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UTTAR PRADESH RAJARSHI TANDON OPEN UNIVERSITY

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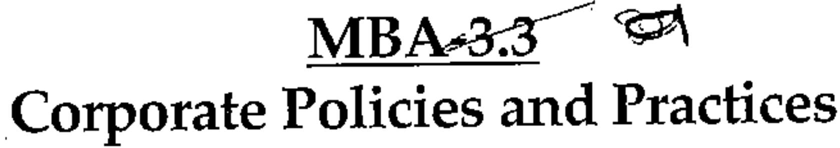
MBA - 3.1



MBA-3.3
Corporate Policies and Practices

FIRST BLOCK
Corporate Strategy And Planning

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MBA-3.1
Corporate Policies and Practices

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CORPORATE STRATEGY AND PLANNING

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BLOCK 1 CORPORATE STRATEGY AND PLANNING

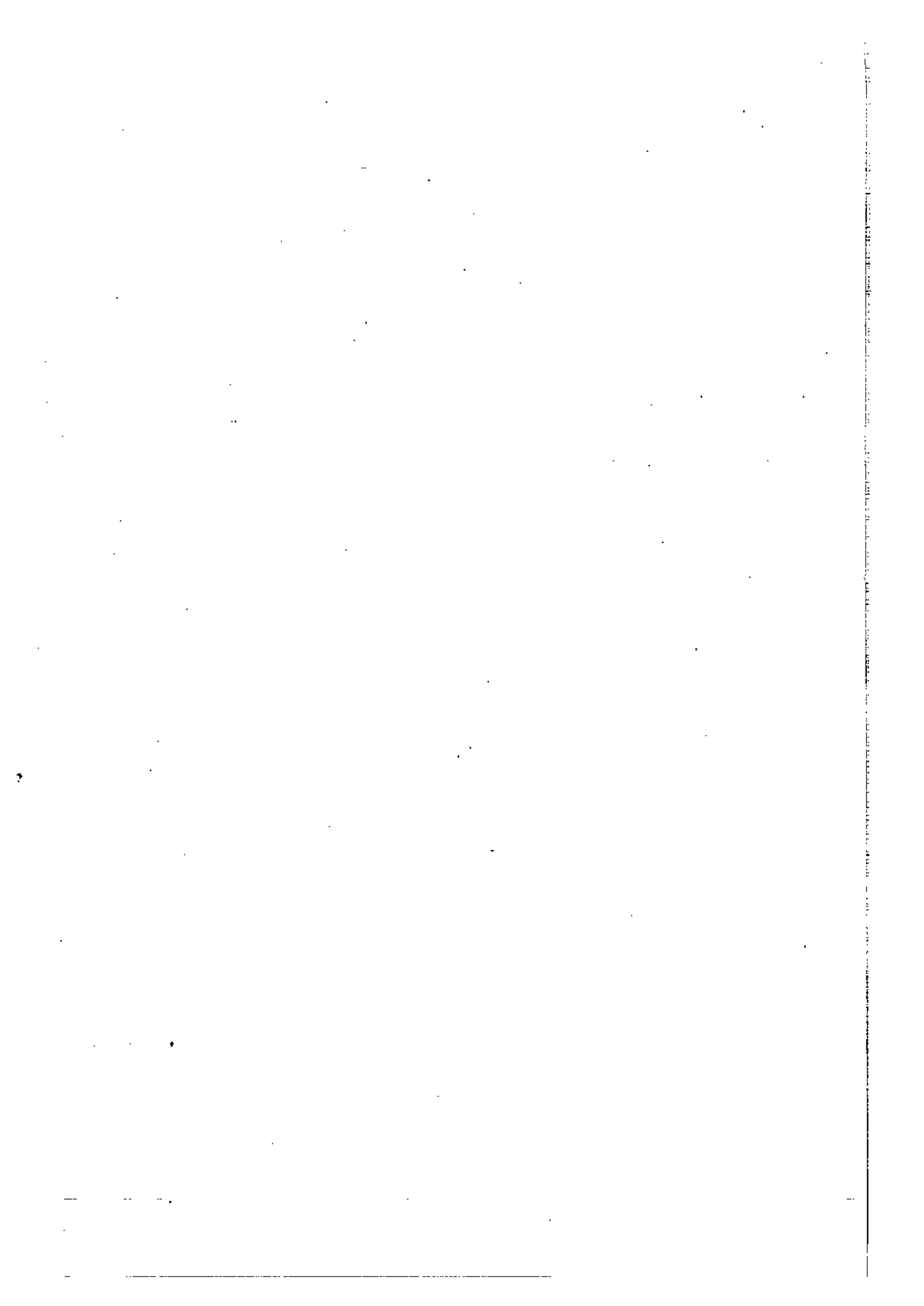
Corporate policy and practices is a challenging and fast developing field of study. It looks at the organisation as a whole and helps to explain why some organisations thrive while others stagnate. In today's dynamic environment, an organisation, whether large or small, must be managed strategically. The decisions in an organisation cannot simply be based on long standing rules, policies, or standard operating procedures. Instead the corporate management must look to the future to plan organisation — wide objectives, initiate strategy, and set policies. The corporate management must answer these questions: firstly, where is the organisation presently, and secondly, where it will be, if no changes are made, at some point in future? If the answer to the second question is not acceptable, then the management must think what specific actions are required to be undertaken and what are their risks and pay offs.

This introductory block is divided into three units.

Unit 1 acquaints you with the Concept of Strategy and its various elements. The various aspects related with strategy, viz., missions, objectives and goals, and policies are explained with the help of suitable examples. The different types of strategies are discussed. The importance of strategy has been highlighted and the various phases involved in the process of strategic management are described.

Unit 2 elaborates upon the components of McKinsey 7-S Framework. The seven Ss, namely, Strategy, Structure, Superordinate goals, Systems, Styles, and Skills are explained and then examined in the context of existing literature in this area. The unit concludes with a brief discussion about the Framework's utility and limitations.

Unit 3 deals with Corporate Policy and Planning in India. The basic concept of corporate planning and its characteristics are discussed. The various steps involved in the process of corporate planning and the approaches that can be followed in preparing corporate plans are described. The usefulness of Systems Concept in constructing corporate plans and benefits from corporate planning are underscored. The unit then focuses on why corporate planning fails and what is required to make the planning experience a successful one.



UNIT 1 CONCEPT OF CORPORATE STRATEGY

Objectives

The objectives of this unit are to:

- develop your understanding about the concept of strategy and its various components
- acquaint you with various kinds of strategies that an organisation can follow.

Structure

1.1 Introduction
1.2 Definition of Strategy
1.3 Organisational Purposes and Missions
1.4 Objectives and Goals
1.5 Policies
1.6 Programme Strategies
1.7 Kinds of Strategies
1.8 Importance of Strategy
1.9 Strategic Management Process
1.10 Summary
1.11 Key Concepts/Terms
1.12 Self-assessment Questions
1.13 Further Readings

1.1 INTRODUCTION

The development of concepts in strategic management has taken place during the last three decades. The key concept in this field is that of "strategy" which is an aid to the top manager in dealing with the problems and dilemmas posed by an increasingly complex and competitive environment.

The Twenty-fifth National Business Conference sponsored by the Harvard Business School Association in 1955 made one of the earliest attempts to highlight the potentially powerful concept of strategy. Subsequently, Chandler's historical study of the development of some of the American enterprises proposed "strategy" as one of the most important variables in the study of organisations.[1] In 1965, Ansoff published his *"Corporate Strategy"*, and Learned, Christensen, Andrews and Guth of Harvard Business School published *"Business Policy : Text and Cases"*. Ansoff relied heavily on his experience at the Lockheed Aircraft Corporation to develop a method for formulating the strategy. The concepts discussed in the text book developed by Harvard Business Policy Group was an attempt to understand the problems of general management in business enterprises with the help of the concept of strategy.

From the literature on strategic management, it is evident that long range planning and/or strategic planning refers to the management processes in organisations through which the future impact of change is determined and current decisions are made to reach a designed future. These concepts have far reaching influence on the organisation. They include the entire process of determining major outside interest groups and their stakes; expectations of dominant inside stakeholders; information about past, present, and projected performance; and evaluation of company strengths and weaknesses; formulation of organisational purposes, missions, objectives, policies and strategies. However, despite the fact that management experts have been trying to emphasise the need for such long-term approaches in organisational management,

they are among the least developed and understood concepts in management. There is empirical evidence to suggest that top managements of organisations recognise the significance of strategic planning, but, paradoxically, they devote little time and effort to it. In the emerging world of business which is likely to be characterised by an increasing pace of change and complexity, top managers would be required to devote greater time and energy to the long-term and strategic issues confronting their organisations.

In this unit we shall explain the various terms related with the concept of strategy, its importance and the steps involved in the strategic management process.

1.2 DEFINITION OF STRATEGY

There is a considerable confusion in management literature regarding the meaning of the different terms used in the area of strategic management. A survey conducted by the American Management Association revealed that the respondents found it difficult to define the word 'policy'. Various companies when asked to define 'policy', used different phrases such as: a broad interest, direction or philosophy; an expression of the corporation's principles and objectives; guides to thinking and action; general standards not subject to frequent change; and procedures and practices, etc.

The problem may be due to the fact that *strategy, policy,* and *objectives,* according to Andrews, embrace a range of statements from the broad and important to the narrow and relatively unimportant ones[2]. Policies merge into procedures and procedures into rules. Strategies blend into tactics while corporate objectives shade into budget limits thus creating an 'ends-means continuum'. The following case illustrates this ends-means continuum.

A company decides upon a sales growth goal of 25 per cent per year and also decides to achieve this by acquiring other companies rather than introducing new products developed through in-house research and development. It may be said that acquisition was the strategy chosen by the company. Once that is decided, the acquisition of a company becomes an objective. The strategic choice then may be between acquiring a large or a small company. Assuming that the decision is to acquire a large company, search for a large company to acquire then becomes an objective, and so on. Depending upon the inclination, the word policy can be substituted in this illustration with strategy.[3]

Some of the definitions of the term "strategy" available in the management literature are presented below. According to Chandler,"Strategy can be defined as the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals..."[4]

Anthony defined strategic planning as "the process of deciding on objectives of the organization, on changes in these objectives, on the resources used to attain these objectives, and on the policies used to govern the acquisition, use, and disposition of these resources".[5]

This definition of strategic planning implicitly provides us a concept of strategy.

Ansoff developed a theory around the "strategic problem"; choosing a firm's objectives and goals; deciding whether to diversify or not; if so in what areas, how vigorously and how it should develop its existing product market position, etc. According to him, strategy consisted of four components, namely, product-market scope, growth vector, competitive advantage, and synergy.[6] The following example of a chemical firm illustrates the concept.

Objectives
Return on Investment : Threshold 10%, goal 15%
Sales Growth Rate : Threshold 5%, goal 10%

Strategy
a) Product-market scope: Basic chemical and pharmaceuticals
b) Growth vector: Product development and concentric diversification

c) Competitive advantage: Patent protection, superior research competence
d) Synergy: Use of the firm's research capabilities and production technology

Learned, et al. defined strategy as: "...the pattern of objectives, purposes, or goals and major policies and plans for achieving these goals, stated in such a way as to define what business the company is in or is to be in and what kind of company it is or is to be".[7]

Chandler's definition highlights the fact that strategy refers to long-term decisions. However, this is not made explicit in the other definitions. In explaining the definitions further the various authors, however, mention this characteristic of strategic decisions. To Chandler, Anthony and Learned, et al. strategy includes objectives, goals and the courses of action adopted to achieve them, whereas, to Ansoff strategy refers to the ways by which a firm can achieve its objectives. Product-market scope, growth vector, competitive advantage, and synergy can be thought of as "courses of action".

In the other definitions. There are other authors who also use the terms "missions" and "strategies" as part of the overall term "strategy" The differences in the meaning of the term are quite evident".[8]

Despite the lack of consensus on the definition of strategy, there seems to be a trend towards accepting a definition which includes the determination of the missions, and the long term objectives of an organisation and the policies necessary for achieving those missions and objectives. This is the definition we shall be using here.

In the following sections the components of strategy are elaborated.

1.3 ORGANISATIONAL PURPOSES AND MISSIONS

The strategic planning choice that must be made by an organisation is that of its purposes and missions. An organisation's statement of purpose and mission is its *raison d'etre,* it tells what it is, why it exists, and the unique contribution it can make. The definition of organisational purposes and missions is one of the most important and difficult tasks of top management. This is very well brought out by Selznick: "...The aims of large organizations are often very broad. A certain vagueness must be accepted because it is difficult to foresee whether more specific goals will be realistic or wise. This situation presents the leader with one of his most difficult but indispensable tasks...".[9]

Drucker elaborates: "...Nothing may seem simpler or more obvious than to know what a company's business is. A steel mill makes steel, a railroad runs trains to carry freight and passengers, an insurance company underwrites fire risks, a bank lends money. Actually, "What is our business?" is almost always a difficult question and the right answer is usually anything but obvious..."[10]

As mentioned previously, there is a semantic ambiguity around the terms "purposes" and "missions". Some authors do not differentiate between the two. Consider the following:

"The strategic planning process begins with the delineation of tentative organizational purposes, essentially a mission statement describing the "business" that the organization might pursue in the future. This statement, preliminary in nature, is intended to put boundaries on future opportunities and to provide a point of departure from which the informational requirements for assessing future opportunities can be assembled and evaluated".[11]

In one of his earlier books, Steiner used the terms purposes, missions and objectives interchangeably as revealed by the following:

The socio-economic purpose refers to those underlying ends which society expects of its business institutions if they are to survive. At rock bottom this means that society demands that businesses utilize the resources at their disposal to satisfy the wants of

society. If this is done, a business will profit and survive. If it is not done well, a business will make no profits and will die unless society wishes to subsidize it to assure its survival .[12]

The basic purpose or missions of the firm are those fundamental ends and lines of business which it wishes to pursue. Basic missions are found in corporate charters, but they are often so numerous and permit such a wide diversity of activity that they provide little or no direction for planning. Managers must choose among them those activities to which the firm is to be committed....[13]

In a more recent book, Steiner, et al. have attempted to explain and differentiate these terms. According to the authors the purposes of an enterprise should include larger societal obligations expected of it and the fundamental aims which its top managers implicitly or explicitly determine. The latter may include both economic and ethical purposes. Purposes are stated in broad terms and tend to have long lives. For instance, one company identified the basic purpose as follows: "To strive for the greatest possible reliability and quality in our products". Another said its purpose was "to be recognized as a company of dedication, honesty, integrity, and service".[14]

The mission of an organisation, according to Steiner, et al. expreses its underlying thrust, which may be stated at different levels of abstraction. In operational terms the mission statement identifies the market an enterprise wishes to serve, the products and services it wishes to supply and the manner in which it would like to compete.[15] The fundamental thrust of American Telephone and Telegraph Company for over fifty years was "our business is service". An example of a more operational mission is, "produce fabricated steel shapes and forms for the construction market". Voltas Limited, one of the large Indian private sector companies, defined its purpose or mission as "profit, growth and excellence".

