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PREFACE

This Faculty publication is produced in parallel with the Braybrooke Press publication of the same name. Accordingly, references in the text to issues of *Manager Update* prior to April 1997 relate to the Braybrooke edition.

Manager Update helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of Strategy and Organisation, Marketing, Accounting and Finance and Human Resources Management are carefully selected from a wide range of publications with the busy general manager in mind. Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date.

The articles represent the personal views of the authors and not necessarily those of their organisations or of the Faculty. The nature of some subjects will preclude the articles from being definitive or mandatory. Being general in nature, the points made in *Manager Update* may or may not be relevant to specific circumstances.

The Faculty committee intends that *Manager Update* will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on *0171-920 8486*. (or by e-mail to CDJackson@icaew.co.uk)

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ARTICLE SUMMARIES

Marketing *Brand Management*

Businesses are increasingly appreciating the value of brands. Customers are more sophisticated yet need to find a way through the masses of information now available in markets, so they tend to look for shortcuts and signposts to make reliable and timely decisions. Brands can provide them with guides to quality and value for money. But in the age of the Web, brand power can shift to new types of retailers and away from manufacturers. Also, brand values can become diluted if brand extensions proliferate. New methods of managing brands in organisations are therefore becoming necessary. **Page 2**

Human Resources Management *Implementing Quality and Re-engineering Programmes: Managing the People Issues*

Many total quality and re-engineering programmes have failed to live up to expectations because ‘the people issues’ have been overlooked. In international organisations, for example, attitudes to the changes inherent in these programmes may vary with national cultures, not all of which are supportive. In other organisations, management underestimates the resistance to change, especially when top-down rhetoric does not match the perceived reality, for example when the changes involve downsizing and increased job insecurity. **Page 6**

Strategy and Organisation *Strategy in the Post-Industrial Society*

Some popular approaches to strategic management are increasingly seen as ill-suited to modern business life. In the post-industrial society, the knowledge and skills of key employees is often more important than physical assets; and externally to the firm, markets become more complex and difficult to predict. Familiar ideas, such as the value chain, therefore need to be adapted to current circumstances, particularly in service businesses. New concepts, such as ‘value networks’ may prove to be more useful. **Page 11**

Accounting and Finance *The Cost of Capital*

Calculating the cost of capital is an important element in estimating the value and return to shareholders, yet it is far from straightforward and remains elusive in practical terms. In this *Update*, various current approaches to its estimation are reviewed. If the right method is still disputed in advanced countries, it is even more difficult in emerging economies, where the necessary statistical and qualitative information is rarely available and where political risk and market volatility are key factors. **Page 14**

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MARKETING

Brand Management

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> *'Successful brands will be those that enable consumers to achieve many goals simultaneously, reconcile conflicting goals or satisfy neglected needs.'*[1]

Current interest in brands is high. Brand managers are struggling with the pressures of small (and reducing) margins, new and competing channels to market, the drive for innovation, shorter product development processes and crucial brand extension decisions. Moreover, some classic and contemporary brands need to confront and manage the changes in the market place, with increasing rivalry, competition and the demands of satisfying increasingly sophisticated, busy and knowledgeable customers. In many respects increasing competitiveness and choice are increasing the importance of the brand. Consumers need to find a way through the masses of information available and, thus, they tend to depend on signposts and look for shortcuts in information processing to help them make reliable and timely decisions.

The ongoing debate on the key aspects of brand management are reflected in their inclusion in a number of *Manager Updates*. Recent work focuses on how customers evaluate brands, on understanding the factors affecting customer behaviour, on purchase intentions and the overall value of the brand. Berthon, Hulbert and Pitt[2] provide an overview of the challenges facing branding and, more specifically, the organisation and management of brands in the enterprise. These challenges for the role of the brand and the changes in the market necessitate internal initiatives to cater for external needs. Gürhan-Canli and Maheswaran[3] focus specifically on the effects of brand extensions on brand name. Brand extensions have become increasingly popular as a strategy, with obvious benefits for companies which are able to build on existing brand characteristics and capitalise on consumers' existing feelings for brands. This strategy has risks, and instead of building equity the extension may dilute the brand in the long run. Grewal, Krishnan, Baker and Borin[4] study the connections between brand name and reputation, the retailer, the store name and pricing strategies. Brands do not exist in isolation. They affect and are affected by other marketing and non-marketing initiatives. In investigating this complex pattern of relationships they make a number of observations for management, and study the impact on purchase intentions. Finally, Silver[5] focuses on branding in the consumer durables market. His particular interest is in the pricing of product variations that carry the same brand identity. He investigates the effect of the launch on the price of the existing brands already on sale, as brands move through the product lifecycle and new variations are introduced.

The future for brands and brand management

The nature and the functions of the brand are examined by Berthon, Hulbert and Pitt, from the customers' and the sellers' perspectives. They state that the essence of the brand is the ability to differentiate between products and service, or in their words: 'to create distinction between entities'.The brand also performs a number of other functions. First, it minimises the amount of time, effort and risks for customers involved in searching and evaluating the quality of the entity through a process of reduction. Second, the identity of the brand helps to facilitate segmentation, repeat purchase, product development and extensions and promotional campaigns. They also attract premium pricing: thus, they act as a facilitator for the seller.

Berthon, Hulbert and Pitt build on work by Tim Amber[6] and state that '. . . brands have brought buyers and sellers together by serving as symbols around which both parties can establish a relationship, thereby creating a focus of identity'. However, they raise concerns about the future of the established brand management practices, reinforcing earlier work by Shocker et al[7] in the Journal of Marketing Research, who outline the challenges and opportunities facing brand management. The key challenges or opportunities are in:

Information technology – the widespread availability of information, on the Internet for example, is making it easier and more cost effective for customers to conduct their own searches. For the sellers, sophisticated systems now provide precise and real-time information about customers which enables them to develop valuable customer loyalty programmes and direct mail. Together they contribute to the shift in the balance of power away from the manufacturers and towards the retailers.

