CHAPTER 6 Evaluating client capabilities and business opportunities

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Learning outcomes

The learning outcomes from this chapter are to:

- introduce a range of analysis techniques to review the business and its environment;
- understand what is meant by and what is the basis for building a business's success (competitive advantage);
- illustrate how to use a range of techniques in order to identify strategic options for the business;
- identify the qualitative and quantitative market research techniques that can aid decision-making.

6.1 Preliminary analysis techniques

We need to start by asking why the business organisation or system exists. What is its mission or purpose and what are its objectives? We also need to establish how this business system fits externally – not just in comparison with competitors but in the 'bigger picture'. Two useful techniques to help set the scene are SWOT and STEEPLE.

SWOT and STEEPLE

The *SWOT analysis* is a good, basic technique for getting the analysis started. SWOT is an acronym standing for 'strengths, weaknesses, opportunities and threats'. The SWOT analysis provides the consultant with a concise and comprehensive summary of a business. It offers an immediate and accessible insight into the capabilities of the business and ways in which it might use them. Normally presented as a four-box matrix, typically, a SWOT analysis will identify a broad-based group of strengths and weaknesses coupled with a number of opportunities and threats (Figure 6.1). The SWOT analysis can be generated through a brainstorming session. It can also be used to keep a summary of features identified by other

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Management Consulting: Delivering an Effective Project, Third Edition, by Philip Wickham and Louise Wickham. Published by Prentice Hall Financial Times.

Strengths Things under the control of managers which will help the business achieve its goals.	**Weaknesses** Things outside the control of managers which will hinder the business and prevent it from achieving its goals.
Opportunities Things under the control of managers which will offer the business a means of achieving its goals.	**Threats** Things outside the control of managers which will hinder the business and prevent it achieving its goals.

Figure 6.1 SWOT analysis

analysis techniques. However, it should be recognised that the opportunities and threats side of the SWOT analysis is a 'wish list'. This side of the equation should be kept realistic.

In order to take a closer look at the business system and 'bigger picture' factors in which the business operates, it is useful to use a technique like the *STEEPLE analysis*. STEEPLE, like SWOT, is an acronym. It stands for 'social (demographic), technological, economic, environmental (natural), political, legal and ethical' factors. The analysis is sometimes referred to as the *PLEEST analysis* (in which the same terms are used, but in a different order. It is also known as the PEST or STEP analysis, where the factors have been grouped). Essentially, *sociological factors* are those that relate to the societal development of buying groups. Look for changes in social trends and attitudes that will affect consumption.

Technological factors are those that relate to the knowledge used in the design, production and delivery of outputs. Technology is changing continually. New products are constantly being developed and existing ones are redesigned. There are broad technological trends, which will have an impact on every business in some way or other. Each industry and sector has its own 'proprietary' technological base where the effects of technological developments are localised.

Economic factors are those that relate to the overall economy. Look for growth in economic wealth (GDP) and its distribution in relation to customer groups. Consider the effects of economic booms and recessions. Other important factors include the impact of interest rates (which make borrowing more expensive) and exchange rates. A strengthening of a currency makes imports cheaper and exports more expensive. Exporters are hit when a currency strengthens; importers benefit. A weakening of the currency has the reverse effect.

Environmental factors refer to what are nowadays dubbed 'green' issues. These tend to have more importance in some industry sectors than others, like chemicals or packaging, but are always worth considering. A good example is the disposal of toxic waste. *Political and legal* factors are those that relate to governance and the attitudes of government agencies. Look for political favour and disfavour, influence with government, lobbying and potential new laws that may give or take away legislative monopolies or change the conditions under which trading will take place. *Ethical* factors, like environmental, play more of a part in medical and food related businesses, for example, but again should be considered as a matter of course even when their influence is not believed to be strong. An example is the use of human genome data.

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6.2 Strategic capabilities of businesses

There are a number of ways in which business strategy can be defined. At one level, a strategy is simply the consistency of the actions the business takes, the fact that it sells a particular range of products to a definite customer group. In this respect all businesses have a strategy of sorts. At another level, a strategy is the way in which the business will compete and beat its competitors. It is the way in which it develops an edge in the marketplace. Ultimately a strategy must dictate the way the business behaves, it must become a plan – a 'recipe for action' to succeed in the marketplace. A firm's competitive advantage is the basis on which the performance of the business is built. A competitive advantage is something that:

- the firm *possesses*;
- creates *value* for its customers;
- in a way is *unique*; and
- competitors find it difficult *to imitate*.

A firm can be said to have competitive advantage when it is *able to sustain profits that exceed the average for the industry*. A good place to start the process of identifying the source of competitive advantage (if any) is by asking a few key questions about the reason for the business's existence or the *business idea*. It is valuable to distil the responses to these questions to a key sentence or maximum two for each question:

- What is the need or behaviour in the market that the type of product or service the firm is providing satisfies?
- What is the basic (existing) offer out there in the marketplace that satisfies this need?
- How does the firm's offering differ or how is it special in a way that the customer values?

Analysing the answers to these questions should provide a clear insight into what the source of competitive advantage is or might be: remember, it must meet the criteria listed above.

Porter's five forces

Michael Porter originally identified three basic types of competitive advantage, namely *cost* (lower cost advantage), *differentiation* (delivery of benefits that exceed those of competing products) and *focus* (focusing on a particular buying group, segment or product line – servicing a market particularly well). These are known as *positional advantages*. There is also a *resource-based view* that emphasises that a firm utilises its resources and capabilities to create advantage that results in superior *value chain* creation (see later). This view suggests that a firm must have resources and capabilities that are collectively superior to those of its competitors. Examples of the source of such resource-based advantage include: patents and trademarks, proprietary know-how, installed customer base, reputation of the firm and brand equity. Together these resources and capabilities form the firm's *core competencies*.

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The model for industry analysis – *Porter's five forces* – still offers a useful means for understanding the industry context in which a company operates and may help suggest how to develop an edge over rivals (*see* Figure 6.2).

What this model offers is an insight into the drivers of competition:

- *Intensity of rivalry among players*: influenced by the number of firms, their market share and cost bases, switching costs (when a customer can freely move from one product to another), levels of product differentiation and exit barriers (the cost of abandoning a product).
- *Threat of substitutes*: price changes in products in other industries affecting the industry under scrutiny, substitution of one product by another in a different industry (one example is the advent of personal digital assistants supplanting diaries and calculators).
- *Buyer power*: the impact customers have on an industry. Where there is one buyer and many suppliers, the buyer has the real power, for example.
- *Supplier power*: the impact suppliers have on an industry. Where a supplier holds a company to ransom over a critical resource, the supplier exerts real control.
- *Barriers to entry*: the possibility that new firms may enter the industry also affects competition. There may be high barriers to entry if there are considerable costs associated with entering a market or where the prices are too low to attract new entrants (a deterrent) or where there are patents in place. The government can create such barriers through regulation too.