On the nature of missions, King and Cleland aver that broad statements are not useful as guides to management. They suggest that the mission should be clear to outsiders as well as to the key internal stakeholders. A sample of such attitudes is: "We are in the business of supplying components to a worldwide non-residential airconditioning market". According to them the mission may be built around technology, product characteristics or needs. Missions built around customers are likely to have short lives as the customers might change as a result of environmental changes.[16] Nearer home, the Gujarat Pharmaceuticals and Chemicals Works, a small pharmaceutical company in Ahmedabad expressed its mission as: "To be a small honest company putting out dependable, standard drugs at low prices". Another example of a mission statement is that of the Oil and Natural Gas Commission (ONGC) of India: "To stimulate, continue, and accelerate efforts to develop and maximise the contribution of the energy sector to the economy of the country." [ONGC — Company Annual Report, 1981-82].

1.4 OBJECTIVES AND GOALS

Objectives and goals provide the foundation for all managerial activity; they are the ends or aims toward which all activities are directed. They serve several functions. According to Brown and Moberg.[17]

- Goals aid in legitimizing an organization and creating a place for it in the environment
- Goals help managers identify interorganizational relationships
- Goals have public relations value; they might help in attracting support from various groups in the environment, and also in attracting the right people to join the organization
- Organizational goals can also help in image building with suppliers, customers, public policy makers and the government
- Goals can help in coordinating the multiplicity of tasks in organizations; conflicts can be more easily resolved if relevant stated goals are available

- Goals provide the fundamental standards for measuring performance
- Goals act as motivators. They provide a challenge to many organizational members. They generate commitment.

King and Cleland identified a few more functions in addition to the above list. They are: to establish a general tone or organizational climate; to serve as a focal point for those who can identify with the organization's purpose and direction and to deter those who cannot, from participating in the organization's activities; to facilitate the translation of the broad purposes and missions into identifiable tasks and their assignment to responsible groups within the organization and to help in allocating organizational resources.[18]

Sears, Roebuck and Company (of USA) has expanded from being a catalogue merchant into a fabulous range of services as a result of a continuing redefinition of its objectives. The usefulness of defining objectives is apparent from this illustration.

Robey has further elaborated upon the list of functions of objectives mentioned above. According to him, the goals reduce uncertainty by clarifying what the organization is pursuing and providing a factual basis for actions. They help an organisation to learn and adapt by highlighting the discrepancy between itself and the actual progress, thereby providing feedback for learning.[19] An organization falling short of its targets might set up a task force to develop new policies for achieving a higher level of goal attainment. Goals can also provide a rationale for designing the organization. A goal of rapid growth through introduction of new products may lead an organization to create a strong R&D department and to create mechanisms for closer integration between the engineering, marketing and R&D departments.

Uptill now we have used the terms "goals" and "objectives" synonymously. But some authors differentiate objectives from goals. According to King and Cleland objectives should be broad and timeless statements, though they may be stated in quantitative or qualitative terms On the other hand goals are specific, time-based points of measurement that the organisation intends to meet in the pursuit of its broad objectives. Usually, goals are stated as specifically and as quantitatively as possible, the emphasis being on measurement of progress toward the achievement of objectives.[20]

For instance, among the stated objectives of the Oil and Natural Gas Commission [Company Annual Report, 1981-82] are to:

- Continue and expand exploration efforts to convert in the fastest time possible, the country's prognosticated hydro-carbon resources to established reserves.
- Build up relevant technology, scientific knowledge and expertise in relevant areas of exploration techniques, exploitation practices and technology, engineering, construction and maintenance.
- Generate and maximise internal financial resources for enhancing growth, consistent with environmental requirements and maximisation of the rate of return on investment.

Organisational goals may be expressed for example as a target of 10% increase in market share; improvement of productivity by 5%; or an annual cost reduction of 15% through a material economy programme.

Types of Organisational Goals

Organisational goals may be classified into three types:

The Official goals are the general aims of the organisation as described in a memorandum of association, charter or annual report. They may also be found in public statements by top executives. As mentioned previously goals have a public relations value, and the official goals are the ones which serve this function. The official goals or the stated goals also perform the function of legitimising the organisation in its environment.

The Operative goals indicate what the organisation is really attempting to do. They may be inferred from the actual operating policies of the organisation. They help organisational managers to focus attention, reduce uncertainty and choose among organisational design alternatives.

The Operational goals are used by supervisory personnel or managers in organizations to influence the behaviour of subordinates and to measure their

performance.[21] An illustration is given by Robey. The official goals of the Metropolitan Comprehensive Drug Programme in the USA, as stated in their charter were, "to locate and assist individuals who suffer from abuses of alcohol and drugs, to provide medical and counselling services for these persons, and to evaluate the effectiveness of various drug assistance programmes". The emphasis was clearly on rehabilitation, service, and research in the official statement.[22]

The "operative goal" inferred from the actual operations was, however, to maintain levels of funds from external sources. This concern, though ultimately significant in the achievement of the official goals, sometimes conflicted with the latter. An innovative programme for prevention of drug abuse could not be pursued as the federal funds were allocated on a per client basis. For the MCDP this approach was self-defeating, since the drug programme had to justify financial needs on the basis of the clients served. The implication was that the larger the number of abusers the more the funds. The operative goal was therefore to ensure funding levels by serving people who had been formally defined as clients rather than pursue a preventive programme catering to potential drug abusers.

The "Operational goals" in the drug programme stressed the measurable factors such as the number of clients seen, the number of referrals made, and counsellor absence and tardiness. Counselling skills, empathy with clients, and quality of assistance were neglected as these factors were difficult to measure. The result was that members did what they were rewarded for, that is, they pursued the operational goals rather than the official goals.

The official goals are abstract, idealistic and outer-directed; the operative ones are the actual goals of the organisation but are not articulated and the operative goals are detailed, measurable and directed downward.

Implicit in the framework of goals described above is a hierarchy which has been very well elaborated by Granger. He says that firstly the objectives or aims are involved in a complex relationship with other guides to action such as purposes and missions, internal and external constraints, measurements of success, budgets, annual and long-range plans. Secondly, there is a hierarchy of objectives proceeding from the very broad to the specific. The specific or more limited objectives should not be in conflict with the broad objectives.[23]

Should an organisation have a single objective or multiple objectives? If an organisation were to have a single goal it would be very easy to determine its effectiveness. The Microeconomic Theory of the firm assumes that the organizations pursue the long-run goal of profit maximisation. However, in reality, organizations are constantly required to attend to demands that necessitate short term orientation. Multiplicity of goals is an organizational reality. An organization has multiple stakeholders: shareholders, managerial personnel, workers, customers, competitors, suppliers, politicians, the government, etc. The different groups of stakeholders have their own goals and hence to keep the various inside and outside groups in balance the organization must achieve a satisfactory level of goal attainment from each one's perspective.

Drucker[24] has suggested eight important areas of business objectives:

1 Marketing
2 Innovation
3 Human Organization
4 Financial Resources
5 Physical Resources
6 Productivity
7 Social Responsibility
8 Profit Requirements.

1.5 POLICIES

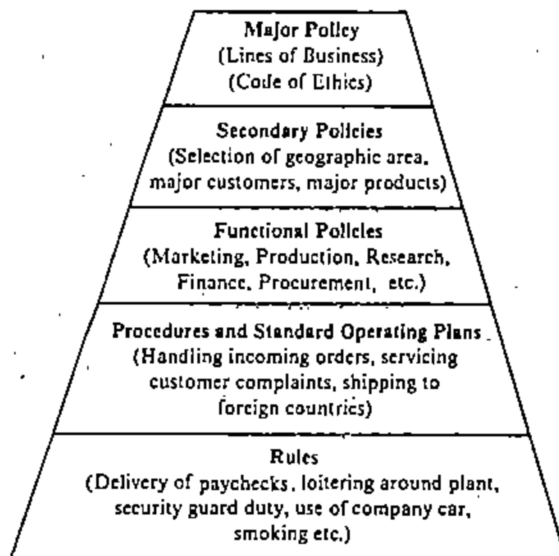
Policy is a guide to action. Newman and Logan define policy as a standing plan which is used to guide specifications.[25] Steiner, Miner and Gray consider policies as

"guides to action or channels to thinking".[26] These definitions of policy more or less convey the same meaning of the term, i.e. policies are guides to action in organizations. A similar meaning is conveyed by a definition, used by the General Electric Company (of USA).[27]

A policy is a definition of common purposes for organisation components of the company as a whole in matters where, in the interest of achieving both component and overall company objectives, it is desirable that those responsible for implementation exercise discretion and good judgement in appraising and deciding among alternate courses of action.

Though the above definitions connote broadly the same meaning of the term "policy", in the business world there is a lack of consensus about it.[28] The confusion about the nature of policies arises from a number of factors. Policies are not always clearly demarcated from the other elements of planning and plans. The process of strategic planning, which sometimes encompasses the formulation of important policies, is not publicised; hence it is shrouded in some kind of a mystery; and in some organizations some policies are considered to be confidential. As mentioned earlier, policy and strategy are sometimes used synonymously. This is true when strategy is considered to be a means for achieving the broader organizational purposes or missions. Some authors have conceptualised policies in a Hierarchical relationship.[29] Figure 1.1 presents a hierarchical relationship between policies of great significance which are at the top of the pyramid and rules which are of much lesser importance.

Figure 1.1
Pyramid of Business Policies



Source : Steiner, G.A. *Top Management Planning*, p. 268

Policies, procedures, standard operating plans and rules are all guides to action but differ in the degree of guidance provided or the freedom given. A procedure is a series of related steps in a sequence to achieve a certain end. A well-established and formalised procedure may be called a standard operating plan. A procedure or standard operating plan is in other words a means to implement a policy. Rules are specific courses of action which permit very little flexibility and freedom of interpretation.

Activity 1

A) Describe the following with respect to the organisation you are working or familiar with:
   a) Its mission or purpose
   b) Its objectives
   c) Its goals (corporate level)
   d) Its policies (corporate level)

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B) Does the organisation in question have a strategy? Spell out what that strategy is and how it is arrived? If necessary, you may talk to a knowledgeable person in the corporate planning department (or cell) at the headquarters.

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1.6 PROGRAMME STRATEGIES

Purposes, missions, objectives and policies are known as master strategies.[10] Programme strategies refer to the specific action plans or methods to be used to achieve an already established objective. An organisation might have decided upon a long term objective of growth in sales turnover at the rate of 25 per cent per year. To achieve this objective, the organisation would have to formulate relevant programme strategies e.g., new product development programmes, product improvement programme, programme for certification of products by renowned inspection agencies, etc.

A programme is a collection of activities that are designed to achieve a certain end or a specific purpose. Programmes and projects have a finite life and have very clearly defined goals, e.g., "to improve productivity by 15 per cent in a period of one year".

1.7 KINDS OF STRATEGIES

Though there is no universally accepted typology of strategies, there are certain common classifications which are in use by practitioners and management academicians. Some of the well-known strategies are mentioned here.

Growth Strategies

Growth is a major objective of most organizations. Guth has discussed seven growth strategies,

i) hold relative position in high-growth product/market area;
ii) increase market share in high growth market;
iii) increase market share in mature markets;
iv) hold strong relative position in mature market, and use "excess" cash flow, funds capacity, and other resources to support penetration in multinational markets with existing product line;

v) hold strong relative position in maturing market, and use "excess" cash flow, external funds capability, and other resources to support penetration of new-product/market areas domestically;
vi) hold strong relative position in multinational markets with present product line, and use "excess" cash flow, funds capability, and other resources to diversify products; and
vii) hold strong relative position in diversified product line domestically, and use "excess" cash flow, funds capability, and other resources to diversify markets.[31]

Dependency Reduction Strategies

Many organisations seek to reduce their dependence on other organisations. Thompson[32] describes six strategic alternatives aimed at reducing an organisation's dependence on the environment,

i) "Maintaining alternatives" refer to options like arranging for alternative sources of supply; entering additional geographical regions to reduce uncertainty due to dependence on local market conditions; and diversifying into coal and shale (in the case of companies) to assure themselves of some source of energy.

ii) Organisations can reduce dependency by building a "positive image" as many organizations prefer to do business with those that have prestige.

iii) "Direct confrontation" is a strategy that organisations can adopt to acquire power over those on whom they are dependent. It involves a direct show of power, which might involve price cutting, unfair competitive practices, espionage, pirating or sabotaging resources, law suits, and takeover, etc.

iv) "Contracting" is a strategy used by organisations to reduce uncertainties associated with some dependencies. Contracts may be negotiated by organizations with their suppliers, competitors, customers or regulators.

v) "Co-optation" is the strategy by which organisations attempt to achieve certainty of future, by absorbing representatives of other organisations into policy-making positions.

vi) "Coalitions" are cooperative relationships formed by organizations to achieve common goals like opposing a common enemy; promoting a product or service; construction of common facilities; and sharing the costs of expensive programmes or equipment, etc.

Vertical Integration Strategies

An organisation's move to produce inputs into its own manufacturing process is termed "backward vertical integration", while a move to gain control of the distribution of the outputs produced is called "forward vertical integration". Harrigan has analysed the advantages and disadvantages of vertical integration. The basic risk is that of losing flexibility.[33]

Generic Strategies

According to Michael Porter[34] there are three potentially successful generic competitive strategic approaches:
i) overall cost leadership
ii) differentiation
iii) focus

Overall cost leadership requires efficient-scale plants, cost reduction from experience, tight cost and overhead control, and cost minimisation in R&D, service, salesforce, etc. Other implications are that the firm which pursues this strategy must have a high relative market share, and possibly a favourable access to raw materials.

A firm pursuing a strategy of differentiation ideally differentiates itself along several dimensions like design, technology, features, customer-service, dealer network, etc., to create an industrywide perception of uniqueness.

Focus takes many forms: concentrating on a particular buyer group, segment of the product line, or geographic market. The entire strategy is built around serving a particular target well, and each functional policy is designed with this in mind.

Mergers and Joint Ventures

Merger involves the complete blending of assets and the formation of a new single organisation instead of the two original ones, in many cases, the name, facilities, and the personnel of the acquired firm are retained. What changes is the ownership. Control of resources and competition are probably the main reasons for mergers. Firms that view mergers from a portfolio perspective often acquire firms whose businesses may not have any relationship to their existing businesses. This kind of merger is called a conglomerate acquisition.[35]

Joint ventures result from the collaboration of two or more organisations. They are jointly controlled and owned by two or more parents and involve only a partial mingling of assets. This strategy permits the pooling of risk in uncertain activities like research in state-of-the-art air transportation, oil exploration, etc.

