

Manager Update

ISSUE 3

Autumn 1997

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)

Manager Update is compiled and edited by Professor Keith MacMillan, Academic Dean and Deputy Principal of Henley Management College.

Susan Foreman is Lead Tutor, Marketing Faculty, Henley Management College.

Richard McBain is Intercompany MBA Programme Manager at Henley Management College.

Mitchell Kusy is Associate Professor at the University of St Thomas, Minneapolis, USA.

Ian Turner is Director of Studies of the Distance Learning MBA and Diploma in Management at Henley Management College.

Roger Mills is Professor of Accounting and Finance at Henley Management College, and Consultant Professor to Price Waterhouse on Shareholder Value.

ARTICLE SUMMARIES

Marketing *Developing Trust in Buyer-Seller Relationships*

The importance of long-term relationships with customers is increasingly being realised in underpinning business success. This can have important implications for the role of the sales force. What type of behaviour by a sales representative builds these long-term relationships? Does it conflict with short-term sales targets? Is it necessary to recruit people with different characters? Is a different kind of sales training required?

Page 2

Human Resources Management *The Human Side of Leadership Promotes the Bottom Line of Organisations*

Recent ideas on leadership stress the importance of 'softer', more human aspects besides technical skills and intelligence. The 'emotional quotient' (EQ) in one article for example, is said to be as critical to success as IQ. A number of studies indicate the advantages of interpersonal skills, the ability to communicate, learning from others, adaptability, and developing a shared vision. But can these capabilities be learned by leaders of the future?

Page 5

Strategy and Organisation *Creating Value by Shaping Tomorrow's Business*

In the thinking on strategic management a new synthesis needs to emerge which combines earlier ideas on competitive strategy with newer ideas on shareholder value and the so-called resource-based ideas. An important new contribution is reviewed in this *Manager Update* which integrates these ideas and provides a useful step forward. It appears to have implications for strategies of differentiation and diversification.

Page 11

Accounting and Finance *Competitive Advantage Period*

One of the most important factors in estimating the value of a business is how to choose the time period over which the calculations should be made. Sometimes referred to as the Competitive Advantage Period (CAP), this is the time during which a company is expected to generate returns that exceed its cost of capital. But what is the appropriate number of years? Does it depend on the industry? How can the choice best be made?

Page 15

ISBN 1 85355 647 5

MARKETING

Developing Trust in Buyer-Seller Relationships

Susan Foreman is Lead Tutor, Marketing Faculty, Henley Management College

Relationship marketing has often been referred to as a 'new - old' concept.¹ Even though relationships have existed between individuals and groups of individuals, since people first began to exchange goods and services, early writing in this area is often attributed to work done in the late 1970s and 1980s. Increasingly, the strategic importance of relationships is recognised in the service, consumer goods and business-to-business sectors.

This issue of *Manager Update* focuses on three articles published recently which emphasise the nature of trust, the importance of relationships and the role of sales representatives in the business-to-business sector. Doney and Cannon² investigate how trust in relationships influences customer behaviour. In particular, they are concerned with trust between the supplier firm, the sales representative and the buyer and how buyers select their current suppliers. Leuthesser³ examines the behaviour of buyers and sellers and asks which kind of behaviour makes a difference to the quality of relationships, and whether this influences the share of buyer's business attained by suppliers. Ramsey and Sohi⁴ researched salespeople's listening behaviour and its impact on buyers' perceptions of trust and satisfaction. All three papers are concerned about buyers' purchase intentions in long term relationships.

The role of the sales representative

It has been suggested that the renewed focus on market orientation and the development of relationship marketing in the business sector has a significant impact on the role of the sales force. The role of the sales representative is at a watershed between 'opening the sale, handling the objections, closing the sale', meeting sales targets and their role in developing long-term co-operative relationships. The focus is shifting to consider their part in developing commitment, trust, co-operation, structural and social bonds which are important throughout the lifetime of the relationship between buyers and sellers. Wilson⁵ shows that activities are prominent at different stages in the relationship. For example, a sales representative may need to concentrate on developing trust in the early stages of the lifetime of a relationship but this may give way to an emphasis on commitment and co-operation in the latter stages. The importance of each activity does not diminish as the relationship develops but is 'latent' until circumstances change and situations need to be reassessed.

Understanding trust

Trust is a central theme running through the selected articles, and a critical element in the development of relationships. Yet there are many interpretations of what it means in theory and practice. The dominant theme in most definitions centres on a mutual exchange and an understanding that the two parties act in each others' best interests. The language of trust includes phrases such as willingness, belief, fulfilment, confidence, expectation and promises. Anderson and Weitz⁶ provide a widely used definition of trust: 'One party believes that its needs will be fulfilled in the future by actions taken by the other party'.

According to Ramsey and Sohi, sales representatives who actively listen to their customers are more likely to develop trust in their relationships with buyers. They use a definition of trust in sales representatives as, 'a confident belief that the salesperson can be relied upon to behave in such a manner that the long-term interest of the customer will be served'.⁷ It is clear that they think that buyers consider

that a sales representative is more trustworthy when they are actively listening and actively trying to satisfy their needs. Leuthesser also bases his work on trust on this definition but in the study he conducted on relational behaviour, he combines buyer trust with buyer satisfaction into one characteristic that he calls 'relationship quality'.

Doney and Cannon state that trust has two components, credibility and benevolence. To be credible, they state that the partner's oral or written statements need to be reliable, and that each party shows benevolence by concentrating on the other party's welfare and striving to achieve mutual gain. They identify five processes that will contribute to the development of trust and show links to factors that will help to develop trust in relationships between the supplier, the sales representative and the buyer.

Learning how to trust

The processes identified from a review of the literature, by Doney and Cannon, are summarised here. The first process they consider is a 'calculative' one. The buyer and the seller estimate the potential costs associated with their counterpart acting opportunistically or dishonestly, and the potential benefits and advantages which can be accrued when relationships satisfy mutual needs in the longer term. Second, each partner uses information collected in previous exchanges to try to predict how the other will behave. The greater the number of positive experiences that can be called upon, the more confidence develops in future behaviour. The third aspect, 'capability', reinforces the emphasis on credibility in their definition. The buyer needs to know that the seller can actually deliver the promises made. Trust will not be forthcoming if the sales representatives words are not supported by deeds. The intentions of both parties are also assessed in the fourth process identified by Doney and Cannon. Here, the basic question of concern to the buyers and sellers is whether the parties to the exchange have honourable intentions. Last, in a new relationship, where there is no previous experience of each other, buyers and sellers seek information from other sources, and use evidence from behaviour they see in other relationships to judge whether the potential partner can be trusted. This process is known as 'transference'.