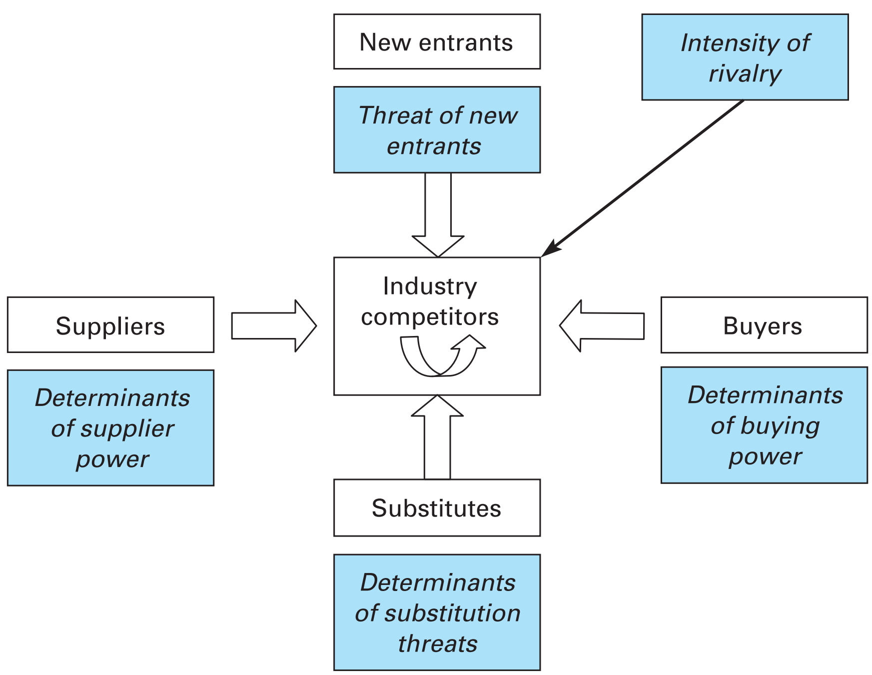

Figure 6.2 Five forces

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The Delta model (and sixth force)

Hax and Wilde in *The Delta Project* argue that their model provides a means of unifying the Porter framework ('five forces', as above, and value chain – see later) with the resource-based view to developing strategy (*see* Figure 6.3). They identify three distinctive strategic positions offering very different approaches to achieve 'customer bonding'. These go beyond the 'best product' (i.e. low cost/differentiated option, mentioned earlier) and further develop the 'focus' option to give 'total customer solutions' and 'system lock-in'. The Delta model also offers a 'sixth force' to add to Porter's five forces, namely, *complementors*. A complementor is a firm engaged in the delivery of products and services that enhance the firm's product and service portfolio. These are typically, though not necessarily, external and are easily overlooked. A classic example of this is the Microsoft Windows operating system and software companies. To get the best coverage and market penetration, a software company needs to be compatible with Windows.

Market segmentation

Market segmentation is the process of dividing a market into distinct subsets (segments) that behave in the same way or have similar needs. Because each segment is fairly homogeneous in their needs and attitudes, they are likely to respond similarly to a given *marketing mix* (also known as *the 4 Ps*): **p**roduct or service, **p**lace – including demographics as well as geography, **p**romotion, and **p**rice). Broadly, markets can be divided according to a number of general criteria, such as by industry, geography or profession. Small segments are often termed niche markets or speciality markets. However, all segments fall into either consumer or

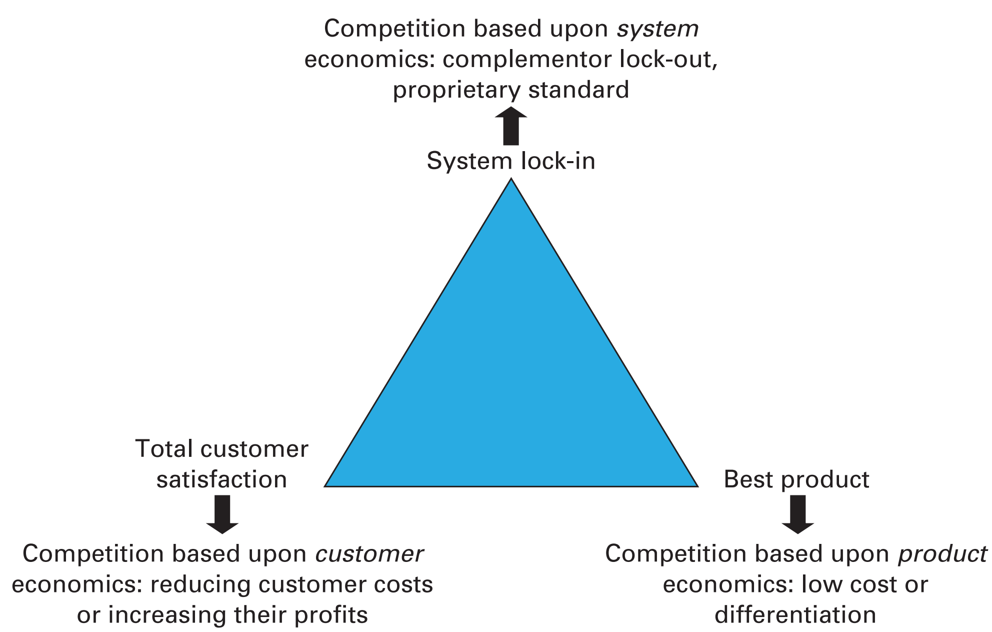

Figure 6.3 Delta model

Source: Hax, A.C. and Wilde, D.L., *The Delta Project: Discovering New Sources of Profitability in a Networked Economy*, 2001, Palgrave Macmillan. Figure 1.1, page 10. Republished with permission of Palgrave Macmillan.

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industrial markets. Although it has similar objectives and it overlaps with consumer markets in many ways, the process of industrial markets is quite different. The overall intent is to identify groups of similar customers and potential customers; to prioritise the groups to address; to understand their behaviour; and to respond with appropriate marketing strategies that satisfy the different preferences of each chosen segment.

Successful segmentation requires that segments be:

- Substantial – large and profitable enough.
- Accessible – can be reached efficiently.
- Different – will respond to a different marketing mix.
- Actionable – the firm must have a product for this segment.
- Measureable – the size and purchasing power of the segment can be measured.