- **Changing customer values** Customers are already more sophisticated and expert in assessing the quality of products and services. They are able to trust their own ability to judge for themselves without the need for 'superficial blandishments'.
- **Brand proliferation** The multitude of brands and imitations competing in a crowded marketplace, which potentially reduces the value of branding as a key part of the marketing programme.
- **Brand extensions** A widely used strategy to build on existing brands when introducing new products. Whilst it may provide an umbrella and security for new product development, it has the associated risk of harming or diluting the existing brand.
- **Trade customers** The power of the retailer as the intermediary between the brand manager and the end customer is an important force in the branding equation.
- **Short-termism** A realisation that short-term financial performance measures need to be replaced by measures which emphasise brand equity and its value as a long term asset.
- **Brand organisation** Traditional brand management systems are not the only way to organise, and new forms are emerging.

Given these challenges, Berthon, Hulbert and Pitt suggest three alternatives for the future organisation of brand management.

1. The evolutionary approach involves some rationalisation and the growth of multifunctional teams.
2. An intermediate approach with more 'corporate or umbrella structures of greater simplicity'.
3. Finally, the revolutionary approach which focuses on the customer rather than the brand and emphasises relationships and communication.

Brand extensions

One concern for brand managers is the impact of brand extensions on the core or original brand. Will they enhance or dilute the value of this brand? New products are often promoted alongside existing brands under the auspices of an 'umbrella' or 'family' brand. Here, consumers use their perceptions of the existing brands to evaluate the new product. However, product failures, where customers do not consider the new product to be of appropriate quality, can lead to negative perceptions which affect the umbrella brand. These perceptions may be difficult to change.

Gürhan-Canli and Maheswaran are specifically interested in the links between brand extension strategies and building brand equity, links which they suggest have produced mixed results in previous research in this area. They conducted extensive research in which the family brand names, products and attributes were selected and then used in the experimental research. The experiments were based on the evaluation of electronic products. Their research shows that what they call 'typicality' (ie the degree to which the individual products in a family group are typical or representative of the family brand image) has an important effect on the family brand name. Therefore, managers can influence perceptions by emphasising the compatible attributes in advertisements and marketing programmes. The authors also found that the level of motivation also has an effect on extensions. Where there is a high degree of motivation, incongruent extensions (where the attributes of a product are not consistent with the others in the family) attract attention and are examined in detail. This examination may lead to a reassessment of evaluations and perceptions of the family brand as a whole. The authors use an example of a company that wishes to change its negative image. In this case they suggest that if there is 'high motivation the promotional strategy should communicate incongruent information about products' – they consider that the more incongruent the information, the greater the likelihood that a modification in attitudes will result. However, if there is low motivation they suggest that information should be spread across the products in the family group. Here they cite IBM's efforts to improve their image by following Gürhan-Canli and Maheswarans' suggestions and designing a broad advertising campaign that focuses on several products.

Retailing, the brand and price

Whilst brands have a number of characteristics and facets in their own right, they do not exist in isolation. Customers' decisions to purchase branded products and services are, as we have seen, influenced by a number of factors. Grewal, Krishnan, Baker and Borin look specifically at the effects of store name, brand name, and price discounts on consumers' evaluations and purchase intentions. The authors develop a model that enables them to investigate the relationship between all these variables. They key features of the model are:

- For the retailer, the selection of brands, the merchandise and the quality of the products on sale in a store influences the perceived store image and the levels of customer patronage.
- The name of the store carries valuable information for the customer, and their beliefs about a store have positive impacts on the levels of store custom. The more positive the store name and reputation, the more positive the buyer's perception of store image.
- The brand name is an important cue helping customers to evaluate the quality of the products. The more positive the brand name and reputation, the more positive are buyers' perceptions of quality. Indeed, a strong brand name helps to stabilise the customers' perceptions of brand quality.
- Price and special promotions are regularly used to attract customers and to increase the level of traffic through the store. The role of price in the store is important. Pricing decisions can attract customers but they can also have negative effects on the perception of the brand and thus the store.
- The more positive the brand name and customers' perceptions of product quality, the higher will be the customers personal evaluations of price. However, where price is discounted regularly, the customers' perceptions of the quality of the brand are lowered and, as they become accustomed to the lower price they reduce the personal evaluation of price.

All the elements of the model were tested under experimental conditions in a top university in the United States. The results provide useful suggestions for managers when designing promotion, price, store and brand strategies. Store image is important to customers, and there is 'added value' which may reside in status or prestige. Careful matching of brand and store is important for manufacturers wishing to convey a consistent image. Alternatively, if the manufacturers wish to build their own brand image they should select stores with a higher perceived image – if the stores will have them! The store image is particularly important for customers who have limited product information. The authors use K-Mart in the United States as an example of a store that carries high and low quality products and has difficulties in developing a consistent image that customers can rely on.

The use of discounts is not necessarily as problematic as originally thought, as the price is balanced by the strength of the brand name and the perceived quality. However, there can be a spiral effect – in which subsequent discounts need to be larger to attract customers' attention, with potentially detrimental effects on profitability. To ensure that customers do not get unduly used to discounts and to prevent the reduced price becoming the norm, special offers and sales should send clear messages indicating that the offer is limited and for a temporary period.

