managing performance through time, it is useful to start by identifying the problems with current approaches to strategy.

SWOT analysis

Assessing an organization's strengths, weaknesses, opportunities, and threats (SWOT) is a method widely used by managers to evaluate their strategy. Unfortunately, it offers little help in answering the quantitative questions illustrated in Exhibit 1.1 and 1.2. Typically, the concepts are ambiguous, qualitative, and fact-free. Discovering that we have the strength of great products and an opportunity in strong market growth offers us no help whatsoever in deciding what to do, when, and how much to bring about what level of likely growth in profits.

Opportunities and threats are features of the external environment; as such, they are better dealt with by considering industry forces and PEST analysis (an assessment of political, economic, social, and technological factors; *see* chapter 4). Strengths and weaknesses, on the other hand, center on the firm itself, so they are closely connected to the resource-based approach to strategic management that underlies much of what we will explore in this book.

Later chapters will explain how to assess resources in more detail, but already we can see, in our two examples, specific tangible and intangible ("soft") factors that need to be taken into account (Exhibit 1.3).

Exhibit 1.3
Examples of resources in retail banking and car industry

Bank rationalization	Automotive rivalry
Customers	Sales force
Branch network	Existing car owners
Customer service staff	Production capacity
Savings and lending products	Dealer network
Reputation for service	Reputation among car owners

Industry analysis and strategy

The analysis of competitive conditions within an industry has dominated efforts to understand and develop firm performance. In summary, this approach says that:

- We try to make profits by offering products for which customers will pay us more than the products cost us to provide.
- The more powerful are our *customers*, the more they can force us to cut prices, reducing our profitability.
- The more powerful are our *suppliers*, the more they can charge us for the inputs we need, again reducing our profitability.
- If we do manage to make profits, our success will attract the efforts of *competitors*, *new entrants*, and providers of *substitutes*, who will all try to take business away from us, yet again depressing our profitability.

These five forces – buyers, suppliers, rivals, new entrants, and substitutes – thus explain something of industries' ability to sustain profitability through time.

The boom and bust of the dot-com era was a classic illustration of the five forces at work. By eliminating substantial costs associated with conventional supply chains, e-businesses could offer valuable products at very low cost, resulting in attractive profit margins. It was anticipated that buyers would face few switching costs in taking up these alternatives. By getting very big very fast, the new providers would establish buying power over their own suppliers and erect barriers against would-be rivals. The established suppliers were the substitutes, whose brick-and-mortar assets would weigh them down and prevent them competing in the new business model.

Unfortunately, the five forces framework also describes quite neatly why most such initiatives were doomed. Buyers who were able to switch to the new offering faced very low barriers to switching among the host of hopeful new providers, and did so for the slightest financial incentive. The new business model was often transparent, requiring little investment in assets, so rivals and new entrants could quickly copy the offering. Worst of all, many enterprises saw the same opportunity for the same high returns from the same business models, so there was a rush of new entrants. Anticipating hefty future profits, many gave away more than the margin they ever expected to make, in the hope that, as the last survivor, they would be able to recapture margin in later years.

It's the time path that matters

At first glance, the industry forces view makes a lot of sense, and there is indeed some tendency for industries with powerful pressure from these five forces to be less profitable than others where these forces are weak. The implication is somewhat fatalistic: if industry conditions dominate your likely performance, then once you have chosen your industry, your destiny is fixed. However, research has found that industry conditions explain only a small fraction of profitability differences between firms.[5] It turns out that factors to do with the business itself are far more important drivers of performance.

Management *does* matter: you can be successful in intensely competitive industries, or unsuccessful in attractive industries. Moreover, the passive industry forces view takes no account of firms' ability to create the industry conditions that they want. In essence, the world is the way it is today because Microsoft, Wal-Mart, EasyJet, and many other firms have made it like this, not because industry conditions have been handed down from on high.

The competitive forces view places great importance on the concept of barriers that prevent industry participants (the competitors themselves plus customers, suppliers, and others) from entering, switching, exiting, and making other strategic moves. This implies that these barriers are absolute obstacles: if you can clear them you are "in," if not you are "out." But business life just isn't like that. Many industries include small firms operating quite nicely with only a little of the necessary resources, while larger firms operate from a more substantial resource base. In fact, barriers to entry don't seem like barriers at all; they are more like hills. If you are a little way up these hills, you can participate to some degree, and the further up you are, the more strongly you can compete.

So, why are strategy tools so weak at answering the basic question of what is driving performance through time? It turns out that most strategy research is based on analyzing possible explanations for profitability measures, such as return on sales or return on assets. Recently, more sophisticated and appropriate measures have been used, such as returns based on economic profit (profit minus the cost of capital required to deliver that profit). Typically, data is collected for large samples of firms and plausible explanations for performance differences among the sample are tested using statistical regression methods.