There is another way of looking at segmentation – called defining by *centre points*. This technique looks at segments in a different way, taking an ideal customer as the centre of the hypothesised segment and envisaging segments like a swarm of bees or school of fish with an identifiable centre. The market strategy is then focused on that centre with communications and a range of products/services dedicated to addressing that ideal customer's needs and wants, what is known as the *whole product*.

6.3 Financial and business performance

The financial situation of a firm is fundamental. The health of a firm's finances is not just an indication of how successful it has been in the past, it is also an indication of the resources it has available to reward its stakeholders and to invest in new projects. In making an evaluation of a business, its performance and its potential for the future the consultant must be cognisant of its financial situation. Finance and accounting are disciplines in their own right. All that is necessary here is to outline the principles of financial analysis and give a flavour of the approach to analysis that is important to the consultant. Businesses are required by law to keep accurate records of their income and expenditure and to produce accounts. The complexity of the accounts will depend on the business and its legal status. They are quite straightforward for a small sole trader; they are extensive and complex for a publicly quoted multinational.

Whilst accounting practices vary between countries, the principles behind all company accounts are the same. There are three fundamental financial documents: the *balance sheet*, the *profit and loss account* and the *cash flow statement*.

The balance sheet

The balance sheet is a statement of what the firm owns (its *assets*) and what it owes (its *liabilities*). The balance sheet represents a snapshot in time. It is a statement of what is owned and owed at the time the balance sheet is produced. Accounts usually have two balance sheets (or the balance sheet quotes two

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columns of figures), an *opening set* and a *closing set*. The closing set is for the date of the balance sheet, the opening set for an earlier point in time (usually one year before). Comparison between the two gives an indication of the changes in the firm's assets and liabilities over the period. There are various sorts of assets. They are usually classified in terms of *liquidity*: that is, how easy it is to convert them to cash should the need arise. *Tangible assets* are things that have a physical form, such as buildings and machinery. These are normally considered to be less liquid than any *stock* stored by the business. Stock is those things that the firm normally exists to trade in, or materials that can be converted into stock. The most liquid assets are cash and investments held by the business, as well as any debts owed to the business. (Care needs to be taken in respect of 'bad debt' that cannot be called in.) Assets that could, in principle, be turned into cash within one year are called *current assets*. Current assets are normally taken to be cash, liquidisable investments, stock and outstanding debts owed to the company.

Intangible assets are things which do not have a physical form but which may, potentially, be sold. Important examples are brand names, copyrights and patents. *Liabilities* are things to which the firm has access but which (technically at least) it owes to outside parties. Liabilities are of two sorts. *Short-term liabilities* are due for settlement within the normal accounting period, usually one year. *Long-term liabilities* are due for settlement after that. The key liabilities are *debts* owed to creditors (suppliers, including employees), *interest* owed to those who have lent to the company, outstanding *tax* owed to the government and *dividends* due to shareholders. As it is the shareholders who actually own a company, they own the difference between its assets and its liabilities. This difference is included in the balance sheet as *shareholders' funds*. It is included as a liability so that the two halves of the balance sheet are equal – so that they actually balance.

The profit and loss account

The *profit and loss account* is a statement of the trading activity of the business over a period, again usually one year. It relates to the balance between the income and outgoings of the business. *Income* is the revenue gained from normal trading activity, that is, sales. Exceptional income from sources that do not represent normal trading activity (for example, investments) will also be included but will be indicated separately in the accounts. *Outgoings* are the expenditures on those things that are needed to keep the business running. Immediate costs are for raw materials, productive equipment and services and salaries of production staff. Together these immediate costs are known as the *cost of sales*. Costs for administration and central staff are known as *overheads*. Other expenditure is on paying the *interest* on loans, *tax* to governments and *dividends* to shareholders. The difference between income and expenditure is the *profit* generated by the business. Different types of profit are quoted after the deduction of different types of outgoings. These are described in Table 6.1.

The different levels of expenditure included in the profit and loss account give an indication of the *cost structure* of the business. It is common, especially in the US, to refer to earnings rather than profit. A common version of earnings used for comparing different types of business is earnings before interest, tax, depreciation and amortisation (abbreviated to EBITDA).

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Table 6.1 Outgoings and profit

Total income minus	Equals
Cost of sales (raw materials + production salaries + production services + depreciation)	Gross margin
Distribution costs (distribution materials + distribution salaries + depreciation on distribution equipment)	Operating profit
Administrative costs (overheads + all other costs not disclosed elsewhere)	Profit before interest and tax (PBIT)
Interest on loans	Profit before tax (PBT)
Tax to government (national and local)	Profit after tax (PAT)
Dividends to shareholders	Retained profits

Cash flow statement

Many profitable businesses fail because they do not manage their cash resources properly, hence the dictum 'cash is king'. This is particularly important for businesses in early stage or high growth phases. The cash flow statement is normally used as an internal forecasting tool. The forecast takes into account not only the elements of income, outgoings and assets that appear in the profit and loss statement but also their timing. A sale is typically registered on the profit and loss account when the invoice is issued but it will be some time before payment is received. This interval is known as *days receivable*. The gap between being invoiced by a supplier and the firm paying the invoice is called *days payable*. Salaries and other administrative costs are scheduled and predictable in cash flow terms. Long-term projects have complex cash flows that can be input to the forecast. Purchasing major capital items also has a significant impact on the cash flow. These factors are used to develop a model of when cash flows into and out of the business and hence determine the ongoing cash position of the firm. This in turn determines what payment terms are acceptable to the firm and what additional finance it may need to maintain adequate liquidity.

Financial ratios

The figures in the balance sheet and profit and loss account do not, in themselves, offer a full picture of the firm in relation to its competitors and its sector. What is important is how they relate to each other. The figures are related to each other through *financial ratios*. Financial ratios fall into three types. *Performance* (or *operating*) *ratios* measure how well the firm is using the resources it has to hand. *Financial status ratios* measure the stability of the business and indicate how well it could weather a financial storm affecting income or expenditure. The third type is used by investors to get an external view of the firm for comparative purposes. They give an indication of its performance as an investment vehicle. The key performance ratios are those that relate to profitability. This may be measured in two ways. The first is the profit margin, the ratio between profit and total sales, also called *return on sales* (ROS).

Profit margin = Profit/Sales

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Different profit margins use different profit lines (such as operating, PBT, PAT, as outlined in Table 6.1).

The most fundamental measure of performance is *return on capital*. *Return on capital employed* (ROCE) gives an indication to managers of the profits they are generating for the money they are using. It is defined as:

ROCE = Operating profit/Capital employed

where capital employed is usually defined as total assets minus short-term liabilities.