Grewal, Krishnan, Baker and Borin suggest that the relationship between these variables will be more important in the next decade, and marketers need to understand the simultaneous effects of these issues. Customers are more knowledgeable given the quality of information about products and their comparative prices that is now widely available through, for example, the Internet. All in all, the customers' awareness is greater than ever before and it places them in a good position to evaluate alternative products and prices.

Brand pricing strategies

Consumers often have a range of old and new products within each brand category to choose from in the market, as manufacturers introduce new and updated models of the brand. Silver is particularly interested in the pricing implications caused by updating existing brands with new models and variations. He uses 'a well-defined product: a Hitachi 14" TV set' as the subject of this investigation. When the new model is introduced into the market – what happens to the prices of the existing versions and what happens to the respective prices of old and new as they 'co-exist'?

The investigation used EPOS barcode data during a 42-month period and examined the price effect at the time of the launch, the effect on price following launch, and the effect on price elasticity on the existing product(s) in the market. Essentially, this complex article presents an econometric analysis of pricing behaviour for one particular product and then for the entire market. The investigation found that products do co-exist in a market and in the TV example seven variations were present. The author states that: 'specific factors affect the pricing of a new model, and the very launch of the model and its continued existence will affect the pricing of existing vintages.'

Many variations exist because customers have different tastes and needs and, thus, retailers need to stock a number of different models of a brand. However, he realises that this is not always the case as retailers sometimes try to 'dump' the existing model to ensure that there is a clear place in the market for the new product. Indeed, some products co-exist because of inefficient dumping strategies rather than the positive desire to provide consumers with a wide range of brands designed to meet their varied needs!

Brands are required to satisfy a startling variety of needs. They maintain a central role in marketing strategy, and in the perceptions and behaviour of each customer. In the face of current challenges in the marketplace, the way branding is organised needs to be reassessed. Branding decisions cannot be made in isolation, as they have ramifications for retailers, brand extensions, co-branding with compatible partners, pricing strategies, and management of image and identity. Despite the risks involved, companies will continue to look for ways to build brands to leverage the value of existing brands to build equity and profits.

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HUMAN RESOURCES MANAGEMENT

Implementing Quality and Re-engineering Programmes: Managing the People Issues

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The past decade has seen an explosion of interest in quality management and re-engineering programmes. There is no shortage of rhetoric from consultants and practitioners on the benefits of Total Quality Management (TQM) and Business Process Re-engineering (BPR), but there is less on the people issues surrounding implementation. TQM is based on the principles of customer and process orientation and continuous improvement,[1] and offers the vision of a unified organisation focusing on quality through empowered individuals and teams. BPR, in contrast, is based on fundamentally re-thinking and re-designing business processes,[2] and is typically focused around project teams. Despite their differences in emphasis, the promise of these programmes is increased business performance. And yet many of these programmes either fail outright, or do not live up to expectations. Dooyoung, Kalinowski and Gaber[3] note that between 60-70% of TQM programmes fail, and similar estimates have been offered for BPR programmes.[4] Does this mean that there is more hype than substance in the claims for BPR and TQM? Dooyoung et al argue that it is not the basic principles of TQM that are flawed, rather the issue lies in the execution of these principles, and the same could be argued for BPR. This *Manager Update* will consider recent research which provides an insight into a number of key issues in implementing such programmes, including: the importance of context; the impact of corporate and national cultures; employee commitment; issues of justice; the impact of the external environment; and managing the change process.

The impact of national culture on TQM implementation

Katz, Krumwiede and de Czege[5] provide a model that examines cultural factors affecting the level of resistance to TQM adoption in different countries – an increasingly significant issue as organisations operate across national boundaries. They argue that the 'fit between TQM principles and national culture explains why TQM adoption is resisted in one country yet embraced in another'.

They begin from four cultural dimensions identified by Hofstede:[6]

- **Power distance** The extent to which members of an organisation accept an unequal distribution of power.
- **Uncertainty avoidance** The extent to which people feel threatened by ambiguous situations and create beliefs and institutions to avoid these situations.
- **Individualism** The tendency of people in a particular culture to look after themselves and their immediate families.
- **Masculinity** The dominant factor in societies that value success, money, and material possessions.

When national culture causes conflict with the philosophy of TQM, workers are not able comfortably to adopt the principles necessary to achieve total quality. They argue that the adoption of TQM fits better with cultures with high levels of power distance, collectivism, feminism and uncertainty avoidance. In order to overcome resistance to TQM implementation, it is necessary to understand and respond to the organisational and individual barriers, and national culture is one of the most significant factors for the long-term success of a TQM programme: 'Managers must include organizational design, incentives, training, and organizational value systems in their tool kit when packing for a foreign assignment involving TQM implementation.' Furthermore, in 'cultures where a high level of individualism and low levels of either uncertainty avoidance or power distance exists, workers will be naturally resistant to aspects of TQM involving group problem solving and developing long-term business relationships focused on quality. In these cultures, the TQM implementation plan should incorporate the use of training, incentives, and organization mission/values. That is, the focus on TQM principles must be focused on the individual as a key to overall organization success. This is especially true in nations having low levels of power distance.'

Employee responses to TQM – the importance of context

Edwards, Collinson and Rees[7] identify two contrasting views of TQM. According to the first, optimistic view, TQM transforms attitudes and behaviour through empowerment, and enhanced commitment – the 'transformational' view. The second, and pessimistic view, is that TQM intensifies work and tightens managerial control over the workforce – the 'intensification' thesis.