Turnaround Strategies

Strategies adopted for reviving sick organizations are referred to as "turnaround strategies". Hambrick and Schecter have classified turnaround strategies into two types; entrepreneurial and efficiency. The former type involves product/market refocusing and efforts to increase market share. Product/market realignment may be accomplished through new products, enhanced research and development and improved product quality. Efficiency oriented turnarounds are characterised by lowering of operating costs through reduction of direct product costs and increase in employee productivity and reduction of assets.[36] Khandwalla's research on turnaround management in India suggests that the major ingredients of successful turnarounds are: one or more powerful change agents; dramatic credibility building actions by change agent, mobilisation of organisation for turnaround through emphasis on companywide missions and goals; concretisation of goals and problems and the involvement of personnel in the turnaround; quick pay-off action to generate badly needed cash and providing a success experience to cynical rank-and-file; negotiating with key outside pressure groups to get temporary relief from pressure; opportunistic harnessing of external environment; selective strengthening of some of the mechanisms for influencing the external environment, selective changes in product-mix; selective professionalisation of management systems; motivational strategy; coordination strategy; performance control strategy; and institutionalisation of the appropriate style of management.[37]

Activity 2

You must have recently read an interesting story about 'turnaround' of a sick industrial enterprise. If not, then read a few issues of some business magazines. You are sure to come across such a story. Read the story thoroughly and assess the causes that led to the sickness of the enterprise (or unit). How was the 'turnaround' of the enterprise brought about? Who were the main actors in the 'turnaround' drama? Bring out the essential elements of the turnaround strategy.

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Business Unit Strategy and Corporate Strategy

Strategies may also be classified in terms of organisational level. A diversified corporation would have several separate businesses, each of which would have its own strategy. Hence in a divisionalised corporation there would be at least two levels of strategy; business unit strategy and corporate strategy. The concept of strategy is applicable to both the levels in general but there are some differences in the concerns of management and the specific content of strategy statements at the two levels. In operational terms a business unit strategy normally should indicate business domain and the products and services to be offered; differential advantage sought in terms of

quality, price, service, and the basis on which these are to be achieved; strategic thrusts through selected programmes and their timing and the goals. Corporate strategy is concerned with the total company consisting of a number of business units. Some units may have to be developed, some maintained and others liquidated. Also new units may need to be acquired or developed. The main elements of a corporate strategy should indicate the desired portfolio of business units and major moves regarding retention, addition or deletion of business units, consolidated resource mobilisation and plans.

Activity 3

What kind of strategies discussed in this section have been or are currently at work in your organisation and for how long? What results they have borne? Analyse critically.

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1.8 IMPORTANCE OF STRATEGY

Determining the strategy is the most significant area of management decision making and the most important one to make right decisions. According to Ansoff, there are three types of management decisions : strategic, administrative and operating. Operating decisions in a business organisation are concerned with resource conversion process and involve allocation of operating resources. Actual decision making tends to be with the operating managers in different units (or sub-units) of the organisation and decisions at this level are made all the time in an organisation. Many such decisions are repetitive. While such decisions may involve some risk and uncertainty, they are generally characterised by relatively short time period between recognising the need to make such decisions and the completion of all the effects following from them. Administrative decisions within an organisation are essentially facilitative. They establish policies and procedures for acquiring resources and ensure an appropriate internal structure of authority and responsibility among those working within the organisation and for managing the flow of information.

Strategic decisions,in contrast to the above two types of decisions,relate to the interface between the organisation and its external environments. Such decision making tends to be centralised at the top level of the organisation as the decisions are concerned with the allocation of the total resources. In contrast to operating decisions, strategic decisions are made relatively infrequently though the analyses required for making such decisions may be a continuing exercise. The effects of strategic decisions will normally be felt by the organisation over a considerable period of time. The most challenging characteristic of strategic decisions is that in many cases the management does not receive any forewarning that such decisions are required to be made. That is why Ansoff refers to them as "non self-generative decisions". This implies that although strategic decisions may be relatively few in number, the organisation must be constantly aware of a need to make such decisions. Therefore, it must ensure that a mechanism exists which would draw their attention to making such decisions.

Although in several cases an organisation's short-term survival is more affected by its operating and administrating efficiency, its success or failure in the long run however depends upon right strategic decision making, i.e., upon doing the right things rather than upon doing things right. Indeed, one of the problems faced by senior management, arising from the non-generative nature of strategic decisions, is that of

concentrating upon day-to-day operating and administrating issues to the almost neglect of strategic issues. Two authors contrast the relative importance and outcome of efficiency in the area of operations and strategy in the form of a matrix shown in Table 1.1.

Table 1.1: Comparison of Operating and Strategic Decisions

How \ What		STRATEGIC DECISIONS: Clear	STRATEGIC DECISIONS: Unclear
OPERATING DECISIONS	Effective	I Clear strategy and effective operations have contributed to success in the past and will contribute to success in the future.	II Unclear strategy but effective operations have conbributed to success in the past but success in the future is doubtful.
	Ineffective	III Clear strategy but ineffective operations have sometimes worked in the past in the short run, but increasing competition makes success doubtful in the future	IV Unclear strategy and ineffective operations have meant failure in the past and will be so in the future

Adapted from: Tragoe B. and J Zimmerman. 1980. Top Management Strategy, John Martin: London, p. 20.

The goal of top management should be the achievement of efficiency both at the strategic and operational fronts. While efficient operations without current strategy may ensure short term survival for the business, no organisation can survive without a clear and appropriate strategy in the long term.

1.9 STRATEGIC MANAGEMENT PROCESS

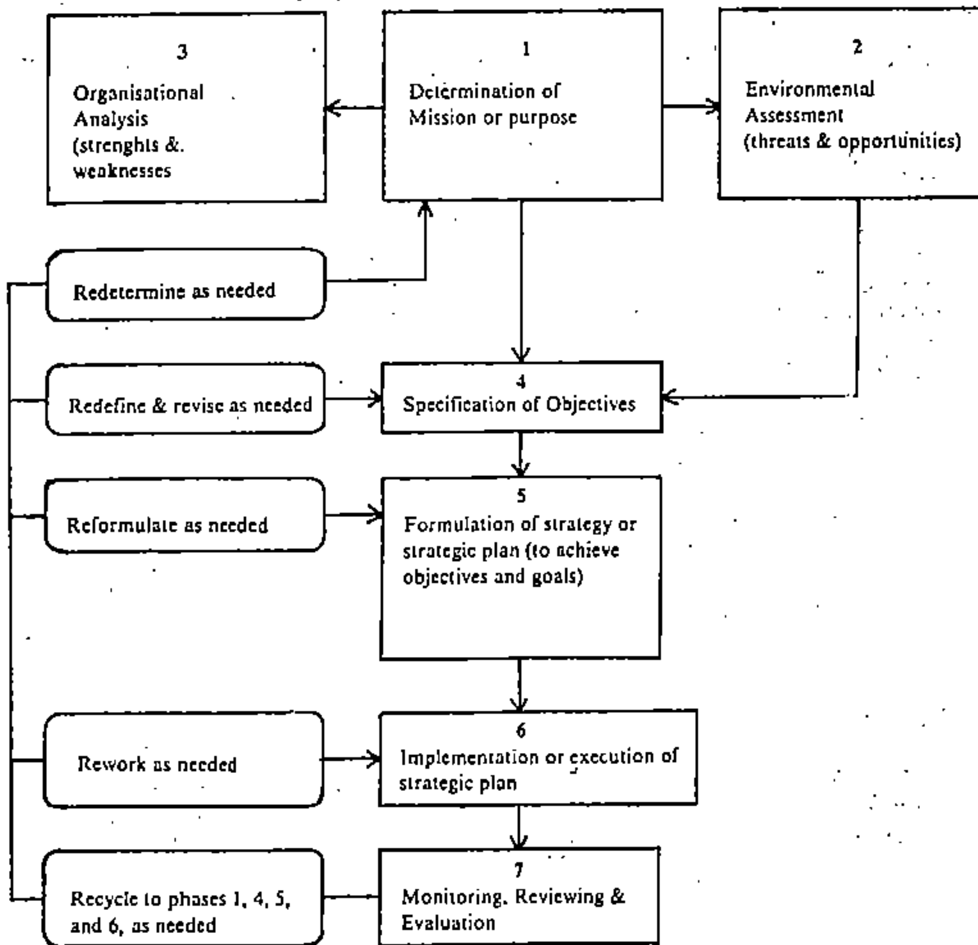
In this course we will be more concerned with the processes of strategic decision making rather than simply with strategic decision making. How strategic decisions are arrived at would be our primary concern.

The strategic decision making process may be viewed to comprise seven distinct but inter-related steps as shown in Figure 1.2. It would be desirable for the top management to make a strategic decision after going through the process outlined in this Figure.

At stage 1, the strategist must determine corporate mission in terms of: what do we intend (not just desire) to accomplish and for whom.

Stage 2 of the strategic decision making process would involve appraisal of current and likely future external environment of a business; its market opportunities and threats. The opportunities for the business may include new market areas into which existing products could be sold or new markets or new demands which would match with unique strengths of the company. Threats might be posed by the decline of markets upon which the business has been dependent in the past, e.g., upward movement in raw material costs or demographic changes likely to have an adverse impact on the organisation.

Figure 1.2 : Strategic Decision-making Process



By contrast, stage 3 of the decision making process involves an organisation's thorough analysis of its own internal capabilities, its unique strengths and weaknesses. Such an analysis will enable the business to identify the key factors upon which its success in exploiting markets and surviving against competitors depends. Such an analysis would also reveal weaknesses that should be remedied if the business is to continue to operate in its markets and survive against competitors. For example, firm may have particular strengths arising from its positive image in the community which it has built assiduously over the years by supplying high quality products and prompt and efficient after-sales service, or it may have considerable financial resources accumulated over the years as a result of past successful performance. However, such a business may also have weaknesses, for example, in the area of productive efficiency due to its outmoded technology, or in the area of physical distribution network due to the nature of its present business. In choosing a strategic option, a company would like to capitalise on its strengths while at the same time remedying or in the short run minimising the consequences of its competitive weaknesses.

At stage 4, the management of the organisation must identify its objectives and goals in terms of its basic mission or purpose, e.g., what would be the nature of the business in the light of the environmental and organisational analysis? It must broadly determine its corporate objectives in quantifiable terms over the next 5 or 10 years. In the case of a business firm, its basic mission or purpose should be expressed in terms of the market in which the business sees itself operating e.g., chemicals industry, banking services, transportation services, information processes, travel and tourism, etc. The objectives can be in broad terms along dimensions of profitability, growth, etc.

Formulation of strategy at the next stage would be preceded by a consideration of as many options as could be possible to the organisation. After all these options (e.g., expansion or consolidation of existing activities) are carefully weighed in terms of

organisation's own strengths and weaknesses, a particular strategy is selected and then formulated in detail. At this stage the organisation in fact attempts to seek a match between its objectives that it has set for itself at stage 2 and the results obtained from the assessment of external environment and the examination of internal strengths and weaknesses in stages 2 and 3. The formulation of strategy is a difficult task. The techniques discussed in Block 3 of this course would be helpful to you in improving strategic decisions. It must however be admitted that the success of a strategy,to a great extent,depends upon the judgement of the organisation strategist.

Implementation of strategy is concerned with the preparation of plans for putting the strategy into action. The necessary mechanisms and support systems will have to be established or the needed reshuffling will have to be undertaken.For this purpose, the design of the organisation may have to be restructured, a distinctive competence may have to be built up, resources may have to be reallocated, people may have to be motivated and a result-oriented climate may have to be created, or a culture supporting to the strategy may have to be created.

The last stage involves monitoring and evaluating the strategy in order to ensure the achievement or organisational objectives defined at stage I. In the light of the feedback obtained at the implementation stage, the basic mission or purpose of the organisation may have to be redefined, objectives may have to be revised, strategy may have to be reformulated, and implementation itself may have to be reworked. Figure 1.2 amply demonstrates that strategic decision making process is an on-going exercise.

Activity 4

Describe briefly the various stages involved in the formulation and implementation of strategy in your organisation or the organisation you are familiar with. What stage or stages you regard as the most crucial and why?

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1.10 SUMMARY

In this unit what is the concept of strategy and how it is related with its various other components were explained. Strategy is an all encompassing plan of the organisation in which its long range objectives are laid down and the route or routes through which these objectives would be achieved are specified. Strategy includes all those actions which an organisation intends to take in order to bring it to the position where it wants to be. Strategic mission consists of a long-term vision of what an organisation seeks to do and what kind of organisation it intends to become. It attempts to answer questions: like what are we presently and what we want to become in the future. Objective and goals indicate the specific kinds of performances and results which an organisational seeks to produce through its various activities. Organisational goals may be official, operative, or operational. Policies are guides to specific actions and therefore, stimulate thinking in specific directions. Policies sometimes may not be very explicit and therefore have to be inferred from the actions of the responsible managers.

There can be different types of strategies. Growth strategy stipulates direction in which the organisation wants to move for further growth. Dependence reduction strategy aims to expand the area of independence for the organisation, thus making it more self-reliant. Vertical integration strategy can be upstream or down-stream. While in the former case it aims to reduce the organisation's dependence on inputs, in the latter case it reduces its dependence on channels of distribution etc. Strategy can be for

merger or for a joint venture or for bringing about turnaround of the organisation. Strategy can be formulated for the entire organisation or for its various units.

In the dynamic environment of today, it is not only desirable but rather essential for any kind of organisation to have a strategy. The operating decisions, however effectively made and implemented, cannot ensure long term success. As strategic decisions tend to be non-self-generative, the management of the organisation must see to it that such decisions are made and constantly updated. The strategic management process consists of determination of mission and objectives of the organisation in the light of its unique strengths and weaknesses and assessment of opportunities and threats. It then goes on to formulation of strategy, its implementation, monitoring and evaluation. The feedback obtained from the review and evaluation can be used for revising the objectives and strategies.

1.11 KEY CONCEPTS/TERMS

Dependence
Growth-Strategy.
Joint Venture Strategy,
Mission,
Merger Strategy,
Objectives and Goals.
Official Goals,
Operative Goals,
Operational Goals.
Policy,
Procedure,
Programme Strategy
Strategy
Strategic Management
Turnaround Strategy
Vertical Integration Strategy,

1.12 SELF-ASSESSMENT QUESTIONS

1 Explain what do you understand by the concept of Strategy? Throw some light on the semantic confusion that prevail in this respect.

2 What is strategic mission and what is its importance in strategic formulation? Can there be a strategy without a mission? Give examples of mission for the following organisations:

a) a passenger transport organisation

b) an electronic organisation manufacturing TVs and VCRs

c) a private sector hospital and nursing home

d) an electricity supply undertaking.

3 i) Differentiate between the following and explain their inter-relationships:

a) Objectives and Goals

b) Objectives and Policies

c) Policies and Procedures

ii) What are different types of goals?