Developing trust in the supplier

Leuthesser suggests that whilst the goals of the supplier and the buyer are not always compatible in every respect, there is common understanding that co-operative long-term relationships should focus on achieving shared goals. Indeed, a supplier's relational behaviour can be instrumental in developing trust. Suppliers should actively work towards understanding customer needs and preferences, provide information about their own activities, and be prepared to disclose relevant sensitive information as, 'a signal of good faith' (Doney and Cannon). This Leuthesser calls initiating, signalling and disclosing. Furthermore, frequent and personal contact between the buyer and the seller can relieve uncertainty and help to develop satisfaction and trust—thus working towards his understanding of relationship quality.

In the early stages of a relationship, supplier reputation and size are important dimensions in establishing trust in the relationship. Even though it is intangible, the standing and reputation that a supplier has developed in an industry, for honesty and trust, is accepted by the buyer according to Doney and Cannon. However, other evidence can be sought to support this belief, and the buyer may examine market shares to estimate the size of the supplier and to establish the level of trust shown by other buyers who work with the supplier.

As the relationship develops, buyers are interested to see whether the supplier will make asset specific investments and adapt or customise their processes. This enthusiasm shows commitment, trust and a long-term perspective. The length and time invested in the relationship reduces the buyers' perception that the supplier will act only in their own best interests. One of Doney and Cannon's basic assumptions is that suppliers are less likely to act opportunistically and thus can be trusted, the longer the relationship lasts.

Developing trust in the sales representative

Sales representatives have a boundary-spanning role, interfacing with the external environment. Not only do they persuade customers to buy goods and services, their contact with the buyers provides an opportunity to develop trust. Furthermore, they are becoming recognised once again as key players in the development and the maintenance of relationships.

In addition to understanding the goods and service that the sales representative is selling, buyers expect to see whether the seller can represent their wider interests with the supplier. The sales representative is judged on whether his/her written and spoken word is reliable. Expertise, according to Doney and Cannon, is the basis of trust. However, they also highlight other benefits of a display of expertise, such as confidence, capability, reliability, and the keeping of promises.

The promises made by the sales representative need to be balanced by actions. In placing the order, the buyer believes that the representative of the supplier has the power to provide. Their trust is enhanced by the ability to keep promises. It is important for the buyer to see that the representative is not only skilled in sales but also has power and influence inside the organisation to meet their needs.

As we move from the era of 'delivering the sales pitch' and 'closing the sale', different skills will be needed. Ramsey and Sohi state that when buyers recognise that the sales representative is not just listening, but is using their active listening skills of sensing, evaluating and responding, their trust is not only strengthened but the likelihood of pursuing future contacts is enhanced. As a basis for their research, they use work by Swan and Oliver.⁸ This shows that, when buyers can sense a sales representative is listening to them and is actively trying to satisfy their needs, the buyers believe that the salesperson is honestly interested in them and therefore can be trusted.

Just as frequency of contact and the length of the relationship are important in developing trust in the supplier, they are equally important in developing trust in the sales representative. The development of social bonds become more important in developing a rapport but also, as Doney and Cannon state, in sharing information and easing communication. Indeed, the longer the relationship progresses the less likely the sales representative will act in an untrustworthy way and risk the relationship.

It seems that buyers tend to trust representatives that they like. In turn, the latter often state that buyers want them to be 'a friend'. Whilst this sounds comfortable, there are some underlying reasons for this type of behaviour. Ramsey and Sohi state that buyers' satisfaction is an emotional response to their evaluation of their contact. Liking is related to the good feelings the contact between suppliers and buyers brings, such as confidence, positive motives and good intentions. Doney and Cannon build on this and suggest that buyers often trust sales representatives they perceive to be similar to themselves. If the representative 'shares common interests and values', buyers feel that they are more equipped and able to assess their plans and actions.

Establishing and maintaining the relationship

The authors of the three papers discussed in this review consider that trust is influential in the development and maintenance of long-term relationships, though in these papers evidence of its impact in the short term is not compelling. In many cases, Doney and Cannon identified that the buyer's decision to purchase was based on product superiority, price and delivery, and not trust. But trust was an important prerequisite—one of the criteria needed even to be considered for the sale. Once the decision is made, trust is evident again since they found that trust in the sales representative and the supplier was related to future transactions. Thus, even though trust is not sufficient in itself, it must be part of the supplier ethos as perceived by the buyer and an integral part of a sales representative's behaviour in order to retain customers and develop the relationship.

If the role of the sales activity is changing business markets, then it is necessary to consider the selection,

training and rewards for representatives. Ramsey and Sohi state that candidates with good listening skills should be identified. Those employed can be coached to develop skills which are central to understanding what customers want and emphasising mutual goals rather than only emphasising the product/service features. Doney and Cannon say that trust enhancing behaviour can be taught. Through the normal training process, such as lectures and role-play, representatives can be guided to concentrate on trust building and relational behaviour.

The current emphasis in marketing upon relationships has reinforced the sales representative's role in customer relations. Whilst their traditional skills of understanding the product, explaining the benefits, displaying their sales expertise and matching the product with the buyer's needs remain, the role needs to be matched by a renewed and positive focus on developing trust and in a belief that partners will invest in relationships and keep their promises. For, as Leuthesser argues, maintaining frequent relationship contact helps to establish trust, with the result not necessarily in short-term orders but in long-term sales.

REFERENCES

- 1 **'Relationship marketing of Services - Growing Interest, Emerging Perspectives'**
Berry, L L *Journal of the Academy of Marketing Science* (Fall) 1995, pp 236-245.
- 2 **'An Examination of the Nature of Trust in Buyer-Seller Relationships'**
Doney, P M and Cannon, J P *Journal of Marketing* April 1997, pp 35-51.
- 3 **'Supplier Relational Behavior: An Empirical Assessment'**
Leuthesser, L *Industrial Marketing Management* 27, 1997, pp 245-254.
- 4 **'Listening to Your Customers: The Impact of Perceived Salesperson Listening Behaviour on Relationship Outcomes'**
Ramsey, R P and Sohi, R S *Journal of the Academy of Marketing Science* (Spring) 1997, pp 127-137.
- 5 **'An Integrated Model of Buyer-Seller Relationships'**
Wilson, D T *Journal of the Academy of Marketing Science* (Fall) 1995, pp 335-345.
- 6 **'Determinants of Continuity in Conventional Industrial Channel Dyads'**
Anderson, E and Weitz, B *Marketing Science* (Fall) 1990, pp 310-323.
- 7 **'Relationship Quality in Services Selling: An Interpersonal Influence Perspective'**
Crosby, L A, Evans, K R and Cowles, D *Journal of Marketing* July 1990, pp 212-236.
- 8 **'An Applied Analysis of Buyer Equity Perceptions and Satisfaction with Automobile Salespeople'**
Swan, J E and Oliver, R L *Journal of Personal Selling and Sales Management* (Summer) 1991, pp 15-26.

HUMAN RESOURCES MANAGEMENT

The Human Side of Leadership Promotes the Bottom Line of Organisations

Richard McBain is Intercompany MBA Programme Manager at Henley Management College. Mitchell Kusy is Associate Professor at the University of St Thomas, Minneapolis, USA.