Their research on six UK companies does not find support for either of these perspectives. Rather, it suggests a third, intermediate, view according to which the effectiveness of quality programmes varies according to context. Furthermore, the success of quality programmes is affected by a number of contingency factors, two of which stood out across the six organisations studied: job security and a co-operative relationship between management and trade unions. Other factors specific to each organisation may promote or inhibit the acceptance of quality management, such as the climate of trust and employee representation systems: 'In line with context dependency, workers have no inherent opposition to the principles of quality, and acceptance of specific initiatives seems to depend on context.'

Interestingly, whilst they found little evidence of empowerment, the growing work effort involved with quality programmes was not widely disliked and favourable views of quality were strongest where the monitoring of workers was most intense. Their research supports the 'disciplined worker' thesis, according to which an organised and disciplined environment is preferred to chaos. However, 'this does not mean that traditional distrust has been eliminated or that workers are empowered in any developed sense'. Quality management is not about dissolving the antagonism between capital and labour but a means of managing it. It 'can be a useful tool in the constant endeavour of management to release workers' creativity while at the same time controlling them. Workers, for their part, seem to accept quality principles while also being aware of the costs and limitations'. Quality management is more evolutionary than revolutionary. Finally, 'as managements continue to experiment with new forms of work organization, the issue of gaining employee commitment is likely to be increasingly significant'.

The failure of a TQM programme – a vision betrayed

McCabe and Wilkinson[8] offer a case study of the failure of a TQM programme in a medium-sized UK bank seeking to differentiate itself in an increasingly competitive environment by means of quality. It also raises relevant points regarding employee responses to TQM and the extent of empowerment actually achieved. They argue that 'employees often welcome new ways of understanding and participating in the world of work and it is only though management's failure to act consistently or to live up to the vision of TQM . . . that staff become disillusioned. Thus, it is not only that empowerment is "task" rather than "power" based but it is also that management often fail to support even the limited form of empowerment that is on offer'. In the case of 'Medbank', this inability of management to live up to the vision of TQM was due to a variety of factors, including the culture of the organisation, the nature of the implementation process and the impact of external factors.

There was no single or simple explanation for the demise of the programme at 'Medbank', given the wide range of factors were involved, differences of interpretation and TQM's uneven hold on the organisation. Amongst the key reasons for the eventual failure were:

- failure to provide adequate infrastructural support;
- an initial 'awareness' training programme that did not embed the TQM initiative;
- a focus on management rather than staff;
- staff allowed only limited ability to take responsibility and to make changes;
- a bureaucratic, authoritarian and hierarchical culture;
- a perception of the TQM programme as the 'latest fad';
- declining senior management commitment;
- eventually business pressures meant that quantity took place over quality.

While TQM may impact on corporate performance, external factors impinge significantly on TQM's outcomes. The context was fundamental change within the financial services sector with the collapse of the 'stabilising pillars' of employment levels, career structures and industrial relations. The bank's response was to restructure by centralisation and, then, downsizing the branch network. These changes contradicted TQM's message of increasing authority and responsibility for branch managers and staff, and accelerated its decline. Insecurity from restructuring led to conflict between employees, rather than team spirit, and the threat of job losses hampered commitment and creativity.

For the authors there was a fundamental contradiction within the apolitical, unitarist, vision of TQM given management's imposition of change and redundancies. Despite a unifying vision, the fundamental differences of interest within the employment relationship are not totally obscured. TQM may temporarily succeed where it can disguise these differences, if it can overcome many of the problems of implementation. The prognosis for TQM is questioned. 'Management may endeavour to bridge the gaps between the vision of TQM and its operation. Yet, how far these gaps can be closed in the long term given the uncertainty and complexity of organisational life remains a matter for debate'.

Implementing BPR – managing the change process

Moosbruker and Loftin[9] argue that the key to the success of BPR is to employ change management principles, and that, furthermore, 'organization development' (OD) provides a framework for organisational understanding and change management that could enable successful implementation of BPR.

They note that even though both have as their goal improvement of organisational performance, OD and BPR are based on different assumptions and values, that they typically start from different presenting issues and follow a different process. BPR deals with the definition of tasks and their relationships within and between work processes in order to improve organisational performance. Its values are hierarchy, financial well-being, control, consistency, analysis, objectivity, and emotional suppression. Typically, a BPR initiative is set up following an issue of performance, and it begins with a definition of quantitative requirements. OD deals with the dynamics of people at work and the whole work system in order to improve both individual satisfaction and organisational performance. Its values are shared leadership, employee well-being, participation, flexibility, synthesis, open communication, and emotional expression. It typically begins from a different presenting issue – people – and the approach is to commence by contracting roles and expectations.

The authors note that OD and BPR organisations typically report to different functions with little incentive to collaborate, and few individuals exhibit a high degree of skill in both disciplines. They argue that OD and BPR need to share more values and value each other more than at present, and a key recommendation is that OD and BPR functions should report to the same functional head.

Securing justice and commitment

Beugre[10] argues that one reason for the failure of BPR initiatives is the focus on new technology and the lack of emphasis on the human aspects of change that must accompany it. Whilst he examines the issue of fairness in the context of implementing BPR, perceptions of justice are relevant to all change technologies.

Organisational justice, which refers to 'perceptions of fairness and their impact on behaviour in organizations', encompasses four dimensions:

- distributive justice (concerned with the distribution of rewards with equity being the best rule);
- procedural justice (relating to procedures, and employees more likely to consider rules as fair if they have contributed to their enactment, and have control over their actions);
- interactional justice (the quality of interpersonal treatment, particularly regarding explanation and values, that people receive during the implementation of a procedure);
- systemic justice (the broader organisational context in which procedures are embedded, representing the general assessment of the degree to which an organisation, and its specific systems such as promotion and compensation, are seen as fair).