Return on equity (ROE) is of interest to investors. It indicates the way in which an investment in the firm is generating a yield. It is defined as:

ROE = PAT/Shareholder funds

Two financial stability ratios are particularly important. The *debt ratio* measures the balance between equity capital provided by investors and loan capital provided by lenders. This is defined as:

Debt ratio = (Long-term debt + Short-term debt)/Capital employed

This ratio is important because interest on debt must be paid, whatever the business's performance. If the company has a high debt ratio, it may face cash flow problems and pressure from its debt providers if profits are squeezed.

Interest cover is a measure of how much 'room' the profits give to pay off interest on loans. It is defined as:

Interest cover = Operating profit/Interest owed

Two ratios are used to measure the *liquidity* of the firm. Liquidity is the ability of the firm to pay off its debts at short notice. The *current ratio* measures the extent to which short-term or current assets can be used to pay off short-term liabilities. It is defined as:

Current ratio = Current assets/Current liabilities

The *quick ratio* is a much tougher test. It is a measure of a company's ability to pay off its liabilities *immediately*. The *liquid assets* are cash, liquidisable investments and debt owed to the company (after allowing for bad debts). It is defined as:

Quick ratio = Liquid assets/Current liabilities

The third type of ratios give an indication of how well a firm's stock (its shares) is performing as an investment opportunity. If a firm is publicly quoted then its shares will be traded in a market which gives them a price. The price of shares for private companies is set by closed transactions.

Shareholders are rewarded in two ways. The first is by means of *capital growth*, the increase in the underlying value of the company's share, which enables a profit to be made when the shares are sold. The second is through *income*. This is the flow of *dividends* paid out of company profits. Each share entitles its owner

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to a particular cash dividend. One form of reward can be played off against the other. If the firm's managers hold back profits (so do not pay dividends), they can use the money to invest in the firm's growth (so increasing share capital value).

The main metrics for investors are:

Earnings per share (EPS) = PAT/Number of shares issued

Price/earnings ratio (P/E) = Market price of share/EPS

Market capitalisation = Market value of shares × Number of shares

Dividend cover = EPS/Dividend per share

Dividend yield = Dividend per share/Market price per share

A P/E ratio is a kind of market rating. A high P/E ratio suggests that the market places a high value on a firm even though its current earnings are relatively low. First, the firm may have quite low risks. Second, the market may expect the firm's earnings to grow in the future.

Care should be taken when using ratios. They give absolute indications of a business's performance. They can be revealing. Yet they provide a full picture only when they are compared with other ratios. This comparison may be *historical*, as a trend in the ratios of a particular firm over time, or *cross-sectional*, as a comparison at a particular time of the ratios of a number of firms in the same or related sectors.

The Balanced Scorecard

Traditionally, approaches to performance measurement have relied heavily on financial accounting measures. Motivated by the belief that this approach was obsolete, a study sponsored in the early 1990s by the Nolan Norton Institute (part of KPMG) revealed that reliance on summary financial measures was hindering organisations' ability to create future economic value. The outcome of this and subsequent work is captured in the *Balanced Scorecard* (*see* Figure 6.4). The Balanced Scorecard is a balanced set of measures and a management system that emphasises that financial and non-financial measures must be part of the information system for employees at all levels in the organisation. Front-line employees must understand the financial consequences of their actions, for example, it argues. The scorecard is designed to translate a company or business unit's mission into tangible objectives and measures. The 'balance' is between outcome or lagging measures (financial) and the drive for future performance or leading measures (driven by the internal activities that give rise to the financial results). Most scorecards have four 'perspectives' with typical generic measures like:

- *Financial*: return on investment and economic value-added.
- *Customer*: satisfaction, retention, market and account share.
- *Internal*: quality, response time, cost of new product introductions.
- *Learning and growth*: employee satisfaction and information system availability.

The 'trick' with the scorecard is to find and use the most appropriate measures for a firm or organisation for its specific objectives and with its mission in mind. When looking at a firm, it is worth considering what metrics are used and why,

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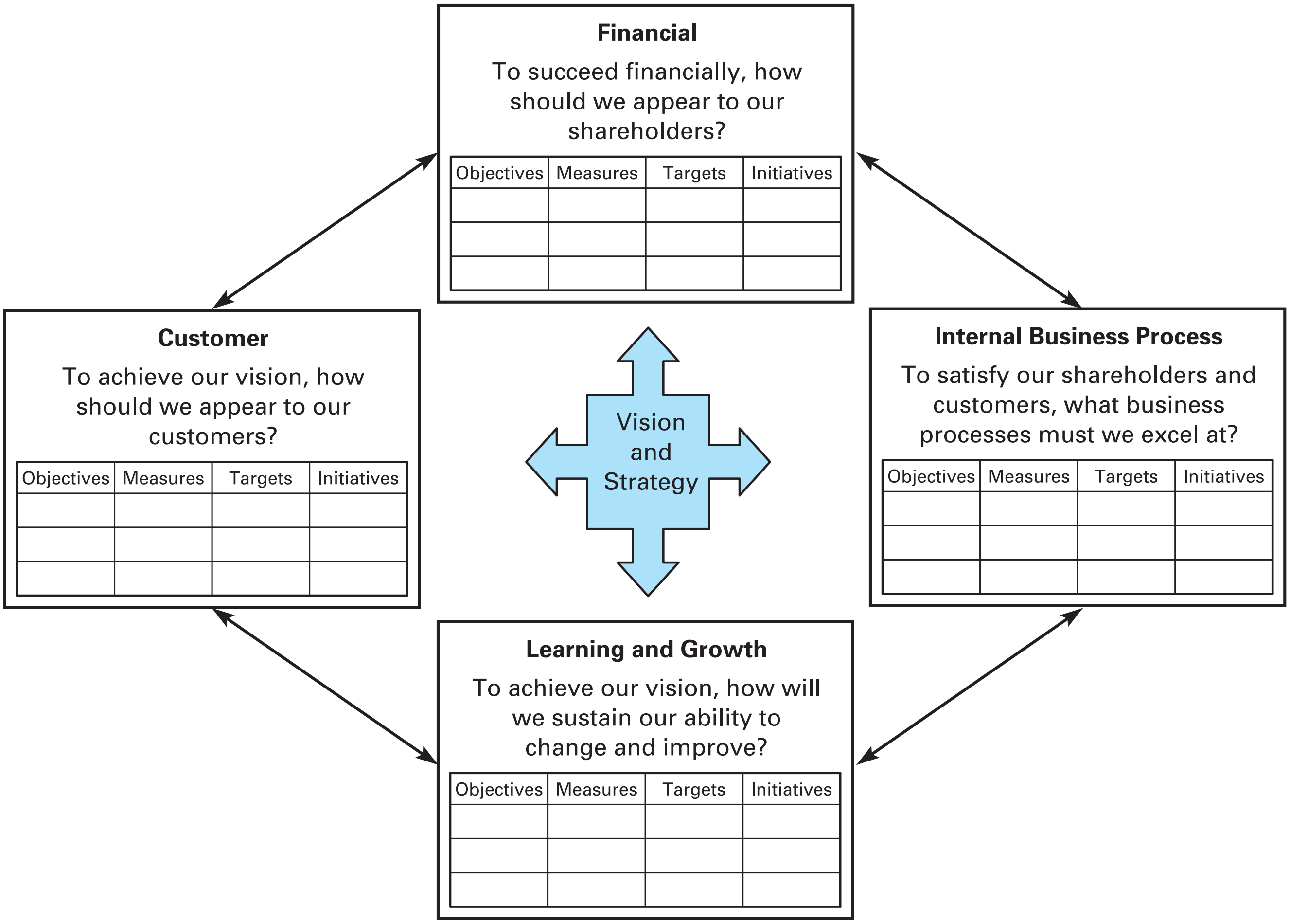