Historically, researchers and consultants who have helped leaders become more effective have tended to focus upon the technical side of leadership, such as marketing, financial planning, strategy and operations. While these areas are fundamental to the success of a business, there is increasing focus on

the human side of leadership. It is not that this approach is completely new; what is new is the attention that this perspective is being given in the management literature because of its link to the success of the organisation.

Emotional quotient: It is not necessarily IQ that spells leadership success

Several studies have discovered that it is neither functional expertise nor intelligence alone that is a significant variable in success in life—it is the interpersonal skills that Savlovey and Mayer¹ define as the awareness of the feelings of yourself and others, as well as empathy for the feelings of others. According to these authors, the brightest are not often the most successful, in their personal or professional lives. In an article about emotional intelligence as it applies to leaders, Gibbs² notes that 'IQ gets you hired, but EQ gets you promoted'.

For Goleman,³ successful leaders are not necessarily the ones who are good networkers and influencers of others. They are adept collaborators and listeners. He found that the primary reasons leaders fail are that they can't lead a team, or can't adapt to change—significant components of emotional intelligence. Furthermore he proposes five components to emotional intelligence:

1. **Self awareness** Being cognisant of one's values and hunches, and using them for effective decision making.
2. **Management of emotions** Keeping one's emotions under control to focus more effectively on the end goal.
3. **Motivation** Using positive emotions to achieve standards of excellence.
4. **Empathy** Sensing how people are feeling and then giving effective feedback; appreciating differences when developing others.
5. **Social skills** Handling the emotions of others.

Cooper and Sawaf⁴ identify four cornerstones to executive emotional intelligence:

1. **Emotional literacy** Building a locus of personal efficacy and confidence through honesty, energy, awareness, feedback, intuition, responsibility and connection.
2. **Emotional fitness** Building authenticity, believability, and resilience, while expanding a network of trust and the potential for listening and conflict management.
3. **Emotional depth** Aligning life and work with potential and meaning and corroborating this with integrity, commitment and accountability.
4. **Emotional alchemy** Building creative instincts, ability to flow with problems, developing capabilities to sense more effectively and taking advantage of potential opportunities.

Whilst this may appear uncontroversial, even common-sense, consider what actually happens in organisations. Promotions to leadership positions may occur to those who are the technical experts in a given discipline. A study of 1000 leaders by Edward Betof⁵ found that 40 per cent of promoted managers and executives failed within the first 18 months in the job. Why? They did not understand the expectations of their bosses. They failed to build successful individual and team relationships. They could not influence others because they could not manage internal politics. And they could not successfully balance their personal and professional lives. All of these are aspects of the human side of leadership.

In another study, Van Velsor and Leslie⁶ discovered the following reasons for general managers not advancing in their organisations: problems with inter-personal relationships, failure to build and lead

a team, ineffective change management strategies, and failure to meet organisational objectives. Only one of these, the last, relates to technical skills, and the remainder deal with the inter-personal aspects of the leadership role. Also, studies of leaders who have lost their jobs and are in outplacement, support the view that these individuals failed because of 'inadequate interpersonal skills, an inability to communicate . . . '(Montgomery⁷).

Empowerment doesn't occur in a vacuum

'Empowerment' is a word that may have negative connotations for a leader—probably because how to make it happen is so nebulous. Empowerment is about educated risk-taking, but not in a vacuum. The leader still has to set parameters, guidelines and expectations. It is not about everyone doing what they want. Empowerment means that those closest to the decision and those having the most relevant information should make the decision: this means that, at times, the leader has to get out of the way of others. Most importantly though, empowerment is about failure and how the leader handles the failure of others. The best way to handle this failure is to create a context for learning by engaging in a dialogue that focuses on:

- What did the person learn from the failure?
- What would s/he do differently next time?
- Will the person teach others what s/he has learned?

Consider this quotation,

'Those men and women to whom we delegate authority and responsibility, if they are good people, are going to want to do their jobs in their own way . . . Mistakes will be made, but if a person is essentially right, the mistakes he or she makes are not as serious in the long run as the mistakes management makes if it is dictatorial and under-takes to those under its authority exactly how to do their jobs'.⁸

Interestingly, this statement was made by William McKnight, founder and CEO of 3M, in the 1940's. Many wonder why 3M has been such a successful organisation . . . empowerment and the importance of learning from failure made it that way.

One of the biggest marketing failures in the US since the introduction of the Edsel was 'New Coke'. The vice-president responsible for New Coke left Coca-Cola. He ended up back at Coca-Cola because as Roberto Goizueta, CEO of Coca-Cola stated in the article in *Fortune* entitled 'So You Fail. Now Bounce Back', 'We became uncompetitive by not being tolerant of mistakes. The moment you let avoiding failure become your motivator, you're down the path of inactivity (Sellers⁹)'. Failure can become a most honoured calling card when learning is part of that failure.

The view that leadership is about empowerment and learning is developed by Heifetz and Laurie¹⁰. They note that organisations face adaptive challenges as the environment and context in which they find themselves are changing. Leaders have to mobilise people throughout the organisation to do 'adaptive work', and they offer six principles for leading such work:

1. **Getting on the balcony** to view and reflect upon the 'field of play' as a whole.
2. **Identifying the adaptive challenge** the essential issue.
3. **Regulating distress** and maintaining a productive level of tension to motivate without disabling.
4. **Maintaining disciplined attention** on the key issues.

5. **Giving the work back to the people** and giving them the self-confidence to accept responsibility for defining and resolving problems.
6. **Protecting voices of leadership from below** since 'leaders must rely on others to raise questions that may indicate an impending adaptive challenge'.

They distinguish between 'adaptive challenges' and 'technical problems'. The latter are routine, while the former need not just a strategy, but a learning strategy: 'Who needs to learn what to develop, understand, commit to and implement the strategy?' They see as 'bankrupt' the prevailing notion that leadership 'consists of having a vision and aligning people with that vision' since it continues to treat adaptive situations as if they were technical, and it reduces leadership to a combination of 'grand-knowing' and selling. Adaptive situations are not amenable to solutions provided by leaders alone: leadership, and the responsibility for solving problematic situations, should be fostered throughout the organisation.

Leadership: the value and limits of participation

Empowerment will not work without a participative management structure. Research studies have demonstrated that involvement brings about greater commitment to the end results. According to Nevis, Lancourt and Vassallo,¹¹ involvement leads to higher quality decisions and higher commitment than non-involved approaches to leadership. Why should leaders be so concerned about commitment? Commitment has a positive effect on three key dimensions—productivity, turnover, and willingness to help co-workers.¹²

But is participative leadership always the most appropriate leadership style? Kahai, Sosik and Avolio¹³ considered the effects of leadership style and problem structure on group process and outcomes in an electronic meeting system (EMS) environment, combining computer, communication and decision technologies. Their research, employing an experimental design, supports the conclusion that in an electronic brainstorming environment a participative leadership style, which involves sharing problem solving with group members by consulting with them, offering directions without imposition, and encouraging input, increases group productivity and satisfaction where the problem is 'fairly structured'. When the task or problem is more structured, a 'directive' style is more appropriate. A directive style involves the leader asserting that s/he is in charge, and providing directions for problem solving to participants without allowing deviation from them.