Managers may overlook issues of justice for a number of reasons: a failure to understand the impact of the issues; a desire to retain power by withholding information; and also a focus on short-term performance rather than human dimension of change. However, Beugre argues that, at each stage of the re-engineering process – preparation, identification, vision, solution, and transformation – issues of fairness need to be considered, and that this forms a key aspect of gaining commitment.

Ideas and rhetorics of quality

Zbaracki[11] focuses on the introduction and legitimisation of TQM ideas at the firm and individual levels. He distinguishes between:

- **Technical TQM** This incorporates 'some fairly well-defined organizational interventions that have clear rules for the use and analysis of information'; and
- **Rhetorical TQM** This is an ambiguous term with unclear organisational implications, consisting of managers' stated claims and accounts, a 'stream of discourse used to construct, spread, or sustain a set of assumptions about TQM' the main aim of which is to persuade.

He follows the social construction of TQM in five organisations, building a model of how it enters the rhetoric and reality of organisational life. Institutional forces distort the technical reality as managers and organisation members generate meanings by a process of accretion out of their use of TQM and, hence, define for themselves the reality of TQM.

TQM enters the organisation through the rhetoric of various managers and experts which simultaneously shapes the actions of people and sustains their belief in TQM. People then experience TQM through training programs, teams, and approaches. Sometimes it works but often it doesn't. However, after they try it, people ignore the failures and select the best stories to tell. 'TQM then goes back out of the organization as rhetoric: success stories from those experiments.' Thus, from rhetoric first defining and then encouraging reality, reality in turn defines rhetoric, and finally rhetoric shapes perceptions of reality.

Zbaracki provides an evolutionary process model which describes how TQM enters an organisation through a succession of stages, which may contain nested cycles and sub-routines, as it proceeds from organisational, to team and to individual levels:

- variation (of organisational procedures as the performance of the organisation does not meet expectations);
- selection (as members encounter specific TQM practices);
- retention (as members alter routines and rhetoric);
- return.

Different forces act on rhetoric and reality, some encouraging rhetoric, and others discouraging reality – examples of the latter include ignorance, intimidation, lack of integration with existing organisational practices at managerial and employee levels and, later on, people turnover and the perception of TQM work as separate from normal work. Rhetoric and reality interact but, inevitably, a gap opens between them as members develop complex and multiple rhetorics.

What are the practical lessons from this research? The key point is that the social construction of the reality, and rhetoric, of TQM is a complex process, with unintended consequences, counter-views and multiple realities. Managers should thus be aware of the benefits and limitations of their rhetoric. Rhetoric helps managers to accomplish their tasks, win support for and legitimise new initiatives. At the same time rhetoric may generate an over-optimistic view, fuelling a fad, and leading to resistance.

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STRATEGY AND ORGANISATION

Strategy in the Post-Industrial Society

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Many writers on strategy have recently been questioning traditional concepts of strategy which seem to be more suited to stable environments than the more uncertain and unpredictable world we now live in. Two Norwegian writers, Lowendahl and Revang,[1] believe that we are witnessing a Kuhnian paradigm shift in strategy at present. In the post-industrial society, where the knowledge and skill of key employees is often more important than physical assets, traditional notions of strategy based on the notion – implicit at least – of the organisation as a machine, are giving way to approaches suited to more organic models of organisation. In the post-industrial society, competitive advantage is:

> *'. . . based on the uniqueness of how companies organize customers and assets and the way they are continuously improving these relationships . . . Systematizing learning from experience and transferring learning to others become important processes in strategies for improvement. Organizational life becomes more an issue of helping your friends (named individuals such as customers or partners and organisational members) than an issue of behaving universalistically.'*

At the core of the strategy, then, is the ability to build and maintain relationships with the best people for maximum value creation, both 'internally' (to firm representatives) and 'externally' (to customers).[2]

Lowendahl and Revang believe that the key problem is that organisations in many industries are now witnessing two simultaneous types of complexity (or, to use their unfortunate term, 'complexification'). Thus, internally, as the emphasis moves from functional efficiency and performance measurement to knowledge acquisition and organisational responsiveness, organisations become more difficult to govern, at least by traditional hierarchical notions of organisational control. At the same time, the external environment is also becoming more complex as technological change becomes more rapid, product life-cycles become shorter, and systemic changes in the political and economic environment often more radical.

So what does strategy have to offer in such situations? Traditionally, the authors argue, we had models to suit the circumstances. In situations of low internal and external complexity, large bureaucratic organisations could compete through economies of scale and cost leadership. When the external markets became more complex for such organisations, they often responded organisationally by moving to multi-divisional structures and, in terms of their strategy, by adopting differentiation and market segmentation. Equally, for those organisations that experienced more complexity internally, more fluid ad-hoc organisational forms were adopted and emergent or incremental strategies – a la Henry Mintzberg – became the order of the day. The problem for the post-industrialist is what happens when both the internal and the external environment are highly complex. In this situation, ad-hoc or emergent approaches are likely to be inefficient and dissipate effort, whilst traditional Porterian notions of strategy are likely to prove too inflexible.

While Lowendahl and Revang do not have any answers to this problem, at least as yet, they do ask some interesting questions.

- What should be the key strategic priorities for firms in this situation – indeed, do they need a long term strategy at all?
- How do such firms sustain their competitive advantage over a long period of time and prevent it from reverting to the mean?
- Are there first mover advantages in deploying revolutionary strategies or is there, by contrast, a 'liability of newness'?
- What cultural and institutional arrangements promote the successful execution of such strategies?
- How can firms sustain the relationships, internal and external, of loyalty and trust which underpin such strategies?