Figure 6.4 Balanced Scorecard

Source: Reprinted by permission of *Harvard Business Review*. Adapted from Figure 1.1: Translating Vision and Strategy – Four Perspectives from 'Using the balanced scorecard as a strategic management system' by Kaplan, R.S. and Norton, D.P. (Jan–Feb 1996). Copyright © 1996 by the Harvard Business School Publishing Corporation; all rights reserved.

bearing in mind the old adage 'you get what you measure'. So ask: are the factors that are being measured the right ones for the organisation and are they right at this time?

Pareto analysis

Every business is different. However, the contribution to sales (or profits) of different lines in a multi-product firm follows quite a consistent pattern: a (relatively) small number of leading lines will make a large contribution while a (relatively) large number of low-volume lines will make a small contribution. This is called the Pareto rule. It is sometimes called the '80–20' rule because often the top 20 per cent of lines make a contribution of 80 per cent to sales and profits. A Pareto curve can be drawn by listing the product lines in order of sales (or profits), with those that make the highest contribution being first. A graph can then be drawn with the cumulative contribution on the vertical axis and the percentage of total product lines on the horizontal axis. The curve will look something like that in Figure 6.5. A Pareto analysis is useful if a firm is considering rationalisation. Whereas different product lines make different levels of contribution, each line

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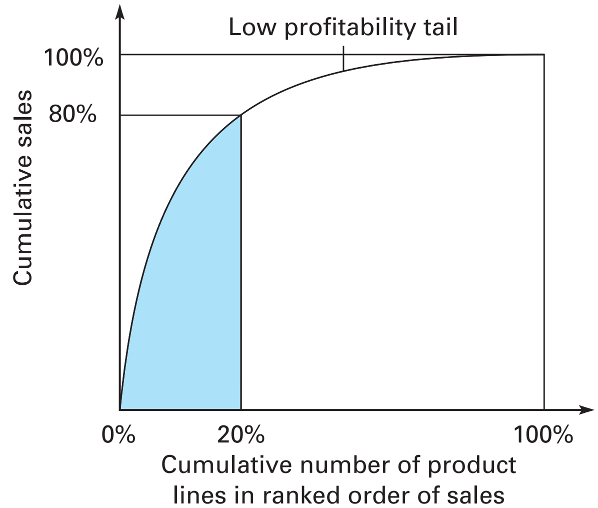

Figure 6.5 Pareto analysis

accounts for a fairly similar level of costs, particularly fixed costs. In general, profitability will be increased by divesting of product lines in the 'tail' of the curve. As with any general recommendation, though, this should be judged in light of the business, its situation and the product concerned.

S-curve analysis

Most living creatures exhibit a characteristic growth curve with an early stage with increasing growth, a middle stage with high growth and a final stage where growth drops to zero. This pattern is depicted in graphical form and appears as an S-curve. The life of most products takes a similar form and is depicted as a graph of total sales against time. The early stage has high risk. The middle stage consumes a lot of resources to expand production and the sales platform. Mature products are usually the profitable 'cash cows' but with a finite life. A balanced product portfolio should contain a range of products at different stages in their life cycle. S-curve analysis reviews the sales profile of each product to identify their stage in the life cycle. This allows the product portfolio to be adjusted to achieve a balance between risk, resource requirements and profits that is consistent with the firm's strategic objectives.

6.4 Identification and evaluation of strategic options

A number of techniques are available that are designed to help with the identification and evaluation of options for development.

The Ansoff matrix

One of the best known frameworks for deciding upon strategies for growth is the Ansoff matrix (*see* Figure 6.6). This offers strategic choices for achieving the company's objectives. There are four main categories for selection:

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Market \ Product	Present	New
Present	Market penetration	Product development
New	Market development	Diversification

Figure 6.6 Ansoff matrix

Source: Reprinted by permission of *Harvard Business Review*. Exhibit 1: The Ansoff Matrix from 'Strategies of diversification' by Ansoff, H.I. Issue No. 25(5), Sept/Oct 1957. Copyright © 1957 by the Harvard Business School Publishing Corporation; all rights reserved.

- *Market penetration*: Here the firm markets its existing products to its existing customers. This means increasing revenue by, for example, promoting the product, repositioning the brand, and so on. However, the product is not altered and no new customers are sought.
- *Market development*: Here the firm markets its existing product range in a new market. This means that the product remains the same, but it is marketed to a new audience. Exporting the product, or marketing it in a new region, are examples of market development.
- *Product development*: This is a new product to be marketed to existing customers. Here the firm develops and innovates new product offerings to replace existing ones. Such products are then marketed to existing customers.
- *Diversification*: This is where the firm markets completely new products to new customers. There are two types of diversification, namely related and unrelated diversification. Related diversification means that the firm remains in a market or industry with which it is familiar. Unrelated diversification is where the firm has neither previous industry nor market experience.

The Boston Consulting Group (BCG) matrix

This matrix aims to give an indication of cash flow stability in a firm by illustrating how cash-generating and cash-absorbing parts of the product portfolio are in balance (*see* Figure 6.7). The key dimensions of the matrix are the growth rate of the sector in which the product range lies (plotted vertically) and the competitive index – the ratio between the market share of the range in its sector divided by that of the most important competitor (plotted horizontally). The BCG matrix assumes that market share relates to profitability, an assumption that has validity but must be challenged for specific businesses.