Kahai et al raise the issue of the generalisability of these results to other organisational contexts. However, it is worth noting that the distinction between adaptive and technical tasks drawn by Heifetz and Laurie can also be seen in terms of their ambiguity and level of structure, and as such the results from Kahai et al's study lends support to the view that a participative leadership style is important when organizations face a period of ambiguity and change.

Transformational leadership and the influence of the context

Contingency theories of leadership have been with us since the 1960s. More recently, there has been interest in the distinction between 'transactional' and 'transformational' leadership. The former is characterised by a focus on role and task requirements, and the provision of material rewards for effort, whilst transformational leadership builds on, and goes beyond transactional leadership. According to Pawar and Eastman,¹⁴ transformational leaders 'create a dynamic organisational vision that often necessitates a metamorphosis in cultural values to reflect greater innovation. To achieve the vision, leaders attempt to secure greater effort and commitment from employees by bonding individual and collective interests'.

Noting that there has been little attention paid to contextual influences on transformational leadership and following a review of the literature, they identify four key contextual factors which influence organisational receptivity to transformational leadership:

1. The emphasis upon efficiency or adaptation orientation: that is, whether there is relative goal stability and a focus on the creation of the greatest possible output from given resources, or a need for innovation and change, particularly in vision, values and beliefs.
2. The relative dominance in the organisation's task system of the 'technical core', which 'performs the tasks of input processing through the operation of technology', and 'boundary spanning functions', which interface with the organisational environment.
3. Organizational structure.
4. Mode of governance, which refers to the 'set of values shared by organisational members and that govern an organisational members pursuit of self-interests'.

Pawar and Eastman contend that an organisation characterised by an adaptive orientation, a dominant boundary-spanning function, an adhocracy or simple structure and a clan mode of governance (involving an alignment between an individual's and an organisation's interests), will be receptive to transformational leadership. In contrast, an organisation characterised by an efficiency orientation, a dominant technical core, a bureaucratic or divisional structure, and a market or bureaucratic mode of governance, is not likely to be receptive to transformational leadership. In the case of the former polar type, a transformational leader would need to harness the positive features of the context, whilst in the case of the latter the transformational leader would need to confront and neutralise the negative aspects of the environment.

Shaping leaders for the future

Recent perspectives on leadership stress the human rather than the technical aspects of leadership. The good news is that the interpersonal skills for successful leadership are behaviours, not personality traits, and behaviours can be learned. Barling, Weber and Kelloway,¹⁵ report the results of a small study on the effects of a training and goal setting intervention, involving a one-day group training session and four individual follow-up sessions, on the transformational leadership behaviours of a group of twenty managers in a Canadian bank. They define transformational leadership as involving charisma, intellectual stimulation and individualised consideration of employees. Using a pre-test-post-test control-group design, their results support the view that transformational leadership behaviours can be developed by training, and that transformational leadership 'can result in changes in subordinate's perceptions of managers leadership behaviours, subordinate's own commitment to the organisation, and in some aspects of financial performance'.

The need to develop the softer skills of managers also helps to account for the growth in other development approaches such as mentoring, and for a reconsideration of existing approaches to management development. Fulmer,¹⁶ noting that 'almost every organisation is trying to create leaders who are capable of helping the corporation shape a more positive future' outlines an evolving paradigm for leadership development the key features of which are a shift from:

- Seeing participants as 'passive listeners' to 'active learners'.
- Designing programmes as 'unique events' to 'never-ending processes'.
- Acquiring knowledge to producing action.
- Focusing on the past to creating a future.
- Using specialists with limited roles, to partnerships with key players.

- A concern with style, towards a concern for substance in both process and outcomes.
- And, from the University campus to the workplace, anywhere.

Your organisation's vision: more than a crystal ball

The new perspectives on leadership stress the importance of the role of the leader in helping a team to develop an understanding of its purpose and the commitment of the members—see, for example, Blanchard, Carew and Parisi-Carew¹⁷ and Nelson.¹⁸ The leader must also pay attention to developing the organisation's vision. But how can this best be achieved?

An organisation's vision becomes alive by involving others in its creation. Many leaders may find this frightening—what if the leader will not agree with what others say the vision should be? Because a leader involves others in helping to create the vision does not mean that these others decide everything. Leaders may solicit inputs, by conducting surveys, focus groups, or interviews about employees' perspectives on the organisation's vision, and then use this input in a visioning session with the leadership team. When leaders unleash this input potential they usually discover some perspectives of the vision that they would not otherwise have known—leaders don't have all the answers.

An even more effective process is to involve all, or selected, employees in creating a vision with the leadership team. This is a new strategy that has been eloquently documented by Jacobs¹⁹ who considers how to lead change in organizations, including the creation of the organisation's vision. This strategy can be used with large numbers of individuals, and requires expert facilitation. The important issue for the leader to decide is whether input or consensus (which is about support, not agreement) is required. It is also vital to clarify the expectations of stakeholders in the process, and for the leader to act in accordance with the expectations—for example if input is sought, then the leader must really listen to this input once it is provided.

A further point is that once the vision is in place it should be integrated into the fabric of what people do every day. For example, when providing feedback to improve individual performance, this feedback should be linked to the vision. Again, is the vision on the organisation's performance appraisal form? More specifically, is the vision one of the items upon which an individual is evaluated? By integrating the vision into the fabric of the organisation, and by involving others in its creation, the vision will become alive.

REFERENCES

- 1 'The EQ Factor'
Savlovey, P and Mayer, J, as reported by Gibbs, N, *Time*, October 2, 1995, p 62.
- 2 'The EQ Factor'
Gibbs, N, *Time*, 2 October, 1995, pp 62-68.
- 3 *Emotional Intelligence*
Goleman, D, Bantam, New York, 1995.
- 4 *Executive EQ - Emotional Intelligence in Leadership and Organizations*
Cooper, R K and Sawaf, A, Grosset/Putnam, New York, 1996.
- 5 'Management Development Report 1995'
American Society for Training and Development, (Fall) 1995.
- 6 'Why Executives Derail'
Van Velsor, E and Leslie, J B *Academy of Management Executive* Vol 9, No 4, 1995, pp 62-72.
- 7 'Organizational Fit is Key to Job Success'
Montgomery, C E *HR Magazine* January 1996, pp 94-96.