On the other hand, they believe that the very notion of providing prescriptive strategy advice, in a post-industrial setting which calls for 'particularist solutions', may be flawed. Instead, they rather vaguely call for post-modern managers and researchers to look for 'pragmatic concepts that help focus action and attention'.[3]

Strategy and post-modernism

In a similar vein, Peter Franklin calls for a post-modern approach to business strategy.[4] Franklin argues that our understanding of strategy is grounded in modernism, a term which is used to capture the ideals of the Enlightenment, when for the first time a rational scientific approach displaced traditional notions of superstition and mediaeval sorcery. Concepts like the organisation, for example, are essentially abstractions or 'objectivications'. Post-modernists, by contrast, believe that the very act of observation and interpretation changes the way we think about concepts. Post-modernists believe that there is not one reality but rather multiple realities which are the outcome of discourses, which in turn are conditioned by power relationships.

As far as strategy is concerned, the post-modernists seem to be more concerned with the process of strategic analysis and decision-making than the content – the 'hows' rather than the 'whats' of strategy. Thus, traditional strategic models like BCG analysis, SWOT analysis and generic strategies are important, not because they represent any objective view of the right strategy to adopt, but rather as a form of rhetoric or discourse by which a particular strategic course emerges and is adopted.

The consequences of post-modernism for strategic management in Franklin's view, it has to be admitted, are pretty bleak. He believes that we have to start from the position that we know very little about strategy and, in this respect, he quotes Hamel's frequently cited confession that the strategy industry does not have a theory of strategy creation.[5]

However, it could be argued that it is not necessary for us to adopt the full post-modernist agenda and start the whole endeavour again from scratch. We should be careful not to move from the proposition that we are not able to predict with certainty what strategies are successful, to the proposition that any strategy is as good as any other and that what matters is how you project it. Despite talk of post-industrial economies and post-modernism, many of our organisations, particularly large organisations in mature industries, have not yet discovered ways in which to rewrite the laws of economics. And, as much of strategy is derived from industrial economics, we should do well not to throw out the baby with the bath water.

Value chains (again)

A good example of a middle way between the extremes of post-modernism and traditionalism is represented by Stabell and Fjeldstad's recent article on value chains – another impressive contribution from the Norwegian School of Management. This article breaks new ground, but looks again at a well-established concept in strategy, the value chain, and redefines it in ways which make sense in a post-industrial setting.[6]

Those who are familiar with Porter's work will have his value chain model pretty well permanently imprinted on their cerebral cortex. We can recall all the sequential stages from inbound to outbound logistics, and the other supporting activities that go along the top, leading up to the margin at the end of the arrow. The problems start when we try to apply it! Porter gives an exhaustive account of how the value chain can be applied in organisations, by analysing each of the different aspects of the value chain and identifying the cost drivers. However, in the real world the value chain model is seldom used in this way, not least because the information which is required to do this type of analysis is rarely available. Another problem associated with the value chain is that it assumes an organisation in a typical manufacturing type industry. So, companies in service industries often struggle to apply the model.

For example, as Stabell and Fjeldstad point out, companies in the insurance industry do not lend themselves readily to the traditional value chain analysis approach. For example, what is received, what is manufactured, what is actually shipped out – as outbound logistics? Nor is it helpful when applying the model to banks to focus on lenders and borrowers as bank customers when, in fact, the logic of banking is about asset spread and risk management.

Value chain analysis, according to these authors, works well in so-called long linked technologies, where processes can be broken down into sequential stages. The value creation logic is about transforming inputs into outputs, and the key drivers are usually cost related to scale and capacity utilisation.

However, Stabell and Fjeldstad believe that there are alternative value 'configurations' which are more appropriate in certain cases. For example, they identify a value 'shop' model. Here, the underlying value creation logic is about resolving customer problems. The activities are not sequential but rather cyclical and iterative. The key value drivers are likely to be the reputation of the company. Value shops are common in professional service sectors but also as functions or parts within larger firms, for example petroleum exploration or research and development. The term 'shop' is used in this context in the North American sense of a workshop, where a trained mechanic addresses a specific set of problems related to, for example, body work repair. The diagram for a value shop looks very different from the value chain. Activities like problem finding and acquisition, problem solving, choice, execution, control and evaluation are linked in a sequential, but iterative, fashion.

A third form of value configuration identified is the so-called value network. Here, the value creation logic is linking customers by promoting, installing and servicing the infrastructure. Whilst the key drivers are likely to be scale and capacity utilisation, the logic is simultaneous and parallel rather than sequential as in the value chain. Organisations like banks, telephone companies, insurance companies and postal services adhere most closely to the value network model. Thus, banks bring together borrowers and lenders, and telephone companies link subscribers. The more customers you have, the greater typically is the value of the network to other potential and actual customers. But, for the network to function, the activities have to be synchronised. Insurance companies with insufficient reinsurance, for example, may go bankrupt following major accidents. The model for value configuration with value networks is also distinctive, with three main activity headings:

- Network promotion and contract management.
- Service provisioning.
- Infrastructure operation.

Stabell and Fjeldstad go beyond using value chain analysis as an analytical method. However, they also believe the choice of value configuration – chain, shop or network – is in effect another form of generic strategy, analogous to Porter's cost leadership or differentiation. Stabell and Fjeldstad's work demonstrates that it is still worthwhile seeking alternative analytical tools, even in this new post-industrial world.