The four quadrants are given evocative labels and the BCG makes recommendations about the product range based on its position in the matrix. Products in the low-growth, high-competitive index quadrant are called *cash cows*. These can generate – be milked for – cash. Above these, in the quadrant for high-growth, high-competitive index products, are the *stars* – the company's success stories. Stars

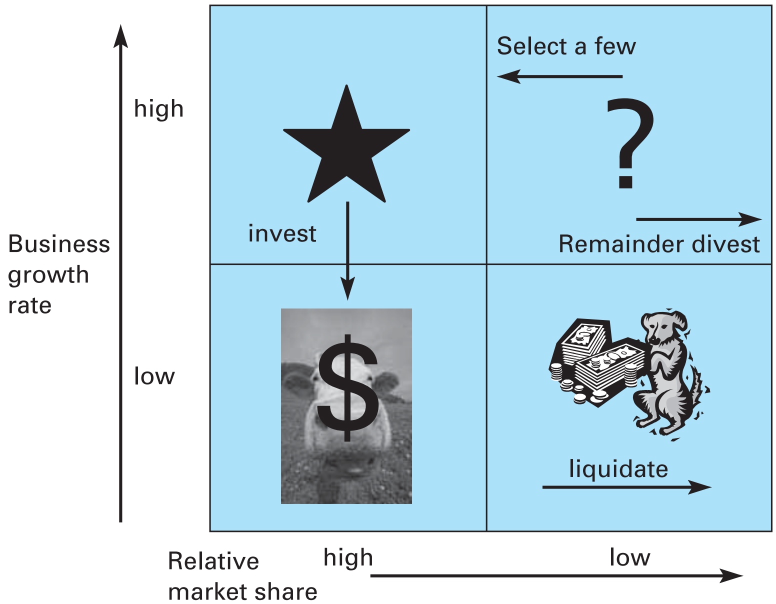

Figure 6.7 BCG matrix

Source: Boston Consulting Group. Adapted from *The Product Portfolio* (1970). The Star, the Dog, the Cow and the Question Mark – The Growth Share Matrix.

may generate some cash but they are equally likely to need investment in order to protect them from competitive attack. In the high-growth, low-competitive index quadrant are the *question marks* (sometimes called *problem children*). These are products about which a decision must be made – to invest in improving the competitive position (to make them stars) or to divest (to drop the product). The final quadrant contains the low-growth, low-competitive index products. The products here – called *dogs* – are said to be cash sinks. They take up more cash than they generate and have poor prospects. The recommendation is to divest these.

The dividing lines between the quadrants are to some extent dependent on industry conditions. Often a 10 per cent growth rate is used to separate high from low growth. A competitive index of one (i.e. a market share equal to competitors) is used to separate a good from a bad competitive position. More information can be obtained by means of the BCG matrix if circles of different sizes, reflecting the sales or profit contribution that they make, represent products. The BCG matrix offers broad recommendations. However, like any analytical method, its recommendations should not be followed blindly but interpreted in light of the particular features of the company's situation.

The directional policy matrix

The directional policy matrix (DPM) is similar to the BCG matrix, but it uses more general factors to determine market attractiveness (plotted vertically) and competitive position (plotted horizontally). Important factors in determining market attractiveness are market growth rate, profitability, stability of profits, customer strengths and environmental conditions (defined by means of the STEEPLE analysis – *see earlier*). Important factors in determining competitive position are market share, production and technical expertise and relationships with distributors and buyers. Different factors can be weighted if they differ in significance. Each axis is divided into three levels – labelled high, medium and low – giving nine sectors in

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total. The DPM enables recommendations to be made on investment and divestment on the basis of the position of the product in the matrix. As with the BCG matrix, the recommendations should not be followed blindly but used to provide insights in the light of the context of the business.

Value chain

Another very useful concept is that of the *value chain* (a term coined originally by Michael Porter). The value chain analysis describes the activities the organisation performs and links them to the organisation's competitive position. Value chain analysis describes the activities within and around an organisation and relates them to an analysis of the competitive strength of the organisation. It evaluates which value each particular activity adds to the organisation's products or services. This idea was built upon the insight that an organisation is more than a random compilation of machinery, equipment, people and money. Only if these things are arranged into systems will it become possible to produce something for which customers are willing to pay a price. Porter argues that the ability to perform particular activities and to manage the linkages between these activities is a source of competitive advantage.

Porter distinguishes between primary activities and support activities. Primary activities are directly concerned with the creation or delivery of a product or service. They can be grouped into five main areas: inbound logistics, operations, outbound logistics, marketing and sales, and service. Each of these primary activities is linked to support activities that help to improve their effectiveness or efficiency. There are four main areas of support activities: procurement, technology development (including R&D), human resource management, and infrastructure (systems for planning, finance, quality, information management etc.). In most industries, it is rather unusual that a single company performs all activities from product design, production of components and final assembly to delivery to the final user by itself. Most often, organisations are elements of a value system or supply chain. Hence, value chain analysis should cover the whole value system in which the organisation operates.

A typical value chain analysis can be performed in the following steps:

- Analysis of own value chain – which costs are related to every single activity?
- Analysis of customers' value chains – how does our product fit into their value chain?
- Identification of potential cost advantages in comparison with competitors.
- Identification of potential value added for the customer – how can a product add value to the customer's value chain (e.g. lower costs or higher performance)? Where does the customer see such potential?

6.5 Planning for the future

Rapid change, new technology and increased competition are some of the factors making for unprecedented uncertainty in today's markets. Planning for the future has never been so difficult. One well-documented and well-established approach

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to planning for the future is that of *scenario planning*. A scenario is a story. It is a tool for ordering perceptions about alternative future environments in which today's decisions may play out, described as 'an outline of future development which shows the operation of causes' by the *Chambers English Dictionary*. Scenario planning is an 'outside-in' approach to strategic management. A scenario describes a possible future business environment but is not a prediction. It explores the extremes that challenge the existing business model.

Creating a scenario

A scenario should be engaging, interesting, challenging and credible, as well as logically consistent with the known facts. It is useful to create a set of scenarios describing a range of possible futures that are ideally mutually exclusive and collectively exhaustive – no more than four scenarios is the norm. Scenarios can be presented in many different forms, such as in a script or a timeline, or within a discussion. The descriptive scenarios need to be supported by some numerical analysis, which should test the credibility of each scenario, explore the magnitude of changes in the environment and evaluate the impact of those changes.