- 8 **'Knighting McKnight'**
Oslund, J J *Star Tribune* April 20 1995, p 1D.
- 9 **'So you fail. Now bounce Back!'**
Sellers, P *Fortune* 1 May 1995, pp 49-59.
- 10 **'The Work of Leadership'**
Heifetz, R A and Laurie, D L *Harvard Business Review*, January-February 1997, pp 124-134.
- 11 ***Intentional Revolutions***
Nevis, E C, Lancourt, J and Vassallo, H G, Jossey Bass, San Fransisco, 1996.
- 12 **'How Commitment Affects Team Performance'**
Bishop, J W and Scott, K W *HR Magazine* February 1997, pp 107-111.
- 13 **'Effects of Leadership Style and Problem Structure on Work Group Process and Outcomes in an Electronic Meeting Environment'**
Kahai, S S, Sosik, J J and Aviolo, B J *Personnel Psychology*, Vol. 50, 1997, pp 121-146.
- 14 **'The Nature and Implications of Contextual Influences on Transformational Leadership'**
Pawar, B S and Eastman, K K *Academy of Management Review* Vol. 22, No 1, pp 80-109.
- 15 **'Effects of Transformational Leadership Training on Attitudinal and Financial Outcomes'**
Barling, J, Weber, T and Kelloway, E K *Journal of Applied Psychology* Vol. 81, No.6, pp 827-832.
- 16 **'The Evolving Paradigm of Leadership Development'**
Fulmer, R M *Organizational Dynamics* (Spring) 1997, pp 59-72.
- 17 **'How to Get your Group to Perform Like a Team'**
Blanchard, K, Carew, D and Parisi-Carew, E *Training and Development* September 1996, pp 34-37.
- 18 **'Ways to Foster Team Spirit'**
Nelson, B *HR Magazine* November 1995, pp 47-50.
- 19 ***Real Time Strategic Change***
Jacobs, R San Fransisco: Berrett-Koehler, 1994.

STRATEGY AND ORGANISATION

Creating Value by Shaping Tomorrow's Business

Ian Turner is Director of Studies of the Distance Learning MBA and Diploma in Management at Henley Management College

In this issue of *Manager Update* we review a major contribution to the strategy literature.¹ Shiv Mathur's work on competitive strategy will be familiar to readers of the *Journal of General Management*, not least because of his pathbreaking treatment of competitive strategy, and differentiation in particular.² Mathur and his co-author Alfred Kenyon have now produced a stunning new synthesis of their own work with several current streams in strategy writing, notably:

- Shareholder value analysis.
- The resource based school of strategy.

The purpose of strategy

In Mathur's view, the objective of business strategy should be to earn more than the cost of capital. Success in financial terms is produced by winning profitable customers in commercial markets. Mathur believes that traditional writings on competitive strategy have mistakenly focused on two aspects. First, they have concentrated on the company as the unit of analysis, rather than the product offering. From the point of view of the consumer (who, it is argued, will ultimately determine the success of the company) what matters is how the product is positioned in the marketplace, not the company that makes it. In fact, a company may produce several products, each of them targeting different segments and bought by different sets of customers in competition with a different range of competing products. Mathur and Kenyon define the sub-unit of the company responsible for a particular product offering as a 'firmlet'.

Second, Mathur and Kenyon believe that competitive strategy should focus on outputs rather than inputs. This means that inputs like 'research and development' or 'efficient production processes' only contribute to competitive advantage if they are translated into outputs which deliver benefits to customers.

Private versus public markets

These principles lead on to a reconsideration of competitive analysis. They take issue with the notion of industry analysis (. . . a la Michael Porter) as being a useful prelude to competitive positioning. Most competition, they claim, is not within a total universe of suppliers of a particular product or between producers who use a common discipline or material. According to traditional definitions of what they term the 'public' market or industry:

- Transactions are publicly visible.
- Each supplier in the industry competes with all the others.
- There is no competition without a group of players in the particular market.

These conditions, they maintain, are not realistic in sophisticated developed economies. Thus, the car industry is not a market in any real sense because luxury vehicles like Rolls Royce or Mercedes are not a direct substitute for a Lada or a Skoda. Indeed, producers of expensive limousines may also compete with producers of luxury yachts, whilst cheap utility vehicles can compete with second-hand cars or motorcycles. Mathur and Kenyon argue for a dynamic model of the market, what they call the 'private' market, which would focus not on traditional industry members but on competitors, irrespective of their origins or status, who offer products or services which can substitute for the offerings of a particular firmlet.

People buy products not companies

At this point, regular readers of *Manager Update* may be asking what possible exception could be taken to Mathur and Kenyon's view of competitive strategy. Surely it is a truism that people buy products and not companies. But, actually, a moment's reflection can produce several examples where the company is the source of competitive advantage, rather than the product. Take, for example, a critical notion in business history: economies of scope. These signify the advantages that producers enjoy by being able to spread their overhead costs over a broad range of different products. It could be argued of course that economies of scope are essentially an input measure: they enable producers to reduce their costs, but offer little advantage to the consumer. But this need not necessarily be the case. Take the example of aircraft manufacturers, who increasingly compete through offering families of aircraft. The benefits to the airlines in terms of standardising on training, spare parts and maintenance can discourage them from switching to competing offerings, even where these alternatives are technologically superior. In

fact, this is quite common and is prevalent in industries like the computer industry, where internal compatibility may be more important than functionality.

Another example where the company may be more important than the product is the case of luxury brands, where consumers may be less interested in making specific comparisons between products in a particular market segment, than in acquiring a product with a particular brand name, eg BMW, Chanel or Armani. In fact, the more one thinks about the Mathur/Kenyon approach to competitive strategy, the more atavistic it seems. Sure, companies compete on product offerings and there is an extensive literature which deals with this (it's called marketing). But the thrust of modern marketing – and arguably of strategy – is surely towards longer term relations between producers and customers, offering what Mathur and Kenyon would describe as 'augmented product or service offerings'. And the more one gets away from competing purely on the basis of product, and the longer-term the contract becomes, the less the nature of competition hinges upon the product per se and the more upon the company's ability to deliver services, specified or unspecified, at some point in the future.

Ways to differentiate

Mathur's most original contribution to competitive strategy is his conceptualisation of differentiation. Differentiation is about reducing price sensitivity and this can be achieved by either differentiating the basic product or merchandise and/or differentiating the levels of support. Where both forms of differentiation are low, the result is a 'commodity buy strategy', where price and the cost of delivery is the only source of differentiation. At the other end of the spectrum, where both merchandise and support are highly differentiated, the competitive strategy is known as 'system-buy'. Thus a car manufacturer might compete, not just by providing a technologically sophisticated product, but also by bundling additional services, eg, free servicing, insurance, finance, etc. Where product differentiation is high and the service levels are low, the resultant competitive strategy can be termed 'product buy'. This tends to be the approach which characterised manufacturing industries in the past, where the emphasis was on technological innovation and products as the source of competitive advantage. Where the product, by contrast, is not differentiated, but there are high levels of differentiation in support, the outcome can be termed 'service buy'. In essence, here the product is homogenous and standardised, but the producer differentiates themselves by the level of support, eg advice, availability, location, etc. Differentiation in support can be further sub-divided according to the degree of customisation to the individual consumer and the degree of expertise in the delivery of the service. Merchandise can likewise be further sub-divided in its differentiation according to whether the differentiation resides in the physical characteristics of the product, ie, the content, or the aura which the product creates, eg, distinct brand attributes.