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ACCOUNTING AND FINANCE

The Cost of Capital

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> *'The development of value-based analysis in Europe has put the concept of cost of capital increasingly in the spotlight.'*[1]

As illustrated in earlier issues of *Manager Update*, there has been a growing interest in the UK in the issue of shareholder value. Shareholder value methods in the form of free cash flow analysis and Economic Value Added (EVA) have been reviewed in previous *Updates* but, as an examination of the popular press and business books on the subject of valuation would reveal, they are not the only choices. For example, in the last 12 to 24 months, a more complex approach, called Cash Flow Return on Investment (CFROI), has attracted much attention.[2]

What do all of these valuation methods have in common? The answer, in very simple terms, is that they all see value as being created if an economic return greater than the cost of capital is achieved. These methods often differ as regards the estimation of economic return and, in addition, they may also draw upon different interpretations of how to measure the cost of capital, but they do agree that risk and return are related.

The purpose of this *Update* is to provide insights into the latest developments in estimating the cost of capital, and to review approaches that may well be adopted in estimating the cost of capital in emerging markets. Emerging markets have been the focus of particular attention in recent times and this is so for the cost of capital, for much of the fundamental data required may not be available.

In fact, the most difficult part of the cost of capital estimation process relates to the cost of equity, where assessing the risk-return relationship presents a significant challenge. A major issue in estimating the cost of equity concerns the application of the Capital Asset Pricing Model (CAPM). The traditional CAPM cost of equity (Ke) calculation takes the following form:

$$Ke = Rf + (ß \times Rp)$$

Where:

Ke = Estimated cost of equity
Rf = Risk-free rate
ß = Beta
Rp = Equity risk premium

(Beta is a relative measure of an equity share's risk, that is determined by comparing its return with the return on the stock market as a whole. The type of risk that beta measures is called systematic, market or non-diversifiable risk, and it is caused by macro-economic factors which affect the returns of all companies' shares. If the returns on an individual company share are affected by these macro-economic factors to the same degree as for the equity market in general, then the company will have a beta of 1.0. The higher (lower) than 1.0 is the beta, the greater (lesser) is the systematic risk of the share.)

Assumptions about the risk-free rate, beta and equity risk premium are of paramount importance and, as will be illustrated, there is little consensus on these even within developed markets, making the estimation in an emerging market context even more challenging. As the Lex column of the *Financial Times* put it recently:[3]

> *'The equity risk premium is an excellent concept but not a visible price. With academics and pundits prepared to come up with figures anywhere between zero and 8%, the scope for companies to engage in creative accounting could be big.'*

Concern about issues associated with the cost of capital has also been expressed by Credit Suisse First Boston:

> *'Although the notion of cost of capital seems pretty clear from a theoretical point of view, there is much debate about practicalities of calculation. Corporate management, investors and analysts share the same concerns, and there is no agreement between academics and professionals on a precise methodology and an appropriate set of benchmarks.'*[4]

Anyone who has built a discounted cash flow model will know only too well; a differential of 8% has an enormous impact upon resulting values. The Glaxo-Wellcome takeover provides a useful illustration. In a report by James Capel, analysts used the approach to estimate a base case value for Glaxo with

Wellcome of approximately 575p per share, compared with Glaxo's existing share price of 732p.[5] Each one percentage point increase in the group's cost of capital decreased the shareholder value by 75p per share.[6]

CAPM developments

There has been an ongoing debate about the relevance of CAPM in estimating the cost of equity, much of which has focused upon the appropriateness of beta as an indictor of market related risk. As the earlier quote from the Lex Column of the *Financial Times* illustrated, this is by no means the only point of attack. In fact, to many who try to apply CAPM, the equity (or market) risk premium (ERP) represents a much greater problem.

The extent of the problem was illustrated recently at two conferences: a well-respected authority on the subject from a major UK business school made a well-substantiated case for the ERP being around 6% for the UK; two weeks later at a different conference, a well-respected representative of a major investment bank made an equally well-supported case for it being 2%. Clearly, this is an area warranting great research effort, a challenge recognised by at least one of the UK accountancy bodies that has sponsored research projects directed at providing greater insights and guidance for practitioners. That aside, there are those shareholder value proponents who argue that CAPM is totally inappropriate, recommending instead the adoption of a market-derived discount approach. According to this view, a cost of capital can be derived by finding the rate of return that equates a prospective stream of cash flows with the value of the business today. This approach seems to have attracted the attention of the fund management community and some emerging market specialists but, as indicated in my own research, the majority view as far as the corporate community is concerned is directed at CAPM thinking. One might ask why? Despite its limitations, what CAPM does have in its favour is the simplicity of the way in which it captures one of the key messages of finance, that higher risks demand higher returns.

Emerging markets

Many of the problems as regards applying CAPM in developed markets concern the ways in which available data is used, ie, in estimating the ERP should long-term historic data be used, if so over what time period, or should prospective (forward thinking) estimates be used? In emerging markets the problem is often quite different – there is no data from which the risk-free rate, betas, or an equity risk premium can be estimated. In such circumstances, methods need to be employed that recognise this problem. The options are doubtless many, and in my experience no single method is used in isolation, but three key contenders are:

1. modified US $ denominated CAPM;
2. local currency CAPM;
3. market derived

The first two of these attempt to use CAPM thinking for the purpose of estimating a cost of equity, and each has appeal under different circumstances. The modified US$ CAPM approach is popular in those markets where reference to the US $ is commonplace, like many Central and South American countries. In other emerging markets, like some Asian countries, it is more normal to make business projections in local currency terms, hence the preference for a local CAPM rate. Nevertheless, both of these approaches tend to focus upon country adjustments only. Translating them into sector and company estimates requires further adjustments. Last but by no means least, the market derived approach may well be used. This was introduced with reference to the valuation method known as CFROI, where the objective is to find the cost of capital (not just the cost of equity) that equates the prospective cash flows from a company with its value today.