4 Enumerate different kinds of strategies which an organisation might follow. Can an organisation have more than one strategy at a time? Elucidate by giving some examples.

5 What is turnaround strategy? Discuss some possible elements of a turnaround strategy for reviving a sick cotton textile enterprise which has been in existence for the last about 40 years and which has been accumulating losses for nearly a decade.

6 Discuss the importance of Strategy. What might happen to a company if it does not have a clear strategy?

7 Describe the strategic management process. What mechanisms you would like to suggest for ensuring that a right strategy is formulated?

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UNIT 2 THE 7-S FRAMEWORK

Objectives

The purpose of this unit is to discuss the essential elements of the McKinsey 7-S Framework and link them with the existing literature in the area.

Structure

2.1 Introduction
2.2 McKinsey 7-S Framework
2.3 Strategy and Super ordinate Goals
2.4 Structure
2.5 Systems
2.6 Style
2.7 Staff
2.8 Skills
2.9 Review of the Framework
2.10 Summary
2.11 Key Concepts/Terms
2.12 Self-assessment Questions
2.13 Further Readings

2.1 INTRODUCTION

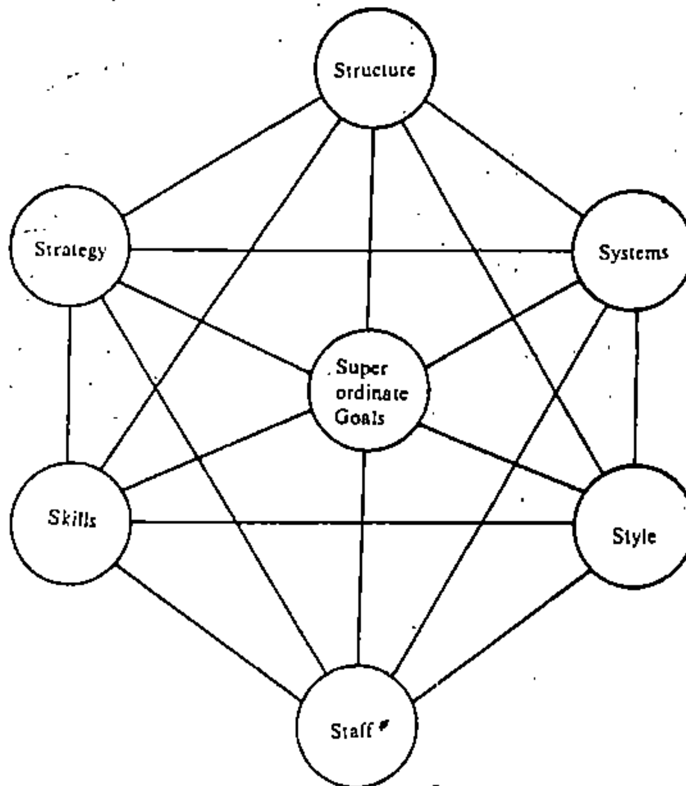
Strategic planning refers to the management processes in organisations which help the management to determine the future impact of change and take current decisions to reach the designed future. The management literature is replete with instances of organisations which have laid stress on strategic planning but have not been phenomenally successful. The question then arises as to how organisations can ensure that they reach their envisioned future. The answer perhaps lies in the proper implementation of strategies. It is in poor implementation that many organisations having good strategies meet their waterloo.

The 7-S framework was developed by the consultants at The Mckinsey Company, a very well-known management consultancy firm in the United States, towards the end of the 70s to diagnose the causes of organisational problems and to formulate programmes for improvement. In the following sections we will discuss the major aspects of this framework.

2.2 McKINSEY 7-S FRAMEWORK

According to Waterman et al., organisational change is not simply a matter of structure, although structure is a significant variable in the management of change. Again it is also not a simple relationship between strategy and structure, although strategy is also a critical aspect. In their view effective organisational change may be understood to be a complex relationship between strategy, structure, systems, style, skills, staff and super ordinate goals.[1] The complex relationship is diagrammatically presented in Figure 2.1.

Chart 2.1 The McKinsey 7-S Framework



Source : Thomas J. Peters and Robert H. Waterman, Jr., *In Search of Excellence: Lessons from America's Best Run Companies* (p.10)

The framework suggests that there is a multiplicity of factors that influence an organisation's ability to change and its proper mode of change. Because of the interconnectedness of the variables it would be difficult to make significant progress in one area without making progress in the others as well. There is no starting point or implied hierarchy in the shape of the diagram, and it is not obvious which of the seven factors would be the driving force in changing a particular organisation at a certain point in time. The critical variables could be different across organisations and in the same organisation at different points of time.

2.3 STRATEGY AND SUPER ORDINATE GOALS

The concept of strategy, you are aware, was dwelt upon at length in the previous unit, and hence it would not be discussed in detail in the present one. However, it would be useful to point out that the concept of strategy, as discussed in the previous unit, include purposes, missions, objectives, goals and major action plans and policies. Theconcept as applicable to the 7-S framework is somewhat narrower in scope. In the 7-S framework there is one variable termed as "super ordinate goals" which may be considered to be the equivalent of the term "organisational purposes" discussed in the previous unit. According to the proponents of the McKinsey framework, super ordinate goals refer to "...a set of values and aspirations that goes beyond the conventional formal statement of corporate objectives. Super ordinate goals are the fundamental ideas around which a business is built They are its main values. They are the broad notions of future direction. That is the way the top management as a team wants to express itself. Examples would include Theodore Vail's "universal services" objectives, which have dominated AT & T of USA; the strong drive to "customer service" which guides IBM's marketing; GE slogan, "progress is our most important product," which encourages engineers to tinker and innovate throughout the organisation; Hewlett-Packard's "innovative people at all levels in organisation"; Dana's obsession with productivity for the total organisation, not just for the few at

the top; and 3-M's dominating culture of "new ventures". Super ordinate goals may be compared with basic premises in a mathematical system. They are the basis on which the system is logically build but are not themselves logically derived..."[2] They are expressed at high levels of abstraction and may not mean very much to outsiders who are not very familiar with the organisation. But they have tremendous significance for those inside the organisation. Super ordinate goals when properly articulated can provide a strong basis for the stability of an organisation in a rapidly changing setting by providing a basic meaning to people working for the organisation

Activity 1

What are the super ordinate goals (values and aspirations) of the corporate management in your organisation? Are such goals recorded in any document? How the organisation ensures that these goals are translated into action at all the levels of the organisation?

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2.4 STRUCTURE

The design of organisational structure is a critical task of the top management of an organisation. It is the skeleton of the whole organisational edifice. Organisational structure refers to the relatively more durable organisational arrangements and relationships. It prescribes the formal relationships among various positions and activities. Arrangements about reporting relationships, how an organisational member is to communicate with other members, what roles he is to perform and what rules and procedures exist to guide the various activities performed by members are all part of the organisational structure. Organisational structure performs three major functions; i) it reduces external uncertainty through forecasting, research and planning in the organisation; ii) it reduces internal uncertainty arising out of variable, unpredictable, random human behaviour within the organisation through control mechanisms; iii) it undertakes a wide variety of activities through devices such as departmentalisation, specialisation, division of labour and delegation of authority; iv) it enables the organisation to keep its activities coordinated and to have a focus in the midst of diversity in the pursuit of its objectives[3].

Organisational structure as described in the 7-S framework may be compared with the "superstructure" of an organisation. The other component of structure, according to Khandwalla, is the "infrastructure". The design of the superstructure involves such issues as division of organisational tasks and allocation of responsibilities among various positions, relationship between different departments. The superstructure of an organisation indicates how differentiated it is or in other words to what extent the activities of the organisation are specialised. One organisation may have an engineering department, a manufacturing department and a quality control department. Another may have an engineering department, a manufacturing department, a production planning and control department, a materials planning department and a research and development department. The superstructure also indicates some of the ways in which the organisation's tasks are integrated or coordinated. The superstructure is commonly depicted by the organisational chart.

Organisational infrastructure refers to the network of information and controls, rules and procedures, decision making mechanisms, authority relationships, etc. These are the less visible aspects of organisations. Infrastructure also enables an organisation to undertake a number of diverse tasks and keep them coordinated for the achievement of organisational goals.

Organisational structure must be designed in accordance with the needs of the strategy. According to Chandler, changes in an organisation's strategy give rise to administrative problems which cannot be resolved with the help of the existing structure, thus necessitating a new structure[4].

According to proponents of the 7-S framework the relationship between strategy and structure, though an important addition to the organisational tool kit, rarely provides unique structural solutions. Quite often the main problem in srategy relates to execution.

2.5 SYSTEMS

"Systems" in the 7-S framework refer to all the rules, regulations, and procedures, both formal and informal that complement the organisation structure. In other words, it is the equivalent of the term "infrastructure", which was used in the previous section. It includes production planning and control systems, cost accounting procedures, capital budgeting systems, recruitment, training and development systems, planning and budgeting systems, performance evaluation systems, etc. Often changes in strategy may be implemented with some changes in "systems" rather than in the organisation's structure. Changes in organisational structure, for instance from functional to divisional or functional to matrix or divisional to matrix would also necessitate changes in the systems in various degrees. The significance of "systems" in the functioning of organisations is aptly expressed in the following words:

> To many businessmen the word "systems" has a dull, plodding middle-management sound. Yet it is astonishing how powerfully systems changes can enhance organizational effectiveness—without the disruptive side effects—that so often ensue from changes in structures.[5]

2.6 STYLE

Style is one of the seven levers which top managers can use to bring about organisational change. It is one of the so-called "soft" Ss. Organisations differ from each other in their styles of working. The style of an organisation, according to the McKinsey framework, becomes evident through the patterns of actions taken by members of the top management team over a period of time. The aspects of business most emphasised by members of the top management tend to be given more attention by people down in the organisation. Reporting relationships may also convey the style of the organisation. In some organisations the quality control function is embedded in the manufacturing function. but in others it is a separate function directly under the chief executive officer. In some organisations an R&D department may exist as a part of an engineering department, but in others it may be a separate one under the top man. Within the same organisation reporting relationships may change as a part of the evolutionary process, thus conveying changes in the style of management.

The McKinsey framework considers "style" as more than the style of top management. Giving the example of an organisation which acquired another company after a thorough analysis but failed to make it successful, Waterman, et al., contended that the failure was due to the mismatch of the corporate culture of the acquired organisation with that of the parent. In their own words, "...The acquisition had failed because it simply wasn't consistent with the established corporate culture of the parent organisation. It didn't fit their view of themselves. They will to make it work was absent. Time and again strategic possibilities are blocked — slowed down — by

cultural constraints...".[3] In the McKinsey framework, aspects of organisational culture also seem to be encompassed by the term "style". Waterman and his colleagues, however, have not attempted to elaborate on this.

Of late organisation theorists have showed an increasing interest in studying organisational culture. There may be several reasons for this. Firstly, culture provides a way to bring in the people dimension in macro organisational analysis without using psychological models of human behaviour. Secondly, the concept of culture describes organisational realities that are difficult to define but are accepted by managers as relevant to running organisations. Thirdly, organisational culture requires researchers to study organisations in depth like anthropoligists. A major impetus for the study of organizational culture has come from the recent focus on Japanese corporations because of their phenomenal sucess.[7] Schein[8], defines culture as:

> The pattern of basic assumptions that a given group has invented, discovered, or developed in learning to cope with its problems of external adaptation and internal integration, and that have worked well enough to be considered valid, and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to these problems.

Sathe defines culture as "...the set of important understandings that members of a community share in common".[9] Rue and Byars have drawn an analogy between culture in an organisation with personality of a person. Humans can be warm, aggressive, friendly, open, innovative, conservative, and so forth. So can be organisations. Organisations' culture is expressed in a variety of ways: unwritten rules and traditions, shared norms about what is important, prejudices, standards for social etiquette and demeanor, established ways of relating with peers, subordinates and superiors, etc. The culture that an organisation wishes to develop is conveyed through rites, rituals, myths, legends and actions[10].

Different organisations develop different cultures. Some illustrations of the cultures developed by three well-known American firms are provided below in the table.

Table 2.1
Cultural Characteristics of Three Firms

Firm	Characteristics
IBM	Concern for marketing drives a service philosophy that is almost unparalleled. The company maintains a hot line round the clock, seven days a week, to service its products.
ITI	Financial discipline demands total dedication. Once, an executive phoned former chairman Harold Geneen at 3.00 a.m. to beat out the competition in a merger deal.
Delta Air Lines	Focus on customer service produces a high degree of framework. Employees will gladly substitute in other jobs to keep planes flying and baggage moving.

Adapted from Leslie W. Rue and Lloyd L. Byars, *Management: Theory and Application*, 1986, p. 569.

2.7 STAFF

Staffing is the process of acquiring human resources for the organisation and assuring that they have the potential to contribute to the achievement of the organisation's goals. Brown and Moberg define staffing as, "the selection, placement, training and development of appropriately qualified employees", which implies that it includes two fundamentally different processes: selecting people for specific organisational positions and developing in them the abilities and skills that they would need to be effective in those and subsequent assignments.[11]

The staffing function applies to the whole organisation, i.e. it cuts across all organisational levels though the processes may be different for different kinds of jobs.

In the McKinsey 7-S framework the term "staff" has a specific connotation. According to Waterman and his colleagues the term "staff" refers to the way organisations introduce young recruits into the mainstream of their activities and the manner in which they manage their careers as the new entrants develop into future managers.[12] They found that superbly performing companies paid attention to the development of managers. They pointed out the examples of IBM, Texas Instruments, P&G, Hewlett-Packard, or City Bank whose top managers took extra-ordinary care in moulding the young persons into future managers[12]. On the Indian scene there are some examples of firms which are relatively more concerned about the process of management development. Larsen and Toubro Limited has a well-established system of recruiting graduate engineers from well-known technical institutions and providing them with on-the-job training in a number of functional areas before deciding on the final placement in consultation with the person concerned.

During the period of training the trainees are also required to undergo short duration training programmes on a variety of management related subjects. Hindustan Lever Limited is well-known for its marketing orientation which is considered to be one of its main strengths. To imbibe a marketing orientation all new recruits for future management positions are required to spend a certain minimum period of time in the field. Both Larsen and Toubro and Hindustan Lever are well-known for their consistently good performance. Japanese firms are known for their considerable investment in the development of their managers. Matsushita is one of the well-known examples.

2.8 SKILLS

Waterman, et al., consider "skills" as one of the most crucial attributes or capabilities of an organisation. The term "skills" include those characteristics which most people use to describe a company. Hindustan Lever and Richardson Hindustan are known for their marketing skills. Larsen and Toubro and the Tata Engineering and Locomotive Company (Telco) are known for their engineering skills. IBM is known for its marketing orientation, customer service and market power; Du Pont for its research skills, and Sony for new product development. Organisations have strengths in a number of areas but their key strengths or dominant skills are few. These are developed over a period of time and are a result of the interaction of a number of factors; performing certain tasks successfully over a period of time, the kind of people in the organisation, the top management style, the organisation structure, the management systems, the external environmental influences, etc. Hence, when organisations make a strategic shift it becomes necessary to consciously build new skills.