Mathur and Kenyon remind us that, in the real world, differentiation between products is rarely simple or capable of being captured on a unidirectional scale. Moreover, sources of differentiation are dynamic and will be a function both of customer perceptions and competitor actions, so that the future competitive positioning that a firm intends with its offering may not be the one that it ultimately achieves.

Cheaper and better

This brings us to an interesting debate, discussed on these pages previously, about the robustness of competitive strategies. Regular readers may recall some research evidence which we discussed in a previous update which revealed that the highest returns on capital employed were in fact realised by companies that had seemingly squared the circle and were capable of offering better products or services at lower cost, thus avoiding Porter's trap and becoming stuck in the middle.³ Mathur and Kenyon, however, support Porter's line, urging strategists to be clear about which elements of the strategy are to be dominant: price or differentiation. Cheaper and better, they believe is unlikely to be sustainable in the longer term. This is because astute competitors will be able to ape the success of the first mover and profit

from the experience curve advantages that the first mover has created without incurring the first mover's costs. Cheaper and better will only be viable, they believe, if the impediments to imitation are sufficiently high to enable the company to sustain its high margins long enough to recoup its initial investment.

Ultimately, however, this defence of Porter's 'stuck in the middle' thesis is not very convincing. To say that 'cheaper and better' will only work if competitors can't easily copy may be true. But it is no different to any other competitive strategy. As we know from the resource-based school, sustainability of competitive advantage is in large part due to skills, routines or capabilities which competitors cannot easily emulate because they are socially complex. It is not clear from Mathur and Kenyon's work why 'cheaper and better' should be more inherently inimitable than any other form of competitive strategy.

Circularity and oligopolistic markets

Most people are familiar with the notion that competition in oligopolistic markets can be driven by differentiation. Mathur and Kenyon also drew our attention to an equally common characteristic: the prevalence of circularity. This is the notion that outcomes are determined not so much by the free play of market forces, as by the possibility of response and counter-response amongst a few key players. Mathur and Kenyon believe that companies should only enter into markets which are characterised by circularity if they possess natural strategic assets (eg, size) or have the skills necessary to anticipate other competitors and their moves successfully. The authors believe the circularity is likely to be a much more powerful influence on competitive strategy than differentiation. However, where players have successfully differentiated themselves (eg, created islands of non-competition around themselves) then this can give them a measure of immunity from the uncertainty of circularity.

As Mathur and Kenyon point out, the reason that circularity has not been so widely discussed is because the notion owes as much to psychology as it does to economics. In fact, there are approaches which deal with aspects of circularity, eg, game theory, and going back even further, writings on military strategy by the likes of Sun Tsu (*The Art of War*). Disappointingly perhaps, neither of these strands of thought seems to have found a firm place within modern business strategy.

The resource-based school

Given Mathur and Kenyon's emphasis on external positioning and the product offering rather than on inputs, it is interesting to note that they broadly subscribe to a resource-based approach to strategy, ie, the notion that companies possess different endowments of resource or capability which can enable them to bring out different offerings and compete successfully in the marketplace. Mathur and Kenyon use Peteraf's resource-based framework as the basis for their discussion. Peteraf believed that, for companies to gain a competitive advantage, they must possess resources which have the following characteristics:

- They are distinctive and not widely available.
- By some felicitous combination of events (either through luck or through superior foresight) the company has been able to acquire a resource at a price lower than would be achieved in a competitive auction situation.
- They cannot easily be copied by competitors, substituted for by another innovation or be expropriated.

However, Mathur and Kenyon believe that the value created by such resources/capabilities chiefly concern the companies themselves, rather than the firmlets/offerings. Indeed, they believe that corporate strategy may be responsible for much of what they term sustained value building activity (= competitive advantage).

The new corporate strategy

Mathur and Kenyon are surely right when they say that the resource-based school has tended to neglect corporate, as opposed to business, strategy. Mathur and Kenyon believe that corporate strategy is a task performed at head office and involves reviewing periodically the company's cluster of offerings to determine whether they still represent the best combination of value-generating activities. They counsel against over-diversification for spurious reasons, and propose four tests which should be applied to all proposals for diversification. These are:

- The 'better off' test, ie, that the company will generate more value with the new firmlet than without it.
- The contractual alternative filter (which proposes that supplier/customer relationships should only be internalised, eg, through acquisition or diversification where there is 'no economic way of obtaining the same business benefit by competitive dealing at arms length'.⁴
- The 'best owner filter' which requires the company to be the best possible owner of a new firmlet.
- The 'robustness filter'. (This appears to be a risk management device since it insists that the new firmlet should not only recover its cost of capital but that it should still generate value over
 - (a) the payback period needed to recover its cost of capital and the lead time needed to;
 - (b) dispose of the offering in the event of an unforeseen shock.

These are intriguing concepts but, as the authors themselves suggest, they may not always be mutually consistent. One wonders how many diversifications—even quite closely related—would meet such stringent tests!

REFERENCES

- 1 *Creating Value - Shaping Tomorrow's Business*
Mathur, Shiv, S and Kenyon, A, Butterworth Heinemann, Oxford, 1997.
- 2 'How Firms Compete: a New Classification of Competitive Strategies'
Mathur, Shiv, S, *Journal of General Management* Vol 14, No 1, 1988, pp 30-57.
- 3 *Manager Update* Vol 5, No 4, (Summer) 1994, pp 1-11.
- 4 Ibid, p 291.

ACCOUNTING AND FINANCE

Roger Mills is Professor of Accounting and Finance at Henley Management College, and Consultant Professor to Price Waterhouse on Shareholder Value

One of the key challenges to the management educator is the fact that the world of management transcends individual subject boundaries. What is more, issues of concern within one discipline may well depend for their explanation upon the understanding of theories, principles and observations drawn from a number of disciplines. This is so in the area of valuation, in which so much interest is currently being expressed, and which has been the subject of a recent *Manager Update*. Valuation is heavily dependent upon the ability of those undertaking the analysis of a business' prospects to identify an appropriate time horizon over which to undertake their review. From personal experience, and from

the evidence available, this very often results in the adoption of a standard planning period, otherwise known as the Competitive Advantage Period (CAP).¹ A further indication of the importance of this issue has been provided by Mauboussin and Johnson, of Credit Suisse First Boston:

‘Although competitive advantage period (CAP) has unassailable importance in valuation, it is a subject that has not been explicitly addressed in finance textbooks in a way commensurate with its importance. Further, many analysts and strategic planners that adhere to a DCF framework reduce the model’s validity by using explicit forecast periods that do not reflect CAP. We believe that CAP can play an important role in linking valuation theory and practice.’²

The CAP is the time during which a company is expected to generate returns on incremental investment that exceed its cost of capital. Economic theory suggests that competitive forces will drive returns down to the cost of capital over time. In other words, if a company earns returns above the cost of capital, it will attract competitors the consequence of which will be a reduction in industry returns.