Using scenarios for business planning

The scenarios are then used to challenge existing business models and stimulate new ideas. They form the basis of a strategic debate that is radically different to the traditional business planning cycle. Scenario planning creates a flexible plan for the business that is composed of a variety of options. The business moves forward by shifting its weight between these options. This enables the business to adapt its plans to the evolving environment.

Evaluating future plans

The evaluation of future investments, for example new product developments or capital investments, requires financial analysis to review the expected risk and returns. The core issue is how to compare a real cash outlay today with a potential return in the future. The common method for addressing this problem is to apply a discount rate to the future returns using a discounted cash flow (DCF) model. For example, it is proposed that a £100 investment today will produce a return of £150 in the future. A discount factor of 20 per cent per annum is used. If the £150 is returned in one year, the DCF is £150 × 80% = £120 and a gain of £20 is predicted. If the £150 is returned in two years, the DCF is £150 × 80% × 80% = £96 and a loss of £4 is made.

DCF models are summarised in one of two forms. Net present value (NPV) uses an agreed discount rate. It gives the total of the discounted cash values throughout the life of the investment, as per the gain and loss example given above. The discount rate is chosen to reflect the level of risk in the project. A low rate would be appropriate for buying equipment to build a standard product but a high rate would be appropriate for developing a product using new technology. NPV gives an absolute indication of the potential return on an investment. Internal rate of return (IRR) works in a slightly different way. The discount rate is varied to achieve an NPV of zero. The rate that achieves this is the IRR. If a bank account

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had the IRR as its interest rate then it would be able to generate the same cash flow as the project. IRR is a relative indication of the potential return. It can be compared with the perceived level of risk in the investment to decide whether the investment is justified. All DCF models carry a high level of risk and their results should be interpreted with caution.

6.6 Opportunity, innovation and information

As mentioned in Chapter 2, marketing research is the process through which managers discover the nature of the competitive environment in which they are operating. Managers make decisions about the direction in which their organisations are to move. Those decisions relate to the selection of strategic options, the implementation of plans and the allocation of resources. If those decisions are to be the right ones they must be informed. If the decisions are to be good ones, managers need information. Market research is a discipline that has developed a number of very powerful techniques for evaluating the market context of a business. This gives managers clear insights into the dynamics of the markets in which they operate and the behaviour of the customers they serve. These insights underpin effective decision-making.

Market research falls into two types. *Qualitative research* aims to answer questions about individual attitudes and orientations. It answers the ‘who?’ ‘why?’ and ‘what?’ questions. *Quantitative research* aims to answer questions about collections of individuals. It answers the ‘how much?’ and ‘how many?’ questions. The two forms of research work together. In combination they can provide a picture of the market in which the firm operates and flesh out the details of a market opportunity. Qualitative methods define the nature of the opportunity. Quantitative methods give an indication of its worth. Market research calls on a variety of sophisticated techniques. It is a specialist area, of which few managers have the relevant knowledge. Supporting managers in developing an insight into market opportunities is something which consultants are often called on to do.

Market research can be expensive. It is an investment in the business. Like any investment it should be undertaken only if the returns are appropriate. Managers must consider the nature of the decisions they are facing, the value of the resources involved and the risks to which they will be exposed and then decide what it will be worth to invest in information that will improve those decisions. A sales representative visiting a prospective customer may dedicate an hour or so researching the company by reading the annual report and a few newspaper articles. A business making a major launch of a new consumer brand may spend millions in analysing market potential, customer buying behaviour and perhaps advertising effectiveness. A firm aiming to buy another will undertake an extensive programme of evaluation – called *due diligence* – involving commercial, finance and legal specialists in order to be sure of the other company’s fitness and potential.

When the level of expenditure available for market research has been decided, it is important that that investment is used wisely. The objectives of the research must be clear. The questions it aims to answer must be made explicit, the right techniques for answering those questions must be selected, and the appropriate groups of customers must be selected for investigation. Consultants may or may not

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themselves be conversant with the details of various market research techniques, though it is certainly useful for them to be able to undertake some of the more straightforward methods. What they must be able to do, however, is recognise how market research can illuminate a management issue and be used to support better decision-making. They must be able to help managers formulate their problems so that a cost-effective, informative marketing research exercise can be devised. The following is intended merely as an overview of market research techniques: an indication of the approaches available. It is recommended that should students be called upon to implement an extensive market research programme, they consult a specialist market research text.

Secondary research

Secondary research uses already published information (as opposed to *primary research* which is original material gathered directly for the task in hand). The amount of information in the world relevant to business is vast and it is growing. Already published information, because it has not been undertaken specifically for the purpose, varies enormously in its relevance. But it is of low cost and it can be very informative. It should always be the first source consulted by the researcher. Some of the most valuable sources are as follows.

The Internet

The first port of call is the Internet. In addition to individual company websites and sectoral reports, there are a number of good sources of business information that are either free or available by subscription. Examples include:

ft.com – general business information;

hoovers.com – worldwide company information, concentrating on larger organisations;

reuters.com – the well-known news service;

dnb.com – information on every registered company worldwide;

hemscott.net – information on UK publicly quoted companies.

Market sector reports

A number of companies routinely publish reports on market sectors. Mintel and Keynote in the UK cover important areas of consumer spending. Euromonitor and Datamonitor look at developments in European and worldwide markets. In addition there are a number of *ad hoc* reports on specific sectors. Many of these are held by the British Library and can be accessed through listings in a good business library.

Company annual reports and websites

Company annual reports and reviews serve a specific and legally defined function, primarily for publicly quoted companies. They must inform investors of the financial state of the business through the balance sheet and profit and loss account. However, most annual reports go beyond just fulfilling this basic function.

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They are exercises in public relations, promoting the company as a whole to all its stakeholders. The chairman's statement gives an indication of the prospects for the sector. In these company documents and especially on the website there may be information on political, technological and social developments in the business's spheres of operation. They may also provide an insight into those areas where the business is investing in the future. Much information relevant to a small business client will be gleaned through a detailed and insightful reading of the information sources of some of the large players in its sector.

Newspaper articles

Quality newspapers regularly feature articles that are of relevance to a consulting project. The *Financial Times* not only covers ongoing events in the world of business, but it also includes regular surveys dedicated to specific business areas, topical issues and geographic regions. *The Economist* (a weekly newspaper with a magazine format) provides a good, succinct and accessible guide to what is going on in the world of international politics, finance and business. This also has regular business and geographical surveys. Profiles of publicly traded companies can be found in the *Investors Chronicle* along with commentary on general developments in the world's stock markets. Most consultants read these publications regularly. Many keep a cuttings file on topics of interest. Business libraries keep back copies and have key word indexes.