Skills in the Mckinsey framework are the equivalent of Selznick's "distinctive competence"[13]. The dominant skills or the distinctive competence of an organisation are part of the organizational character. Consider this example: a company which decided to mass-produce a comparatively low cost speed boat for wide distribution was unable to cope up with the effort to shift commitments from its earlier products which were high quality craft, made of the finest materials and built by master boat-builders. Workers and supervisors continued to be preoccupied with high cost and superior quality craftsmanship. The selling and marketing people could not shift emphasis from "snob appeal" to price appeal. The quality commitment was so strong that a new plant, hundreds of miles away from the existing one, had to be set up and new people had to be recruited to do the job successfully[14].

Activity 2

Write the main elements of the various components of 7-S Framework in the relevant columns.

Super ordinate Goals	Structure	Systems	Style	Staff	Skills	Strategy

2.9 REVIEW OF THE FRAMEWORK

The successful implementation of a strategy requires the right alignment of various activities and processes within the organisation, viz., structure, resource allocation, staffing (both managerial and technical), skills, styles and competences rewards and incentives, policies and procedures, shared values and beliefs. The McKinsey consultants call "strategy" and "structure" the "hardware" of the organisation and suggest that the other five-Ss, i.e., systems, style, staff, skills and shared values are the "software" and are often ignored by corporate strategists (some authors consider "systems" also as a constituent of "hardware"). While strategy and structure are important to the organisation, they by themselves cannot assure success which comes about by corporate commitment. It is the other five Ss which play an important role in creating a climate of commitment. The better the alignment between and among all the seven levers of the organisation, the better are likely to be the results.

Shared values, the central core of the Framework, give rise to a certain spirit among organisational members regarding "who we are and where we are headed." The spirit permeating in the organisation in turn is reflected in the values, attitudes and philosophy of its members. The corporate values define the ideals and beliefs which guide the organisational operations. They lay down the foundation of the organisation's management philosophy and give rise to a particular culture.

The virtue of the 7-S framework is that it highlights some important organisational interconnections and their role in effecting change. Whether and to what extent the organisation will be able to bring about the needed shifts in strategy would depend upon the extent of and pace of accomplishment of action plans in the spheres of seven Ss. The 7-S framework illustrates, in a simple way, that the real task of implementing strategy is one of bringing all seven-Ss into harmony. "When the seven-Ss are in good alignment, an organisation is poised and energised to execute strategy to the best of its ability." The McKinsey model provides a convenient checklist for judging whether organisation is ripe for implementing strategy. It also helps in diagnosing why the results emanating from the implementation of a strategy fell short of expectations and therefore what new "fits" would be required. The Framework helps strategists in evaluating their organisations along each of the seven dimensions, thereby identifying organisational strengths and weaknesses. Arguing forcefully for their model, McKinsey consultants say :

> In retrospect, what our framework has really done is to remind the world of professional managers that "soft is hard." It has enabled us to say, in effect, "All that staff you have been dismissing for so long as the intractable, irrational, intuitive, informal organization can be managed. Clearly, it has as much more to do with the way things work (or don't) around your companies as the formal structures and strategies do. Not only are you foolish to ignore it, but here's a way to think about it. Here are some tools for managing it. Here, really, is the way to develop a new skill.

The McKinsey Company was not the first to propose a multivariable model of organisational change. Harold Leavitt had many years ago proposed a model for analysing change in organisations. According to that model organisational change, whether it originated in the organisational structure, the tasks, the technology deployed for performing the tasks, or the organisation's human component, was likely to have effects on the other three.[15] The 7-S model, however, emphasizes a few other variables which Leavitt had not considered. Tought the research base for the framework may be the subject of considerable academic discussion and criticism, the Framework is useful to practising managers as it is easy to remember because of the alliteration and also because it provides useful checklist for a comprehensive look at managing organisational change.

Thus,7-S framework is a powerful expository tool. However, it may be stated that changing the culture of the organisation which is pivotal to the McKinsey model is a difficult task. Even after prolonged efforts spaning a period of 5-7 years, the organisation may achieve only partial success. Nonetheless, the organisation must endeavour to recreate its culture if it is regarded as an important determinant of its success, as is envisaged in the 7-S model.

2.10 SUMMARY

The 7-S framework was developed by the McKinsey Company towards the end of the 70s in response to a growing feeling of inadequacy of the then well known structural solutions for strategic problems. The proponents of this framework emphasized that in a large number of cases the problem in strategy lay in its execution, and structure was only one lever in the hands of management. The other levers were systems, staff, style, skills and superordinate goals.

The successful execution of a strategy depends on the right alightment of all the Seven Ss. The shared values (a component of culture) play a crucial role in creating a climate of commitment among the members of the organisation. The 7-S framework highlights the importance of some inter-connections within the organisation and their role in successful execution of strategy. Changing the culture of the organisation however is not an easy task.

2.11 KEY CONCEPTS/TERMS

Skills
Staff
Structure
Style
Super ordinate goals
Systems

2.12 SELF-ASSESSMENT QUESTIONS

1 What are the distinctive features of the Mckinsey 7-S Framework?

2 Are the Strategy and Super ordinate goals the same?

3 What functions the organisation structure performs?

4 Differentiate between organisational structure and organisational infrastructure? How do "systems" fit into these concept?

5 "Style is more than the style of top management". Explain.

6 "Of late theorists have shown an increasing interest in studying culture in organisations" What are the reasons?

7 What connotation the term "Staff" has in the Mckinsey Framework?

8 Discuss, with suitable examples, the relationship between strategy and skill development.

9 What is the meaning of "distinctive competence"? Illustrate with examples.

10 What are the major implications of the 7-S Framework?

11 Critically examine the 7-S Framework.

2.13 FURTHER READINGS

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UNIT 3 CORPORATE POLICY AND PLANNING IN INDIA

Objectives

The objectives of this unit are to :

- provide you a broad overview of the process of corporate planning and policy making and the genesis of planning in India
- understand the basic nature and elements of corporate planning
- develop an understanding of corporate planning by discussing the case of a large public sector corporation
- discuss various planning approaches and their characteristics
- understand the reasons for success and failure of corporate planning at the firm level

Structure

3.1 Introduction
3.2 Corporate Planning: Definition
3.3 Corporate Planning: Important Characteristics
3.4 Corporate Planning Process: An Overview
3.5 Corporate Planning and System Approach
3.6 Benefits of Corporate Planning
3.7 Corporate Planning at BHEL
3.8 Planning Approaches and Characteristics
3.9 Why Corporate Planning Fails
3.10 Prerequisites for Success
3.11 Summary
3.12 Key concepts items
3.13 Self-assessment Questions
3.14 Further Readings
Appendix — 1
Appendix — 2

3.1 INTRODUCTION

Corporate planning had its genesis in India sometime in the sixties when a number of subsidiaries of multinational companies introduced the process in compliance with their parent companies' directives. Since then quite a few companies have introduced formal planning for a variety of reasons. Some introduced it because their top managements felt that it would help them achieve their long term objectives; some introduced it because of a fad, not wanting to be left behind by others, and some others because they were directed to do so. Many public sector enterprises adopted corporate planning because they were directed to do so by the Bureau of Public Enterprises, the governmental body that regulates all public enterprises. Despite the fact that there are now quite a few firms which have introduced corporate planning, such firms still constitute a small minority.

On the academic side, research in India on corporate planning has not taken off. There are very few studies on corporate planning practices in Indian firms. Of late some leading Indian management education institutions have begun to offer short duration executive development programmes on corporate planning. A quick examination of the teaching materials used in these programmes clearly shows a predominance of materials originally developed in the United States. This is not surprising because strategic planning at the enterprise level had its genesis there. Strategic planning or corporate planning is a management process which enables a firm's management to explore the future impact of change and make current decisions to move towards the envisioned future. The Western economies, characterised by a

rapid rate of change and fierce competition became an ideal home for the development of the concept of corporate planning. The Indian economy till recently provided protection to firms from change through a plethora of regulations which did not provide an impetus for the development of a planning orientation. However this scenario is changing rapidly as a result of increasing liberalisation effected by the Government in its policies towards industry. A number of industries are now characterised by a high degree of competition, e.g., textile, television, passenger car, two-wheeler, commercial vehicles, cable, paint, etc. It is therefore very likely that corporate planning will be adopted by many firms in the near future.

In this unit we shall discuss the concept of corporate planning, its major characteristics, and the important steps involved in corporate planning and then provide some illustrations.

3.2 CORPORATE PLANNING : DEFINITION

Though corporate planning has been widely used in the United States and some European countries for the last twenty five years or so, there seems to be a lack of consensus on its definition. There are also many misconceptions about it. These misconceptions exist even in the very place where it has had the greatest development.

Corporate planning is concerned with changes in the overall shape of an organisation and these changes usually take many years to fructify, which implies that corporate plans are necessarily long-range. However, corporate planning and long-range planning do not mean the same thing. Long-range plans can be prepared for anything, like building a submarine or modernising the manufacturing plant of a company but they cannot be called corporate plans[1].

Long-range planning in most cases is carried out on the assumption that current environmental factors relating to the organisation will continue to affect it in the same way as in the past and is often simply a forward projection of existing operations. Long-range plans are normally set down in financial terms, and by their nature are built up from the lower level of the organisation. By contrast, strategy begins by asking what activities the organisation should be in and what its long-term goals should be on the basis of its present and likely future resources and opportunities available to the organisation. Strategy making, implied in the corporate plan, must be carried out on the basis of very wide range of data and inevitably begins with the first step taken by the top management.

The two main features of a corporate plan are : i) it denotes planning for future of the organisation as a whole, and ii) it considers all aspects of organisation activities. Peter Drucker defines corporate planning as "a continuous process of making entrepreneurial decisions systematically, and with the best possible knowledge of their futurity; organising systematically the effort needed to carry out these decisions; and measuring the results against expectations through organised systematic feedback". This definition clearly emphasises the relation of corporate planning to strategy. In nutshell corporate planning means a systematic approach to strategic decision making.

According to Hussey[2] "...corporate long range planning, is not a technique, it is a complete way of running a business. Under it, the future implications of every decision are evaluated in advance of implementation. Standards of performance are set up beyond the time horizon of the annual budget. The company clearly defines what it is trying to achieve. A continued study is made of the environment in which the company operates so that the changing patterns are seen in advance and incorporated into the company's decision process. There is no magic in this, so corporate planning cannot guarantee that the company will never again be affected by adverse circumstances : just as when we walk on a crowded city street we cannot always avoid being jostled and bumped — but that is no excuse for walking with our eyes shut! Corporate planning is a way of keeping the company's eyes open."

Steiner, Miner and Gray[3] use comprehensive corporate planning, comprehensive managerial planning, strategic planning, long range planning, formal planning, over

all planning, corporate planning, and other combinations of these words synonymously. In this unit we shall use the term "corporate planning" in the same way as Steiner, et al. did.

3.3 CORPORATE PLANNING : IMPORTANT CHARACTERISTICS

Some important characteristics of corporate planning are as follows :

- Corporate planning deals with the futurity of current decisions. It involves the systematic identification of threats and opportunities, threats that lie in the future which, in combination with the current and potential weaknesses of the organisation, provide a basis for making current decisions to exploit the opportunities and avoid the threats.
- Corporate planning may be viewed as an organisational process that results in the development of the organisation's purposes, missions, objectives, goals, strategies, policies and detailed action plans to achieve the objectives.
- Corporate planning in a philosophical sense may also be considered as an attitude, a way of life. The underlying belief is that planning must become integrated with management, implying that the management must be dedicated to decisions emerging from the planning process.
- The process of corporate planning integrates strategic planning with short range operational plans.

Activity 1

Name your organisation and identify it in terms of its main objectives and functions. Does your organisation have a corporate plan? Since when it is having such a plan? What are the main characteristics, including the approach followed, of the corporate plan presently in operation in your organisation.

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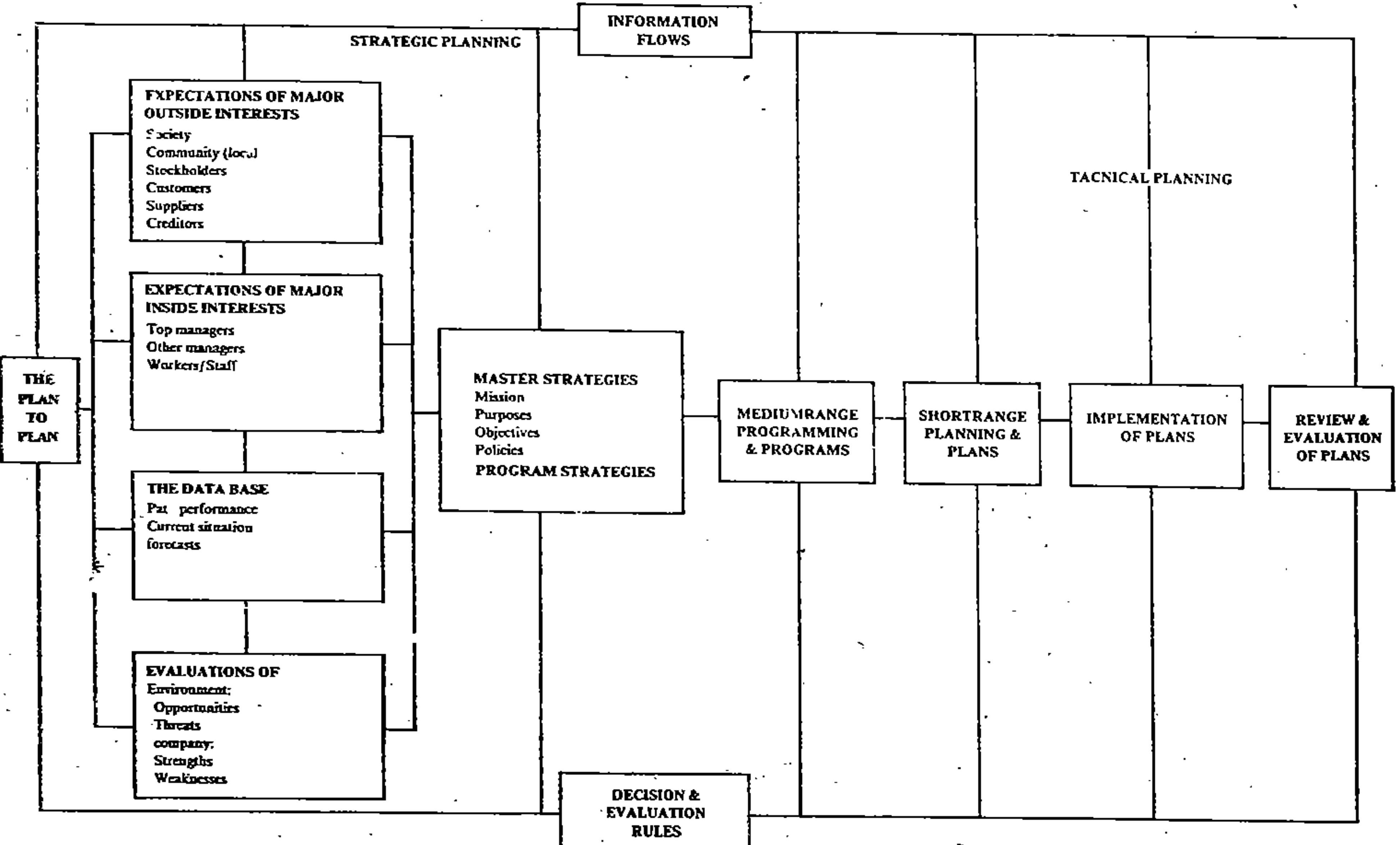
3.4 CORPORATE PLANNING PROCESS: AN OVERVIEW

Figure 3.1 depicts a typical model of a company-wide planning process which includes medium-range programming and programmes, short-range planning, implementation and review.[4] The Figure describes the process of corporate planning which may be followed in the form of a procedure to be followed by concerned executives in an organisation. Planning systems in organisations may be simple or complex depending upon their particular situations. The following description of a typical planning process is based on Chapters 2 and 7 of Steiner, Miner and Gray.