Case example
EasyJet

An example of the failure of conventional industry analysis – and a testament to the success of a resource-based approach pursued over time – is provided by EasyJet. This low-cost airline operates a business model similar to that of Southwest Airlines in the United States. Its success came at a time when the global airline industry faced increased costs combined with static or declining passenger numbers. There was sympathy for the comment from Richard Branson of Virgin that "The safest way to become a millionaire is to start as a billionaire and invest in the airline industry."

Stelios Haji-Ioannou, 32-year-old founder of EasyJet, followed Ryanair, another budget European operator, in challenging the industry situation when he launched the airline in November 1995. He focused on creating an ultra-efficient operating system, building brand awareness, and maintaining high levels of customer satisfaction – factors that would reinforce each other and ensure EasyJet's distinctiveness. In his view, "If you create the right expectations and you meet or exceed those expectations, then you will have happy customers."

EasyJet's success built on a model originally developed by Southwest Airlines, with one type of aircraft (Boeing 737), short-haul travel, no in-flight meals, and rapid turnaround time resulting in aircraft utilization up to 50 percent greater than the industry average. EasyJet took this approach further, avoiding travel agents, not issuing tickets, selling food and drink on the plane, and building sales through the Internet. These measures developed and reinforced the strategic priorities of efficiency, awareness, and customer satisfaction, and made EasyJet popular, distinctive, and successful in a fiercely competitive market. The launch by British Airways of a rival low-fare airline, Go, only flattered EasyJet, which eventually acquired it.

In a sector where intense competitive forces have made the global industry endemically unprofitable for decades, EasyJet, Ryanair, Southwest and a few other determined players have managed to do very nicely indeed.

Such studies generate an estimate of how much of the variation in the profitability of different firms is explained by the suggested causes. These may be external factors such as competitive intensity, or internal factors such as technology or staff training. Unfortunately, today's profitability ratios are a very poor guide to future earnings, and of little interest to investors. Would you, for example, prefer to have $1,000 invested in a firm making 20 percent margins but with declining return on capital, or in another firm making 15 percent but doubling in size every year?

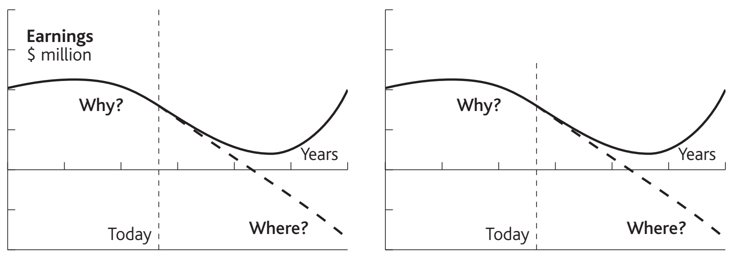
What about non-business settings?

The last main criticism that can be levelled against existing strategy methods is that they have little to offer the large number of managers who run organizations that are not primarily concerned with making profits. Public services in many economies have been made quasi-commercial in recent years through privatization, outsourcing, and other structural changes. Nevertheless, substantial fractions of all developed economies are still accounted for by public services. In addition, charities, non-governmental organizations (NGOs), security services, and other organizations also have objectives to pursue and resources with which to pursue them.

Current strategy methods are of little help to such organizations, being almost exclusively built on economic analysis of competitive markets. Yet there is a remarkable similarity between the challenges faced by managers in business and non-business settings (Exhibit 1.4). In all cases, they are expected to have sound answers to three key questions:

- **Why** is our performance following its current path?
- **Where** is it going if we carry on as we are?
- **How** can we design a robust strategy that will radically improve this performance into the future?

Exhibit 1.4
Performance questions in commercial and non-commercial settings

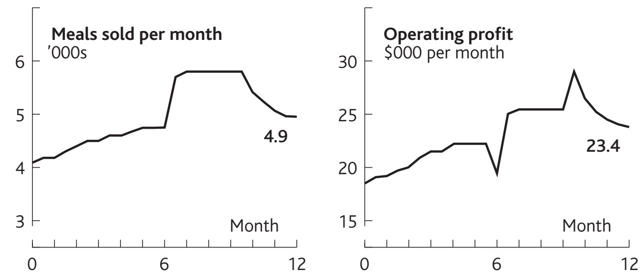


Diagnosing performance

A simple example helps to explain how this process of understanding, predicting, and improving performance works in practice. We will start it here and develop it in later chapters.

You find yourself in charge of a restaurant in a medium-sized town that gets most of its business from regular customers. You also win a few new customers from time to time, some of whom become regulars. You have had a frustrating time over the past 12 months, as Exhibit 1.5 shows.