The concept of CAP is not new and has existed in the finance literature for many years, although not necessarily under that name. It has been labelled variously, examples of which are ‘value growth duration’ and ‘T’.^{3, 4, 5} For example, it was formalised by Miller and Modigliani through their seminal work on valuation.⁶

A number of strategic approaches have been developed that can, in principle, be applied to determine the length of the competitive advantage period. One approach commonly quoted within the context of business valuation is that associated with the five forces developed by Porter.⁷ However, although the contribution by Porter has been invaluable, there has been considerable interest in terms of what makes firms that operate within the same industry different. There is evidence to suggest that the performance achieved by an organisation depends more upon its relative performance within an industry rather than the industry sector in which it operates. For example, Rumelt analysed the returns of a large sample of American firms by reference to their profitability in different industries.⁸ Rumelt’s findings are summarised below:

	%
Corporate ownership	0.8
Industry effects	8.3
Cyclical effects	7.8
Business unit specific effects	46.4
Unexplained factors	36.7

Figure 1 Contributions to variance of profits across business units

By far the largest contributor to explaining differences in profits is business unit-specific effects, which account for 46.4 per cent of the contribution to variance of profits. In other words, there are no systematically successful firms or industries, but there are systematically successful business units. These are the businesses that enjoy competitive advantages and outperform their competitors year by year. The other major contributor is the unexplained factors, which have come to be collectively referred to as the ‘x’ factor.

Mauboussin and Johnson⁹ have illustrated the potential significance of CAP in explaining this ‘x’ factor. They demonstrate the importance of CAP in the analytical process associated with valuation, and argue that its neglect can be attributed to two main factors. First, the vast majority of market participants attempt to understand valuation and subsequent stock price changes in accounting terms, despite the empirical evidence, which suggests that cash flow is more important than earnings. Second, most companies use a forecast period for strategic planning purposes (usually three to five years) that is substantially different from their CAP. It also should not be ignored that practice in discounted cash flow valuations may be influenced by capital project appraisal practices. In evaluating a capital project, the issue of what time period

is relevant may often be relatively trivial, insofar as normal practice looks to select a time period that is consistent with the useful economic life of the asset(s) involved. Any value at the end of the time period used in such appraisals tends to be recaptured in assumed disposal values for fixed assets and the liquidation of stocks and debtors. However, for many strategic decisions, a good case can be made for saying that an investment could have an indefinite life, providing any necessary capital expenditure, say for replacement, was undertaken. The argument here is that if an investment has been undertaken because a potential opportunity has been identified and, hence a competitive advantage, then this advantage will not necessarily be completely eroded at the end of the time period used for developing a forecast.

Estimating CAP in practice

In determining CAP in practice, the assumption used about the time horizon will have a significant impact upon the size of any terminal value. Terminal value, that value arising from beyond the assumed CAP, known as the 'continuing period', is often a source of considerable concern in many valuations. It is important because it frequently accounts for a significant proportion of total value. In fact, in some circumstances, like a start up or a development in a new market, it may account for nearly all of the total value. A good example of this was the valuation of Orange plc, which was floated in 1996. Values for the business in excess of £2.7bn were initially estimated by a number of analysts, of which £2.1bn was the result of a terminal value estimate beyond a 10-year forecast period for free cash flows. A similar observation regarding the potential contribution from the terminal value was also confirmed by McKinsey and Company, which demonstrated that over an eight-year forecast period the terminal value in four industries accounted for anywhere between 56 percent to 125 percent of total value.¹⁰

Research at Henley Management College revealed that five years is used as the CAP in the case of many UK companies.¹¹ This finding was interesting, though hardly surprising. It is useful to see it alongside the P/E multiples for the FTSE 100 index and the FTSE All-Share index, which stood at 17.76 and 18.52, respectively, on 2 July 1997.¹² Crudely, this can be interpreted as implying that the market puts a value of between 17 and 19 years on the current after tax earnings attributable to shareholders. When looked at alongside the fact that many businesses plan for somewhere in the region of five years, there is the potential for what can be thought of as a 'value gap'.

It can be argued that one way of preventing a value gap is for a longer-term CAP to be used, but this raises the immediate concern that planning for just five years can often be difficult enough. The fact that management looks typically only to a limited future period, say five years, is the real problem and there should be explicit recognition that the continuing period and the terminal value associated with it are variables explicitly within management's control. It is not a residual, but one of the most critical parts of the 'value future'. As such, it needs to be owned and actively managed, even though it may deal with a time horizon too distant to analyse prescriptively. If the valuation of this time period is seen to relate to the selected CAP, it is much more than a passive residual. In fact, it can be seen as being the consequence of actions taken over the time period falling within the comfort zone of management action.

Two broad approaches for dealing with the CAP and terminal value are market implied duration and applying scenario analysis.

Market implied duration

This approach can be attributed to Rappaport and can be thought of as involving the following steps.¹³ First, a proxy for unbiased market expectations of six value drivers (other than CAP) is required, assuming use of a seven value driver model, ie, sales growth rate, operating profit margin, cash tax rate, fixed capital needs, working capital needs, cost of capital and CAP. Second, an valuation model is built, including a terminal value calculation based upon an assumed perpetuity. Last, the time period over

which the forecast is undertaken is 'stretched' as many years as is necessary to achieve the company's current market price for its shares. The resulting time period is the assumed CAP.

There is a belief that lengthening the CAP in this way can help to explain the 'x' factor. A good illustration of this has been provided by Mauboussin and Johnson.¹⁴ Based upon a study of a selection of companies within the packaged food industry in the September 1982 to August 1989 period, they found using the approach described above that the CAP for this group roughly doubled in the seven-year period. In fact, this time period corresponded with most companies streamlining their business portfolios, cutting costs, increasing vital marketing expenditure, and increasing cash flows.

Whilst this approach is useful as a practical tool, it does have some limitations, that may be summarised as follows:

- It presupposes that the other six value drivers in the seven value driver model are in some way 'correct'. There is some potential circularity here because the cash flow drivers are typically inextricably linked to assumptions about CAP, ie, there is the chance of trying to explain an outcome based upon assumptions relating to the outcome.
- It presupposes that the market price of the share is an appropriate reflection of future prospects, but there may be a radical shift in prospect that has not been detected by the market. Many acquisitions have been concerned with business transformations not reflected in the share price until the occurrence of a predatory move.
- What happens when there is no share price, eg, for a private company or division/business unit? In this case there is no share price against which to 'stretch'. In the present writer's experience this can be dealt with effectively by undertaking market implied duration stretch on a carefully selected set of peer group companies, combined with scenario analysis (described in the next section).