The purpose of strategic planning process is to formulate the organization's purposes, missions, objectives, goals, policies, programme strategies and major action plans to

Figure 3.1 A Conceptual Model of Corporate Planning



Adapted from : 1 George A. Steiner, et al., *Management Policy and Strategy: Text, Readings and Cases*, p. 18.

2 John D.C. Roach and Michael G. Allen; "Strengthening the Strategic Planning Process" in *The Strategic Management Handbook*, Kenneth J. Albert (ed.), p. 7-10.

achieve its objectives. The strategic planning process requires a number of inputs: expectations of dominant inside interests; expectations of major outside stakeholders; information about past, current and forecast performance; and assessment of the organization's strengths and weaknesses — the outputs of the situation audit. The organization's mission, purposes,objectives and major policies are called "master strategies" by some authors. The term "corporate strategy" is also used by some people. These terms have already been explained in detail in Unit 1 and hence would not be elaborated upon here. Medium-range programming refers to functional plans that are required to implement strategies. Typically, the planning period is five years but there is a tendency among high-tech companies to plan ahead in some detail for seven or more years. Medium-range plans generally cover only the major functions and are quantified on relatively simple forms. Large decentralized companies prepare functional plans for major programmes only. In the majority of firms these plans are translated in financial terms in the form of proforma profit and loss statement.

Short-range planning and plans refer to actions that must be taken today or in the very near future to implement medium-range programmes and strategies. There is a divergence of opinion on the desirable extent of linkage between medium-range plans and short-range plans. In approximately fifty per cent of the firms in the USA that practise formal corporate planning, the numerical information for the first year in the medium-range plans is the same as in the annual operational budgets. Some planners believe that a close linkage between medium-range plans and annual plans or budgets is necessary for achieving realism in long-range plans. The other view is that a tight linkage will create a bias towards current issues and as a result creative alternative strategies may not get generated. If the linkage is loose the strategic planning process can provide a perspective and influence the short-range planning process. In some companies short-range plans have a one year or two years horizon. In others the annual operating budget and the short-range plan are almost synonymous. Short-range plans are numerically very detailed. Short-range plans may include plans for production, plant location, warehouse location, setting up of distribution network, setting up a R&D facility, work methods analysis and improvement, employee training, negotiations with unions, etc.

Implementation refers to those activities which are necessary for achieving the plans already formulated. Quite often companies having good strategies are not successful in the market place. Often the reasons for corporate failure are associated with poor implementation. Allisson gives the example of the case of the Cuban missile crisis. President Kennedy had several times ordered the withdrawal of U.S. missiles from bases in Turkey, but in vain. Though the strategy was clear in the mind, it was not translated into action. Nearer home, the Planning Commission in India has formulated very elaborate plans for poverty alleviation through a number of programmes but it is a well-known fact that the achievements in terms of the original goals are far from the targets. Effective implementation of strategy requires the design of appropriate organization structure, management systems, and organizational culture so that the people in the organization can be motivated to perform in the desired manner.

Review and evaluation of plans refer to the analysis of actions taken to determine whether they are in accordance with the plans. Plans and also the planning process must be reviewed and assessed periodically. The review and evaluation process should highlight the lacunae in the strategies, methods of implementation and the planning process itself. The planning process may also need to be adapted to the peculiar characteristics of a firm. It evolves over time.

An alternative presentation of corporate or strategic planning in the form of a flowchart is given in Figure 3.2.

Activity – 2

Identify the main steps involved in the corporate planning process in your organization and present them in the form of flowchart. What steps of the process

you regard as crucial to the success of the corporate plan. How well these steps are being performed presently in your organisation. Evaluate.

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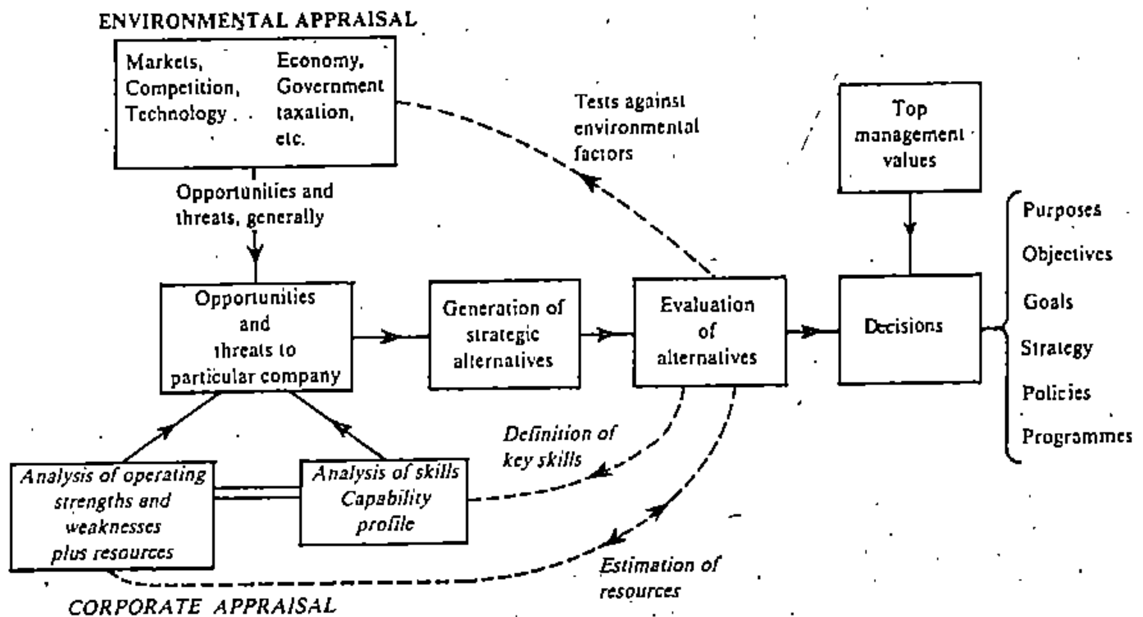
Figure 3.2 Strategic Planning Flow Chart



Source : B.W. Denning (ed.), *Corporate Planning* (London: McGraw-Hill, 1971) p.8.

3.5 CORPORATE PLANNING AND SYSTEMS APPROACH

The systems approach can be of great help in planning in a large enterprise. The systems thinking implies that the repercussions of decisions with respect to any one of the systems (e.g. a division or a business sector) on the total system or company as a whole should be examined. The need for such an approach is self-evident when the

organisation is running a physical network such as railway or gas distribution system, or when a company has several units located at different places. While formulating a plan for the organisation as a whole, it is desirable to take a corporate view and consider the implications of the developments in any part of the company on the overall performance.

Computer models can be used as an adjunct of the systems approach. You will recall that a model is a simplified representation of reality and embodies the significant factors in an adequate measure to give a satisfactory answer to a problem in hand. Models are particularly useful in handling planning problems of large integrated enterprises with a number of inter-related plants, especially for financial for financial evaluation purposes. A typical model represents cost and capacity at various manufacturing plants, and prices and sales volume in the market served by such plants. The model can be used to estimate revenue, costs and profits year by year for different combinations of new and existing plants on various assumptions about market potential. Further, in a large organisation, planning models may be constructed at several different levels of the organisation, for example, at corporate level, divisional and plants levels, or for different products or groups of products. The higher the organisational level and greater the area of activity covered, the less is the amount of details required on an individual plant or product.

However, constructing models for a large enterprise with multiple divisions or units located at different places is frought with some serious managerial problems. Further, for using the computer models effectively, the data must be regularly updated. The use of models should neither create any tensions in the organisation nor should it hinder the objective analysis of the strategic problems under consideration.

3.6 BENEFITS OF CORPORATE PLANNING

An enterprise practising corporate planning can reap several benefits. Corporate planning enables a company to anticipate technological changes and achieve strategic objectives and goals successfully. It ensures a rational allocation of resources and improves coordination between various units or divisions. A more formal approach to planning forces the managers to think forward and anticipate problems before they occur. A habit of forward thinking is encouraged. The main benefit from planning arises from a continuing dialogue about the future of the organisation, between top management and middle management, between line and staff, between divisions and head office, and even between management and unions.

Once the process of corporate planning gets established and accepted, it becomes a part of the corporate approach to management. Due emphasis therefore is likely to be given to manpower development, new product development and long term investments that are considered essential to the survival and growth of the company. With corporate planning, management gains a new sense of direction. There is a greater awareness of the business environment, and a sense of making a systematic and critical review of the business is developed.

Corporate planning can lead to significant improvement in performance. Studies in the USA indicate that companies using corporate planning outperformed companies that used informal planning methods. Companies with corporate planning performed around 30-40 per cent better in terms of earnings per share, earnings on common equity and earnings on total capital employed. The performance of the companies improved after they introduced corporate planning. The improvements were impressive : sales grew by 38 per cent, earning per share grew by 64 per cent and the share prices increased by 56 per cent.[5]

A formal planning system can help the management in responding to a dynamic environment and in managing a strategically complex organisation with limited resources. Armstrong analysed relevant behavioural science experiments and concluded that formal planning systems are more useful when large changes are occurring either in the environment or in the organisation. It is also helpful when uncertainty is high or when complex tasks are involved.[6]

3.7 CORPORATE PLANNING AT BHEL

Bharat Heavy Electricals Limited (BHEL) is a highly diversified public sector undertaking operating in a number of businesses based on complex technologies. It is regarded as one of the most promising public enterprises in the country. BHEL is known for the professionalism of its management and was one of the earliest public enterprises to adopt corporate planning.[7]

BHEL is basically engaged in three broad business sectors: energy, industry, and transportation. Corporate planning at BHEL follows the general pattern in other public sector enterprises in India. Public enterprises in the country have emerged as a part of the national planning exercises. At the time of the inception of many of the public sector enterprises (PSEs), detailed feasibility reports with a long term orientation were prepared. However, there were no built-in contingency plans for tackling uncertainties and discontinuities. When these public sector enterprises reached a stage when the original concepts and forecasts were no longer applicable as a consequence of environmental changes, they faced enormous problems. Enterprises operating in high technology areas and which had a high investment found it extremely difficult to cope with the changing environment. BHEL was no exception. However, it was able to overcome the problems by adopting comprehensive corporate planning. Planning had commenced at BHEL from the very beginning. Till 1969, planning was done with a short-term orientation. The real efforts in the direction of long-term planning were started during 1970-71. It was during this period that an Action Committee consisting of professional managers and academicians was constituted to examine the working of various PSEs including BHEL. The committee suggested a reorganization, including the merger of Heavy Electricals India Limited (HEIL) with BHEL. An analysis of the corporation's strengths and weaknesses, and the opportunities and threats that were present in the external environment was undertaken and a detailed action plan was developed for achieving rated capacity. Beginning in 1973-74 efforts were made to build systems for comprehensive planning, programming and budgeting. A corporate plan was developed and circulated among executives. Initially, revenue budgets for each division were prepared for a two-year period which also incorporated the objectives of the division for another two years so as to achieve linkage between short-term and long-term plans. Frequent discussions were held, functional and cross-functional committees were appointed for achieving integration between head office and the divisions. The organization's structure was changed to transform the company from a manufacturing orientation to an engineering orientation with an increased emphasis on marketing. A Corporate Planning and Development Division was created at the corporate level with each division having its own planning and development cell.

The Corporate Planning and Development Division was placed under the charge of an Executive Director. The division was organised around the following groups : investment and facilities planning, long range planning, operations planning, and optimisation and modelling. The investment and facilities planning group was responsible for company-wide investment programmes.

Various activities included project formulation and appraisal, coordination of review committees, project monitoring, and preparation of annual capital projects. The long-range planning group was responsible for environmental analysis, review and appraisal of long term plans, review of integrating devices, transfer of technology, collaboration, subject licensing,and training. Operations planning included analysis of performance budgets, coordination of operations,monitoring, project management studies for industrial projects, production coordination and materials management. The optimisation and modeling group was responsible for undertaking the development of various models using quantitative techniques and studies relating to optimal utilisation and scheduling of machines and facilities, investment analysis and energy modeling.

The role of the Corporate Planning and Development Division could be summarised thus: i) planning for modernisation and expansion of manufacturing, ii) development

of technology management capability in the context of rapid rate of technological obsolescence, iii) assisting in the development, review and evaluation of product plans, iv) synthesising divisional plans and product plans into the sectoral plans and weaving them together as a corporate plan, v) introduction of contingency planning in all areas, vi) improving planning capability at the divisional level, vii) providing assistance in the preparation of functional plans, viz., engineering plans, technology plans, etc., viii) undertaking organizational studies, ix) strategic management development, x) monitoring of divisional performance, xi) enhancing information processing capability and analysis of environmental conditions.

The Corporate Planning and Development Division was responsible for directing and coordinating the total planning activity in the organization. But the basic inputs into the plan were generated by the various units. Each division prepared its long term plans keeping in view its relevant environment. Each division also developed product plans, which included an analysis of technological gaps and actions required for bridging the gaps. Based on these technology plans of the units, a corporate technology plan was prepared which provided direction for technology acquisition and/or development. Product plans and divisional plans were reviewed, evaluated coordinated and integrated into sectoral plans.

The development of the corporate planning function over time is captured in Appendix I.

Activity 3
Watch the video programme on "Corprate Planning Process" with particular reference to the four phases in the evaluation of corporate planning. At what stage is the corporate planning at BHEL according to your assessment.