6.7 Qualitative methods for evaluating opportunities

Markets are made up of individual decision-makers. The dynamics of a market must be understood in terms of both the influences on individual decision-making and the way individuals aggregate to generate overall demand. A number of techniques are available to explore the nature of individual needs, buying and product selection.

Depth interviews

Depth interviews are one-to-one interviews in which the investigator gets the potential customer to explain how he or she makes buying decisions. The interview may be partially structured but the investigator will keep open the option of exploring interesting avenues as they are revealed. Examples of products and other stimulus materials might be used to encourage the discussion. This is usually done face to face but occasionally is conducted by telephone, although the latter method is limiting in terms of the time and the type of questions that can be asked.

Focus group discussions

Focus group discussions involve a small group of potential customers (usually about four to seven people) who are invited to explore their views on a product category. The session will usually last between two and three hours. A facilitator

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who will be responsible for interpreting the findings afterwards leads the discussion. Again, product examples and stimulus materials may be used.

Product placements

With product placement the customer is exposed to the product in a normal usage situation before being questioned via one of the above techniques. This technique can give an insightful picture of the customer's reaction to the product on which to base further development and promotion. It does, however, demand that a product, or a prototype, be available. This can prove to be expensive and may present security issues if the product is in a development stage. Each of these techniques has its strengths and weaknesses. They may be used in combination to give a full picture of the buying behaviour of potential customers. Often a small number of flexible but relatively expensive techniques (e.g. depth interviews, focus groups) will be used to establish broad issues which can then be explored in more depth using quantitative methods as described below.

6.8 Quantitative methods for evaluating opportunities

Once the character of the individual buying process has been established, the researcher must move on and establish how buyers as a group present an opportunity to a particular business. This calls for quantitative techniques: the most important are as follows.

Postal or email surveys

A representative sample of customers is mailed or emailed a questionnaire. This will include questions relating to what products they buy, from what suppliers, how often they buy, how much they use and how frequently they use them. This is often the cheapest cost in total, but as response rates are often low, it might not be the most cost effective in the long run.

Omnibus surveys

In omnibus surveys, a representative sample is asked similar questions to those used in the postal survey. As speed is of the essence, the telephone is the usual means of communication, although increasingly electronic means are used if appropriate to the target audience. There may be more potential to open up new lines of enquiry here than in the postal survey. However, consumers may not have time to reflect on their consumption (as they will have with a postal survey) and a follow-up call may be needed.

In-hall or on-street testing

This is a familiar method, whereby respondents are recruited on the street and interviewed directly or are asked to attend a short session in a local building. Despite

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costing more than postal or telephone surveys, you do have the advantage of being able to ask different questions as respondents can see the new product or other stimulus material. This technique is used for consumer products in particular.

Distributor or retail audits

Distributor or retail audits are a particularly important source of information on markets, their structure, size and growth. The technique used requires a representative sample of distributors (who may be wholesalers or retailers) to keep a record of their purchases and sales. This information, which can nowadays be kept electronically, can be supplemented by direct outlet audits. A distributor audit allows a market to be broken down in a number of ways. The overall market can be represented as the product of *rate of sale* (the number of units a typical distributor sells) and *distribution* (the proportion of distributors selling the stock). Other information includes *stock holding* (the amount of a product a typical distributor holds) and *forward stocking* (the amount on display to the buyer). Information of this type allows the business to make subtle decisions about its distribution strategy and how to manage its relationship with distributors. A meaningful distributor audit is likely to be time consuming and expensive. A number of companies offer store audits on a commercial basis, the leading two being A.C. Nielsen and Information Resources.

Team discussion points

1 Read the following short case study.

Halifax Foods is an upper-medium-sized supplier of own-label canned goods to major supermarkets. It has ten key product categories. The firm is concerned about its costs and a consulting team has been called in to help the company develop a rationalisation plan. The team has held a brainstorming session with key players in the firm. Using the factors discussed above, the team has established the ratings (out of ten) shown in Table 6.2 for market attractiveness and competitive position for each product category. These are listed with the sales for each category.

Table 6.2 Market attractiveness and competitive position

Category	Annual sales (£m)	Market attractiveness	Competitive position
Fruit	11	5	4
Baked beans	2	4	2
Traditional soups	39	7	8
Ethnic soups	1	10	2
Mixed vegetables	24	3	7
Carrots	7	2	4
Peas	6	1	3
Stir-fry vegetables	1	8	1
Broad beans	2	6	4
Flavoured beans	1	8	2
Total sales	94		

Construct a Pareto analysis and a DPM matrix for the firm. What strategic recommendations would these analysis methods suggest?

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2 Consider the decision you made to undertake your course in management consulting. What market research methods would you adopt to evaluate the interests of your colleagues in such a course within your institution? How would you measure the overall demand for such a course? How would you investigate ways in which the course might be modified to make it more attractive in the future?

Discuss your ideas in a group.

Summary of key ideas

A number of techniques are available to the consultant to aid analysis of a business and its environment. An evaluation might include the following:

- A simple summary of the business's capabilities and the environment in which it operates.
- A review of the business's source of competitive advantage and the environment in which it operates.
- An evaluation of the firm's performance and product performance.
- Identification and evaluation of strategic options.
- Planning for the future.
- An assessment of markets and their segmentation.
- The use of market research techniques both qualitative and quantitative.

Key reading

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Case exercise

DQS

DQS is a large Asian display manufacturer that has a strong position in the declining market for cathode ray tubes (CRT) for televisions. It has developed a good position in supplying LCD panels, up to 21 inch diagonal, for use in laptop computers and computer monitors. The majority of their sales are to European Original Equipment Manufacturers (OEM) for building into complete products. A small proportion of output is sold as finished products using the company's own brand names.

The company's CEO, John Shih, sees the future for the company's television business as being in large flat-panel products of at least 40 inch diagonal. He has a dilemma because the established technology in the large flat TV sector is plasma display panels although LCD TVs are starting to make inroads. The investment in building a new production line for large panels of any type is several billion pounds. He can only afford one and the choice has to be right.

John has worked in the US and has used consultants before. He calls you and asks you to look at the following questions:

- What is the consumer perspective on the two alternative technical solutions?
- What is the market size and expected growth?
- What are the market drivers?
- What sizes of TV should DQS build?
- What performance is required?
- What is a reasonable target market share and how does this split between own-brand and OEM?
- What price does DQS need to sell at to establish a sustainable competitive position?
- Can DQS achieve a return on investment that is acceptable to its board and investors?

Q1 What analysis techniques would you use and why?

Q2 What would a SWOT analysis covering DQS's entry into the large flat panel television market tell John?

Q3 What market research material would be required to support the choice of technology and define the product specification?

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