1. Modified US $ CAPM

The modified US $ CAPM approach recognises that the results of beta analysis for emerging markets often gives results contrary to common sense. For example, based upon the analysis of equity returns of individual countries against a world portfolio, Goddfrey and Espinosa found that:[7]

- All developed countries have betas higher than 0.5.
- Fifteen of 26 emerging market countries have betas below 0.5.
- Four such countries have negative betas, implying costs of equity below risk-free rates.
- Risk premia in emerging market countries are lower than the risk premium for the US.

By comparison, the volatility of the emerging markets covered by the analysis, as measured by the standard deviation of mean equity returns, revealed a picture far more in keeping with expectations. This, together with other reasoning, led to the proposed use of the modified US $ CAPM.[8] According to this approach, adjustments to the risk-free rate are made for country risk by the addition of a credit spread. Adjustments are also made to the beta for the volatility of the market in relation to a US reference point, as measured by the relative standard deviation, ie,

$$Ke = (RfUS + \text{Credit Spread}) + (\text{Adjusted } ß \times RpUS \times \alpha)$$

Where,

Ke	=	Estimated cost of equity
RpUS	=	US Market Risk Premium
Rf	=	Risk-free rate
Adjusted ß	=	$\sigma i/\sigma us$
α	=	Adjustment for the interdependence between the risk-free rate and the market risk premium.

By way of an example, the application of this approach gave the following result for Brazil:

$$\text{Brazil} = (6.00 + 4.1) + (5.55 \times 5.5 \times 0.6) = 28.4\%$$

The comparative effect of applying this approach can be seen in the following table, where the cost of equity in the US has been estimated at 11.5%:

Argentina	28.7%
Turkey	28.5%
Brazil	28.4%
Poland	27.3%
Hungary	27.0%
Czech Republic	23.3%
Mexico	22.3%
Philippines	18.9%
India	17.8%
Thailand	17.1%
Indonesia	16.3%
South Korea	15.5%
Malaysia	14.7%
South Africa	14.7%

Source: CSFB (note that the value is time dependent)

This approach makes a number of important assumptions: first, that the equity risk premium in the US market is an important performance benchmark; second, the equity risk premium (ERP) demanded by investors in local markets can be inferred from the ERP of the US, adjusted for the volatility of the local markets relative to US; and, third, that there is an interrelationship between the risk-free rate and ERP. (CAPM assumes these are independent but in reality they respond to similar events in the macroeconomic environment and hence are interdependent.)

However, there are some recognised problems of the approach. First, a dollar denominated view is not applicable in all markets: second, it does not seem to work according to expectations for some markets; and, third, it is based upon historical volatility, a highly questionable proposition in emerging markets, as events during the latter half of 1998 have shown.

2. Local currency CAPM

As indicated, in some markets there is greater preference for a local currency CAPM approach. This uses the basic CAPM formula but focuses in particular upon making local adjustments to the risk-free rate and the equity risk premium. In the case of the risk-free rate, local currency fixed deposits are used as proxies, but are adjusted to reflect their short-term maturity. As regards the equity risk premium, the difference between average local currency historical returns from the equity market and average assumed local currency historical returns from risk-free securities are estimated over a given time period.

However, there are some acknowledged problems with estimating the ERP in emerging markets that relate to the availability of reliable, long-term data. Typically, their stock markets have only been operating for a short period of time relative to those in the developed countries. As a consequence, reference is made to political risk and the structure and volatility of the market as factors that need to be taken into account in one's analysis.

By way of illustration, Credit Suisse First Boston arrived at the following estimates using the local currency CAPM approach for Asia:

	Cost of Equity
Taiwan	12.5%
Singapore	10.0%
Hong Kong	14.0%
Malaysia	15.6%
India	17.8%
Korea	19.0%
Thailand	21.0 %
Philippines	22.0%
Indonesia	25.4%

Source: CSFB

CAPM approaches are likely to be popular when business risks can be related in some way to home opportunities, assessment of risk differential is seen as being possible, and the mark-up of target returns can be viewed relative to a home country perspective. Otherwise, the Market Derived Cost of Capital may be used.

3. Market derived approach

This involves forecasting a stream of cash flows for a relevant group of companies, and solving for the discount rate that equates the cash flow stream to the sum of the market value of each company's equity plus the book value of its debt.

By way of an illustration, the following Market Derived Discount Rates were compiled from information provided in the Chief Financial Officer journal:[9]

	Cost of Capital
US	10%
Brazil	22.1%
Argentina	13.6%
Chile	11.3%
Hong Kong	11.9%
Singapore	7.8%

In using the market derived approach, one of the major issues concerns how to model the potentially infinite stream of future cash flows. Various solutions have been proposed to solve this problem. One, simple approach is to forecast in detail for a finite time horizon, often 3-5 years, and then to make the assumption that the cash flow of the year immediately following the time horizon continues into perpetuity. A more complex approach entails modelling the financial economics involved by using the notion of holding returns constant for a period of time, and then fading subsequent returns to the long-term average of the economy over a couple of decades. The difference between the approaches is one of the degree of sophistication one wishes to employ in their respective calculations.

Conclusion

There is little doubt that the cost of capital is going to be a very hot topic in all markets. By way of illustration, the first conference on the subject in the UK of which I am aware, attracted a large number of delegates and was on the agenda of a competitor conference organiser in the following week!

We have a long way to go in meeting the needs of practitioners on this subject. One senior financial manager of a major UK corporation concluded that the conference he had attended on the subject had merely raised questions and provided few answers. In light of this, watch this space is an appropriate response! However, recognising that many readers may find such an open-ended comment frustrating, I can recommend a recently published book on the subject. Whilst it tends to raise as many questions as it provides answers, it does at least provide a relatively user-friendly perspective on a complex subject.[10] I have little doubt that many other books will follow on the subject.

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