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3.8 PLANNING APPROACHES AND CHARACTERISTICS

The short description of the corporate planning process at BHEL provided some glimpses into its complexities. The experience of BHEL is not typical because organizations of the nature and complexity of BHEL are not too many in the country. Corporate planning systems vary from organization to organization depending on a variety of factors: environmental conditions, organizational size and complexity, age, top management values and styles, initial trigger for the commencement of planning, etc. Variations in the corporate planning systems across organisations may be found first in the top management's basic approach to doing corporate planning. These approach may be any of the four types[8]: top-down approach, bottom-up approach, hybrid between top-down and bottom-up approaches, team approach.

Top-down Approach: Firms adopting this approach plan at the top and the various departments are supposed to do what they are told to do by the top management.

Bottom-up Approach: In firms adopting this approach the top management asks the departments or divisions to submit their plans. These plans are then reviewed by the top management and accepted or sent back to the originating departments or divisions for modifications. The consolidated divisional plans in the case of a decentralised company may not add up to the top management's targets. Additional plans are then required to be prepared which might necessitate planning for acquisitions or diversification into highly unrelated business areas.

Hybrid Approach: A combination of top-down and bottom-up approaches is the approach which is generally used in decentralized companies. In firms using this approach the top management provides certain guidelines to the divisions or strategic business units (SBUs). The SBUs are distinct businesses with their own set of resources that can be managed in a manner reasonably independently of other businesses within a firm. The top management guidelines are sufficiently broad to permit flexibility to the SBUs in developing their plans. There is a vertical communication between the top management and the divisions or SBUs at different phases of the planning process. Broad objectives, policies and strategies may be arrived at through a dialogue and negotiation between the top management and the divisional or SBUs managers.

Team Appraoch: In smaller centralized firms where lateral communication between the top managers is easier than in large decentralized firms, the chief executive may himself, in collaboration with the senior managers, prepare corporate plans. In some very large firms also this practice has been found to exist.

Differences, in the planning systems in organizations may be in terms of the approaches adopted, as noted earlier, and also the dimensions given below:

(Adapted from G.A. Steiner, et al., 1982, *Management Policy and Strategy*, Macmillan: London, pp. 186-189.)

- Completeness of Planning Cycle
- Depth of Analysis
- Degree of Formality
- Use of Staff and Corporate Planning Specialists
- Linkage among Plans
- Method of Introducing Planning
- Degree of Documentation
- Participation of People
- Role of the CEO

3.9 WHY CORPORATE PLANNING FAILS

Academics, corporate planning practitioners and consultants have been attempting to uncover the factors responsible for success or failure of corporate planning. Check lists of reasons for failure of corporate planning or major pitfalls that should be avoided are available in most books on corporate planning.[9] No research seems to have been done on the reasons for the success or failure of corporate planning in India. S.K. Bhattacharyya (In a talk given in an executive development programme on Corporate Planning at the Indian Institute of Management, Ahmedabad in 1986), attributed the failure of initial efforts in introducing corporate planning in India to the following factors:

- Often corporate planning is introduced by the chief executive after he had been to a short course on the subject. The chief executive asks an MBA to prepare a

corporate plan. He thus hands over the task of corporate planning to a corporate planner.

- In some companies a corporate plan is prepared and circulated among senior managers and external consultants for comments. This approach also fails in many cases because senior managers do not have the time to go through the plans nor do they have the skills to look at the future. They are good at budgeting but often do not understand or make an assessment of the external environment.

- In many firms there is an overemphasis on hard data. The companies which had c) introduced corporate planning found it difficult to manage the conflict between the available soft data whose reliability is debatable and the manager's need for hard answers.

  In many companies the corporate plans are not accepted by a large number of d) middle level managers who play a leading role in implementation. There is a high degree of alienation among them. The reasons could be attributed to a lack of understanding of the role of corporate planning and the nature of inputs required to make it successful. For instance, engineers do not understand economics, chartered accountants do not appreciate the technological imperatives, etc.

Bhattacharyya's observations on the reasons for the failure of initial corporate planning efforts in many Indian companies is corroborated by the observations of corporate planning specialists in Western countries. A list of the common reasons for the failure of corporate planning is given in Appendix 2.

3.10 PRE-REQUISITES FOR SUCCESS

Bhattacharyya and Chakravarti [1981 : 253] have observed some commonalities in instances of successful introduction of corporate planning in Indian companies. The most important characteristics found by them are the following:

- The chief executive (CE) of the company believes that corporate planning is absolutely necessary for providing direction to the company in an uncertain future.

- The CE is totally committed and involved in the corporate planning process. Though he might appoint a corporate planner to provide him assistance, he does not delegate the task of planning to the planning department.

- The initiation of corporate planning is preceded by an attempt to learn about the process from other organizations. A managerial education process is set in motion whereby it is ensured that the senior managers understand the various aspects of corporate planning and are convinced of the need for corporate planning.

- The CE understans that the real purpose of corporate planning is not management control but providing direction to the organization just as the Pole Star used to guide ship navigators when sophistricated instruments had not been invented. He understands that the organisation can derive immense benefit from the participation of creative people, in the planning process.

- The CE realises the need for participation in the process by those executives who would be responsible for implementing the corporate plan so as to ensure commitment.

- The CE realises the need for a continuous corporate planning process to enable the company adapt to the changing external and internal conditions.

- The CE uses the corporate plan to allocate resources for achieving future objectives. He realises that the most important benefit of corporate planning is the development of middle and senior managers into potential general managers with multi-functional orientation and an ability to think strategically.

Activity 4
List and analyse the causes/factors for failure/success of corporate planning in your organisation.

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3.11 SUMMARY

Corporate planning is a structured approach to achieve long term objectives of an organisation. The purpose of corporate or strategic planning process is to formulate the organisational missions, objectives, goals, policies, programme strategies and major action plans to achieve its objectives. The company-wide planning process includes medium-range and short-range programmes, implementation and review. Short-range plans are often very elaborate and encompass all the sub-units and functions of the organisation. The corporate plan however elaborately conceived and formulated is likely to fail if its implementation is deficient or faulty. Effective implementation of corporate strategy requires an appropriately designed organisational structure, management systems, and a right culture and climate. Further, the plan must be reviewed periodically so that corrective measures are taken in time.

Different approaches to formulating the corporate plans (top-down, bottom-up, mixed) can be found in practice. The use of systems approach is implicit in corporate planning. Computer models are being increasingly used by business enterprises in the West for formulating corporate plans. The practice of corporate planning encourages the members of an organisation to take an overall view in making decisions and planning their sub-units. Corporate planning ensures rational allocation of resources. It makes the managers forward looking and encourages vertical and lateral communication and interaction between them. Further, it encourages a sense of direction through out the organisation.

Several enterprises in India, both in the private and public sectors, have introduced corporate planning in their organisations. With increasing liberalisation of government policies and consequently the enhanced role of competition, corporate planning in India is likely to pick up greater momentum in the near future. Bharat Heavy Electricals Limited (BHEL) is one of the earliest public enterprises to adopt corporate planning. Engaged in diversified business sectors like energy, industry and transportation, the company, with the help of corporate planning, has been able to come to grips with problems of uncertainties created by changing technological and socio-economic environment. In the initial phases, corporate planning in BHEL had a short-term orientation. However, in recent times this has changed into quite a long-term one. Besides, corporate plans are comprehensively prepared. The company views itself not merely a manufacturing company but an engineering company with emphasis on marketing. The corporate planning and development division, which is organised around various functions, is responsible for total corporate planning activity in the organisation.

Barring a few organisations, the corporate planning in India does not seem to have made much progress. The reasons are: lack of planning, preparation and casual approach to introducing corporate planning, lack of systematic studies preceding

corporate planning exercise, over-reliance on numerical data included in the corporate plans, and alienation of middle level managers from corporate planning process.

To be successful, therefore, corporate planning effort needs the whole-hearted support of the Chief Executive of the organisation, and education of all managerial levels regarding the potential benefits of corporate planning and their participation in the process.

3.12 KEY CONCEPTS/TERMS

Bottom-up Planning
Corporate Planning
Corporate Strategy
Master Strategy
Medium-range Planning
Review and Plan Evaluation
Short-range Planning
Top-down Planning

3.13 SELF-ASSESSMENT QUESTIONS

1 What is Corporate Planning and what are its important characteristics?

2 "In general the environment for business in India is highly fluid and uncertain. Corporate Planning is therefore meaningless?" Do you agree with the statement? Comment.

3 What would be the various steps in the corporate planning process in a large industrial enterprise like BHEL? Can we develop a generalised corporate planning model which would apply to all sorts of organisations?

4 "Corporate Planning is as good as is its implementation". Discuss

5. "Corporate Planning should not become a number game." Examine the statement thoroughly.

6 In the initial stage corporate planning at BHEL was short-term oriented. Later it develop a sufficiently long-term orientation. What were the reasons for this change in the complexion of corporate planning? What differences do you note in the 1st and the 4th phase of corporate planning at BHEL in terms of their focus and value systems.

7 Why Corporate Planning often fails? In what way can the failure be prevented? Discuss.

8 In Appendix 2, twenty seven reasons are listed for failure of Corporate Planning. Identify five reasons which appear to you the most important ones in terms of your own experience.

9 "Corporate Planning is nothing but budgeting for an extended period." Critically evaluate.

10 In what way "systems approach" can be helpful in corporate planning.

11 Discuss the benefits of Corporate Planning.

3.14 FURTHER READINGS

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Appendix I

Development of Corporate Planning Function at BHEL

S.No.	Phase	Period	Functions Performed
I	Project Implementation and Initial Production Phase	1964-1969	• Monitoring and review of new projects • Maintenance of Liaison with Govt. agencies, collaborators, site organizations. • Planning for projects • Sales Coordination • Strategies for pricing
II	Preparation for Developing Corporate Plan	1969-1974	• Assist Chairman in generating and evaluating alternatives • Integrating programmes of divisions • Organisation Development • Improving communication and coordination • Preparatory work for first Corporate Plan • Establish data base for planning and developing the planning systems
III	Implementing the first Corporate Plan	1974-1979	• Structuring planning function and defining responsibility matrix. • Assist in developing strategies. • Studies for fulfilling the planning programmes. • Environment analysis. • Monitor implementation of long-term and short-term programmes. • Stimulate formal planning in divisions. • Bring out formal planning documents. • Monitor transfer of know-how and overseeing. • Organisation design • Assist various functional/product committees in drawing programmes • Secretariat for executive committee. • Dovetailing operational planning with strategic planning • Liaison with Government agencies.
IV	Corporate Refounding for the 80s	1980-1990	• Plan for modernisation and expansion of manufacturing base. • Develop technology management capability in view of the rapid rate of technological obsolescence. • Assist in the development, review and evaluation of product plans. • Synthesising divisional plans and product plans into sectoral plans and weaving them together as a corporate plan. • Introduce contingency planning in all areas of business operation.

- Raising planning capability at divisions by conducting workshops on strategic planning, etc.
- Assist in preparation of functional plans, viz. Engineering Plan, Technology plan,
- Study reorganisation needs.

Appendix 2

Reasons Why Corporate Planning May Fail

1. Failure to develop throughout the company an understanding of what strategic planning really is, how it is to be done in the company, and the degree of commitment of top management to doing it well.
2. Failure to accept and balance interrelationships among intuition, judgement, managerial values, and the formality of the planning system.
3. Failure to encourage managers to do effective strategic planning by basing performance appraisal and rewards solely on short range performance measures.
4. Failure to tailor and design the strategic planning system to the unique characteristics of the company and its management.
5. Top management becomes so engrossed in current problems that it spends insufficient time on the strategic planning process, and the process becomes discredited among other managers and staff.
6. Failure to mesh properly the process of management and strategic planning, from the highest levels of management and planning through tactical planning and its complete implementation.
7. Failure to modify the strategic planning sytem as conditions within the company change.
8. Failure to keep the planning system simple and to weigh constantly the cost/benefit balance.
9. Confusing the extrapolation of financial and/or economic projections with strategic planning.
10. Management's failure to understand the analytical tools used in different parts of the planning process and thereby becoming captive to staff experts.
11. Failure to secure in the company a climate for strategic planning that is necessary for its success.
12. Failure to balance and link appropriately the major elements of the strategic planning and implementation process.
13. Failure by managers to understand the importance of implementation of strategy and how to make that process efficient and effective.
14. Blame strategic planning for failures in other managerial and staff procedures.
15. Chief executive does not believe in it, but has a planner becuase other firms also have such a person.
16. Insufficient backing by chief executive leads line managers to underestimate its importance.
17. Chief executive instructs planner to avoid upsetting line managers, as they are too busy with current activities.
18. Chief executive gives planner too low a status that he is unable to converse with general managers on equal terms.
19. Chief executive creates a planning committee rather than give planning task to one individual.
20. Chief executive allows some managers to opt out of the system.
21. Chief executive spends too little time on planning,
22. Corporate planner tries to do all planning himself.
23. Planner of low calibre.

24 Planner has only a part-time interest in planning and has to spend much of his time on other activities.

25 Planner is a narrow specialist who lacks ability to see full scope of his task and views planning only in terms of his own discipline (e.g. O.R., Accounting).

26 Lack of attention to one or more of the basic steps.

27 Company tries to move into an advanced management area before it is ready (e.g. companies with no accounting function).

Source: Compiled from G.A. Steiner, et at., *Management Policy and Strategy,* p. 195 and D.E. Hussey, *Introducting Corporate Planning,* p. 24.