Exhibit 1.5
Restaurant performance example



As the year started, you were selling 4,000 meals per month and making profits of $18,000 per month. Business and profits increased slowly for a few months, then seemed to reach a limit, so in month 6 you carried out some marketing, hence the drop in profits and the rise in meals sold. However, meals sold per month soon reached a new limit, so profits also plateaued. In the last months of the year you cut the marketing spend, saving money and increasing profits sharply, but at the cost of a fall in meals sold.

This kind of account is what we mean by focusing on performance through time: we are not just concerned with static performance measures such as market share, profit margins, or return on capital.

Valuing performance

A particularly important reason for understanding performance through time is to put a value on firms. Essentially, investors hope to see a strong, increasing stream of "free cash flow": the cash that is generated after reinvesting what is needed to deliver that growth. Free cash flow is the product of:

Operating income
+ Depreciation
– Tax payments
+ Non-operating income
– Net investments in current assets
– Net investments in fixed assets

The forecast for free cash flow is discounted back to give a present value, whether for the firm as a whole or for an investment it intends to make. How these measures are calculated and the method of valuation are explained in detail elsewhere,[6] so we will from now on simply discuss earnings, profits, or operating income. We will assume that finance professionals can carry out the necessary translation into the correct financial measures.

The methods used by the finance and investment communities to assess the value of firms and their strategic initiatives are exceedingly rigorous and analytical. Regrettably, though, this rigor is applied to flawed models of how businesses function, and speculative estimates of the future. It is during the forecasting stage that financial evaluations lose touch with a firm's strategic reality. A typical approach is to estimate sales growth (on the basis of industry forecasts) and project cost ratios and profit margins (on the basis of assumptions about efficiency improvements). As we will see, there are dynamics at work within organizations that make such approaches to projecting performance highly unreliable.

Notes

1 This example is featured in Donald Marchand, William Kettinger, and John Rollins, *Making the Invisible Visible* (John Wiley, New York, 2001). Banco Bilbao Vizcaya merged with Argentaria Bank in January 2000 to form Banco Bilbao Vizcaya Argentaria, one of Spain's two largest banks.

2 Darrell K. Rigby, *Management Tools 2003: An Executive's Guide* (Bain & Company, Boston, 2002).

3 Kevin P. Coyne and Somu Subramaniam, "Bringing discipline to strategy," *The McKinsey Quarterly*, 2000, Number 3, pp. 61–70.

4 Michael E. Porter, *Competitive Strategy: Techniques for analyzing industries and competitors* (Free Press, New York, 1980).

5 Anita M. McGahan and Michael E. Porter, "How much does industry matter, really?" *Strategic Management Journal*, 1997, Volume 18, Issue S1, pp. 15–30.

6 Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and managing the value of companies* (John Wiley, New York, 2000).

Action checklist
Starting with a performance time path

A sound time path of past and future performance describing the challenge your organization is facing is an essential starting point. It highlights how the future might play out if resources and events continue to develop along their current path. Time paths are not forecasts, and there is little to be gained by trying to get them right. As the examples show, they signal an important idea: that an unattractive future might turn into disaster if a firm does not respond well.

On the other hand, as in the case of BBV, a better response can make a substantial improvement to a firm's future. Time paths provide clarity, helping to shed light on important and complex issues by showing where the organization is heading, where the current situation may lead, and what impact may follow from specific decisions.

Here are some tips for preparing a performance time path:

- ☐ Start with a chart of the measure that would ultimately spell success or failure.
- ☐ Remember that **numbers matter!** Put a numerical scale and a time scale on the measure you have chosen, going back far enough to cover the explanation for your current situation (except in the case of new ventures, obviously).
- ☐ In most business-level challenges, a financial outcome is often appropriate, though intermediate outcomes such as sales or customer numbers may serve, provided the team recognizes that it is assuming these will lead to good financial results.
- ☐ In non-commercial settings, adopt the same principle of looking for a performance measure that closely indicates the outcome you are seeking, such as "beneficiaries served."
- ☐ Where you are tackling a challenge confined to a single functional area such as marketing, staffing, or product development, again look for an indicator that will signal progress toward your preferred outcome, such as sales, staff turnover, or product launch rate.
- ☐ Use absolute numbers (such as millions of dollars or unit sales) rather than ratios. A 50 percent return on sales of $10 is not very interesting; nor is an 80 percent share of a $100 market!
- ☐ Consider supporting the main performance chart (e.g. profits, revenue) with a chart of a measure that contributes to that outcome (e.g. unit sales, customers). This can help indicate where you expect the main source of the challenge to lie.