From an external perspective, stretch represents a useful starting point. However, whenever possible, it can be very powerfully combined with scenario analysis. In fact, the present writer's experience has shown scenario analysis to be invaluable in understanding CAP from an internal, operational perspective.¹⁵

Applying scenario analysis

Scenarios, which were reviewed briefly in a recent *Manager Update*, start from the premise that there is more than one future. They involve a disciplined group process intended to address the question 'what could happen' rather than 'what will happen'. Typically, the discipline of the group activity means that individuals who initially approach a situation from different perspectives will see their own specific point of view reflected in an interpretative scenario. The knowledge that one's own point of view is on the agenda means that it is possible to listen to alternative points of view. As a group process it is intended to overcome political posturing in which the exchange of views becomes impossible.

The point of scenarios is not so much to 'get it right' as to have a number of scenarios that illuminate the major forces and trends driving the system, their inter-relationships, and the critical uncertainties. The value of performing this procedure is not so much the ultimate valuation number that it produces, but the insights discovered in the process of investigating the nature and existence of the opportunities available to management.

Specifically, the use of scenarios can help to avoid the shortcomings associated with traditional approaches to analysis in which the assumptions used will often be extrapolated from the present situation with inadequate attention being paid to the impact of changes in the external environment of a particular business. Instead of a specific impact analysis there is an assumed vacuum, as if discontinuities and turbulence will not punctuate the external environment. Drawing upon scenario

analysis can make considerable improvements. When linked appropriately, valuation and scenario analysis constitute a distinctive way of grasping the key navigational questions about the future of a business. In terms of the CAP, the approach seeks to force questioning and thought about when the conditions signalling the end of the CAP might occur, ie, a return greater than the cost of capital cannot be achieved. This questioning and thought process can be built around the following five steps:

1. Value the current plan and find the CAP using the market implied duration stretch approach described above.
2. Challenge input data and model.
3. Apply scenario analysis—create alternative scenarios and compare their consequences in CAP and value terms.
4. Produce the strategic response.
5. Pull the threads together to achieve a new level of strategic awareness.

In our experience it is rare for the outcome of the application of scenario analysis to produce a CAP corresponding with the stretched, market implied, duration CAP. The consequence of this is that the terminal value issue, so neatly dealt with by virtue of the definition of market implied duration, raises its head again. Typically, the CAP resulting from scenario analysis is different than that for the stretched version. If it is shorter it means that the all important question of terminal value arises. In very simple terms, the terminal value implied is the difference between the market implied price and the value of the scenario. Analysis of the terminal value arising from this difference can be undertaken to see the assumptions implied. For example, a significant difference between the perpetuity value of the terminal value determined from scenario based calculations and the market implied terminal value can be examined in terms of the implications by way of prospective growth assumptions. This examination can be by way of an extension of the scenario activity, in which external financial observations are challenged in terms of their managerial implications for the value drivers within the valuation model, ie, 'what rate of growth is implied by the difference and what would be necessary to make it happen?'

Options and CAP

Whilst the approaches described in the previous section may be appropriate for many businesses, there are some for which it is helpful to review from a slightly different perspective. These are businesses for which the bulk of their value can be seen to lie within the terminal value. They may be businesses currently generating little current profit or cash, or even generating negative free cash flows, but to which the market place ascribes a high value. This value is seen to be a speculative estimate of the future value they may be able to deliver. For such businesses, there is no CAP readily observable; all is speculative and may, or may not happen. In their case, the type of approach discussed in the last Manager Update is more appropriate.

REFERENCES

- 1 'The Use of Shareholder Value Analysis in Acquisition and Divestment Decisions'
Mills, R W et al *Chartered Institute of Management Accountants*, 1997.
- 2 'Competitive Advantage Period 'CAP': The Neglected Value Driver'
Mauboussin, M and Johnson, P *Frontiers of Finance, Credit Suisse First Boston* January 14, 1997, p 10.
- 3 'CFOs and Strategists: Forging a Common Framework'
Rappaport, A, *Harvard Business Review* May-June, 1992.

- 4 **'Dividend Policy, Growth and the Valuation of Shares'**
Miller, M and Modigliani, F *The Journal of Business* October 1961.
- 5 ***The Quest for Value***
Bennett Stewart III, G New York: Harper Collins, 1991, pp 289-298.
- 6 Miller, M and Modigliani, F, op cit.
- 7 ***Competitive Strategy: Techniques for Analysing Industries and Competitors***
Porter, M E The Free Press, 1980.
- 8 **'How Much Does Industry Matter?'**
Rumelt R P *Strategic Management Journal* Vol 3, March 1991, pp 167-186.
- 9 Mauboussin, M and Johnson, P op cit.
- 10 Copeland T, Mueller and Murrin, Valuation, McKinsey & Co, 1994.
- 11 Mills, R W et al, op cit.
- 12 ***Financial Times*.**
- 13 **Creating Shareholder Value,**
Rappaport, A, Free Press, New York, 1986, p 85.
- 14 Mauboussin, M and Johnson, P op cit, p 9.
- 15 **'Calculating Shareholder Value in a Turbulent Environment'**
Mills, R W and Weinstein, B *Long Range Planning* Vol 29, No 1, 1996, pp 76-83.

Each member of the Faculty in the year of publication will receive one copy of every *Manager Update* published by the Faculty free of charge. Copies are not available to non-Faculty members.

Manager Updates published to date are:

- Issue 1: April 1997
- Issue 2: July 1997
- Issue 3: October 1997

Any members who have not received the above should contact Chris Jackson at the Faculty using the contact details set out below.

Comments and suggestions should be addressed to Chris Jackson BA FCA, Secretary to the Faculty, telephone 0171-920 8486, e-mail CDJackson@icaew.co.uk, or write to the Faculty of Finance and Management, Institute of Chartered Accountants in England & Wales, PO Box 433, Chartered Accountants' Hall, Moorgate Place, London EC2P 2BJ. (The ICAEW web site is located at <http://www.icaew.co.uk>)

This issue of Manager Update is produced by Doyle & Co, Colchester and printed by Spottiswoode Ballantyne, Colchester on behalf of the Faculty of Finance and Management of the Institute of Chartered Accountants in England and Wales.

© Braybrooke Press 1997. All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (including graphic, electronic or mechanical, photocopying recording, recorded taping or retrieval information systems) without written permission of the copyright holder.

The views expressed herein are not necessarily shared by the Council of the Institute or by the Faculty. Articles are published without responsibility on the part of the publishers or authors for loss occasioned in any person acting or refraining from acting as a result of any view expressed therein.