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NOTES

NOTES

Uttar Pradesh
Rajarshi Tandon Open University

MBA-3.1
Corporate Policies and Practices

Block

2

CORPORATE MANAGEMENT

UNIT 4
Board of Directors : Role and Functions 5

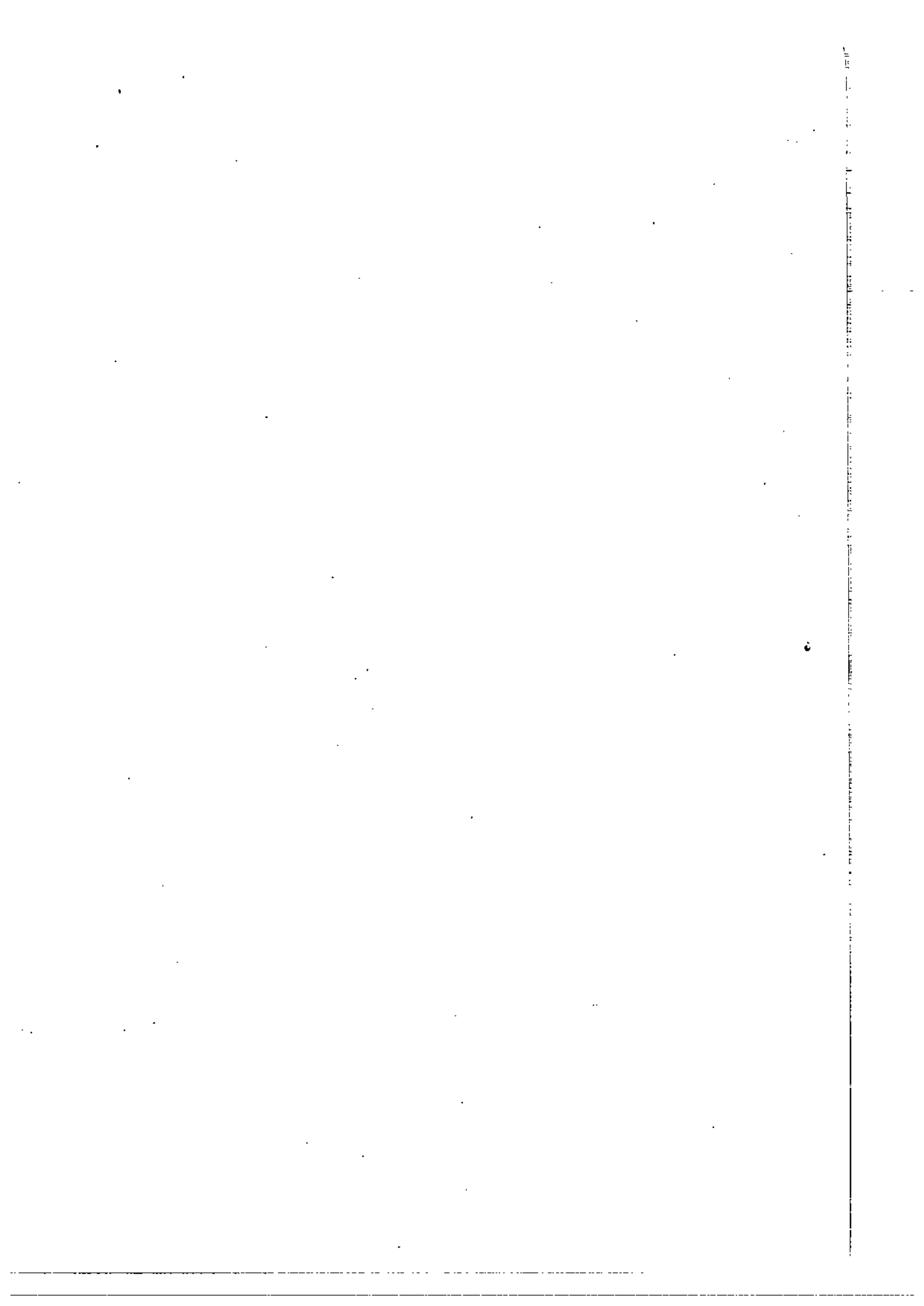
UNIT 5
Top Management : Role and Skills 23

BLOCK 2 CORPORATE MANAGEMENT

This block is concerned with the functioning of corporate Board of Directors and the role of top management. This block has two units.

Unit 4 deals with the functioning of Board of Directors (BODs). The legal and managerial expectations of the board and their responsibilities in general are discussed. The role of the boards and their involvement in strategic management are examined. This is followed by a discussion on the size and structure of boards in private and public sectors. Some other matters and issues relating to boards are also dealt with, and suggestions are offered for making the functioning of boards more effective. In the end, some incidents relating to what happened in a real life case are mentioned, and the emerging issues are examined in the context of a management framework.

Unit 5 examines the role and skills of top management. First, the role of Chief Executive in a corporate entity is discussed. Then, the role of the top management and their values and styles vis-a-vis strategic management are examined and analysed. Further, skills required of top management are discussed.



UNIT 4 BOARD OF DIRECTORS : ROLE AND FUNCTIONS

Objectives

The objectives of this unit are to help you :

- to appreciate the nature of the long-term policy and strategy-making role of Boards of Directors (BODs) in industrial enterprises
- to evaluate the degree of success achieved by the BODs in the role expected of them
- to anticipate future changes for improving the effectiveness of BODs in India

Structure

4.1 Introduction
4.2 Law-related Expectations
4.3 Managerially-derived Expectations
4.4 Responsibilities of BODs
4.5 Strategic Management : Role of the Board
4.6 Size and Composition of Boards
4.7 Board Structure and Corporate Performance
4.8 Boards in Public and Private Sector Enterprises
4.9 Board Committees
4.10 Two-Tier Boards
4.11 Chairman vis-a-vis Managing Director
4.12 Directors' Remuneration and Fees
4.13 MIS for BODs
4.14 Board Meetings—Process Aspects
4.15 Enhancing BODs Effectiveness
4.16 The EID-Parry Board Tussle—Some Insights from a Real Case
4.17 Summary
4.18 Key Concepts/Terms
4.19 Self-assessment Questions
4.20 Further Readings

4.1 INTRODUCTION

Large organisations usually have an apex policy making body which is known by different names. In the industrial and commercial enterprises, whether in the public or private sectors, such top level bodies are known as Board of Directors (BODs). The members of the Board exercise their authority and responsibility collectively. The composion of the Board, the professional credentials and commitment of the members have far-reaching impact on the fortunes of the company. This unit discusses law and management related expectations of the BODs and several other issues connected with their functioning. How the functioning of the BODs could be made more effective is examined towards the end of the unit. Some insights based on the analysis of a real life case are also provided.

4.2 LAW-RELATED EXPECTATIONS

The Indian Companies Act does not define the Board of Directors (BODs). Even 'Director' is defined blandly as: 'it includes any person occupying the position of Director, by whatever name called' [sec. 2(13)]. With the help of this open definition of Director, we may infer that a Board of Directors is a group of individuals each of

whom is labelled as 'Director' (or by any other title with identical substantive intention). No person is to hold more than 20 directorships.

Sec. 269 says that, with the commencement of the Companies (Amendment) Act 1988, certain specified public companies or private companies which are subsidiaries of public companies, shall have a Managing or Wholetime Director or a Manager, and each such appointment must be made with prior approval of the Central Government.

What is a BODs supposed to do? This again we can know inferentially by referring to the definitions of 'Manager' and 'Managing Director' in section 2 of the Act, and also sections 291-93. Both these incumbents have to exercise their powers of management 'subject to the superintendence, control and direction of the Board'. Thus, the BODs, in broad terms, is expected to perform the role of overseeing the running of the enterprise by its Chief Executive.

On whose behalf does the BODs perform this role of overseeing? It is expected to do this on behalf of the shareholders. It is they who elect the directors on the board. And it is the BODs which, in turn, selects the Chief Executive.

The directors individually have no powers in the eye of law. It is only the collective body of directors, i.e., the board which has a superior total power over the Chief Executive. The intent of the Indian Companies Act appears to be to include only outside non-employee directors on the board. Otherwise, if internal wholetime executives (say the MD) were to be the directors on the board, how could they exercise 'superintendence, control and direction' over themselves? We shall discuss more about this aspect later.

Sec. 291 stipulates that the BODs shall be entitled to exercise all such powers, and to do all such acts and things, as the company is authorized to exercise and do, except those things which can be done in a general meeting of the company. The powers exclusive to the BODs (sec. 292) are:

- to make calls on shareholders in respect of money unpaid on their shares
- to issue debentures
- to borrow money otherwise than through debentures
- to invest the funds of the company
- to make loans

Correspondingly, sec. 293 restricts the powers of the BODs, by making them subject to the consent of a general meeting of the company, in respect of selling, leasing or disposing of the property of the company; remitting debt due by a director; borrowing money to an extent which exceeds the net worth of the company etc.

The Board of Directors is expected to meet once in a quarter, and the quorum for a valid BODs meeting is one-third of the total strength or two directors whichever is higher. The power to declare dividend is exclusive to the BODs.

Sec. 322 of the Companies Act allows the 'memorandum of association' of a limited company to provide for a director or directors with unlimited liability.

4.3 MANAGERIALLY-DERIVED EXPECTATIONS

The dimension relating to the managerially-derived expectations of the Board of Director's role seems to be of relatively recent origin. In the last two decades or so, industrial development has been marked by far-reaching technological changes, leading to equally fundamental competitive reorientation at the global level. As a result, many erstwhile great names in industry have been humbled. With such rapidly mounting changes and uncertainties, the role of BODs has begun to be viewed from much wider and long-term perspective—beyond the minimum requirements of law. Probably, upto the 1970's, the duty of BODs to 'superintend, control and direct' had gone by default. Stable environment had helped this key role to remain dormant. What are then the renewed ramifications of this role at present? These are meant to ensure that:

- the enterprise continues to remain effective on the standpoint of technology parameters.

- the enterprise continues to achieve healthy market growth in competitive conditions,
- divestment and diversification take place on sound lines.
- long-term productivity and quality are never sacrificed at the altar of short-term profitability.
- judicious earnings retention policy is adopted for financing growth, modernisation etc.
- serious and sustained attention is devoted towards building a sound system of human values and exalted corporate culture.

It is a common observation that BODs function rather passively. Often the members are selected not because of their knowledge of the specific functioning of the company which they are supposed to oversee but because of their compatibility, prestige or esteem in the community. Traditionally, as it happens, the board members are expected (or requested) to approve the proposals put forward to them by top management. Usually, the Chief Executive Officer (CEO) or the group of promoters have a free reign in choosing the directors and in having them elected by the shareholders. The CEO or the promoter group may select board members who, in their opinion, will not disturb the company's policies and functioning. The directors so selected often feel that they should go along with any proposals made by the CEO and his group. Thus, a strange or somewhat paradoxical situation arises. The board members find themselves accountable to the very management they are expected to oversee.

Even today, the boards in India, especially in family owned or closely held companies, are mere figureheads. Over the recent past, however, lending institutions, financial media and corporate analysts have seriously questioned the role of BODs. The investors and government in general are now better aware of the role of BODs. In general, it is felt that there is a critical lack of responsibility on the part of BODs. Though the Companies Act throws some light on the powers of BODs and the restrictions placed on those powers, it does not specify to whom they are responsible and what for. However, there is a broad agreement that BODs appointed or elected by the shareholders are expected to:

- oversee the management of the company's assets
- establish or approve the company's mission, objectives, strategy and policies,
- review management actions and financial performance of the company
- hire and fire the principal executive and operating officers of the company.

An important issue in this context is : should BODs merely 'direct' or may they 'manage' also? Many experts and practising top managers say that BODs should only oversee and direct, and never get involved with detailed management. There are others who feel that, for direction to be realistic and sensible, some indepth involvement with details is necessary. The majority view, however, is in favour of directors **directing** the affairs of the company and not **managing** them.

Probably, in the majority of cases in India, the real problem is one of non-involvement of board members—almost to the extent of callousness—in enterprise affairs. Especially in those enterprises which are sick, or are near to this state, it should be clearly decided whether their BODs will merely 'direct' and feel satisfied, for such enterprises often lack competent managers at all levels. So, whom would BODs direct? Is there a need, therefore, for the BODs here to spend more time and 'manage' such enterprises too—for a stipulated period of time?

4.4 RESPONSIBILITY OF BODs

The board is expected to act with "due care". That is, they "must act with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions." If a director or the Board as a whole fails to act with due care and, as a result, the company in some way is, harmed, the careless director or directors may be held personally liable for the harm done.

Further, they may be held personally responsible not only for their own actions but also for the actions of the company as a whole.

In addition, directors must make certain that the company is managed in accordance with the laws and regulations of the land. They must also be aware of the needs and demands of the constituent groups so that they can bring about a judicious balance between the interests of these diverse groups, while ensuring at the same time that the company continues to function.

4.5 STRATEGIC MANAGEMENT : ROLE OF THE BOARD

According to Bacon and Brown, a BODs, in terms of strategic management, has three basic tasks.

- **To initiate and determine** : A board can delineate an organisation's mission and specify strategic options to its management.
- **To evaluate and influence** : A board can examine management proposals, decisions and actions; agree or disagree with them; give advice and offer suggestions; develop alternatives.
- **To monitor** : By acting through its committees, a board can keep abreast of developments, both inside and outside the organisation. It can thus bring new developments to the attention of the management which it might have overlooked.

The members of the board may be having varying commitments to the organisation in terms of their involvement with the above strategic tasks. The degree of involvement of the board in the organisation's strategic affairs can be viewed as a continuum, ranging from 'phantom' boards, with no real involvement, to catalyst boards, with a very high degree of involvement. Expectedly, highly involved boards tend to be very active. They take their task of initiating, evaluating and influencing, and monitoring seriously and provide advice to management whenever it is felt necessary and keep them alert. As depicted in Figure. 4.1, a catalyst board may be deeply involved in the strategic management process. The BODs of some public enterprises (e.g., BHEL and HMT) and some private sector companies with multinational links (e.g., Hindustan Lever and L&T) have a reputation for their active involvement in strategic affairs. You will see that the degree of involvement lessens as we move further to the left of the continuum. The three types of boards

Figure 4.1
Board of Directors Continuum

DEGREE OF INVOLVEMENT IN STRATEGIC MANAGEMENT					
LOW (Passive)					HIGH (Active)
Phantom	**Rubber Stamp**	**Minimal Review**	**Nominal Participation**	**Active Participation**	**Catalyst**
Never knows what to do, if anything, no degree of involvement.	Permits officers to make all decisions. It votes as the officers recommend on action issues.	Formally reviews selected issues that officers bring to its attention	Involved to a limited degree in the performance or review of selected key decisions, indicators, or programs of management.	Approves, questions, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performs fiscal and management audits.	Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. It may have a very active strategy committee.

(Adapted from Wheelan, Thomas J. and J. David Hunger, Strategic Management and Business Policy, Addison-Welsey. 1983. p. 49)

towards the left of the continuum can be described as passive boards. Such boards in general do not initiate or determine strategy. The board members' interest may be aroused only when a crisis overtakes the company. Very few companies are fortunate to have catalyst boards or even boards with active participation. The boards of most of the companies in the private sector will fall in any one of the four categories on the left side of the continuum.

A great responsibility lies on the chairman of the BODs. It is he who can ensure that the board functions effectively. The influencial shareholders, financial institutions, managements of holding companies can also play an important role in this regard.

While a BODs is not expected to involve itself in day-to-day operating decisions, they are nonetheless expected to consider and give their views on all such matters that have long-term connotations. In fact, such matters by convention are referred to the board. These relate to issues such as introduction of a new product, new technology, collaboration agreements, senior management appointments and major decisions regarding industrial relations.

The "directing" function of the board has internal and external components. Internal component relates to various actions taken by the executives and their implications for the organisation, including R&D, capital budgeting, new projects, new competitive thrusts, relationships with financial institutions and banks, foreign collaborators, major customers and suppliers. External component relates to identifying broad emerging opportunities and threats in the environment and feeding them to the management so that "strategic mismatches" do not occur. The board should see that the organisation always remains in alignment with the social, economic and political milieu.

It is quite likely that many Chief Executive Officers (CEOs) and even some board members may not want the board to be involved in strategic matters at more than a superficial level. The reasons are not far to seek. Many companies may not have an explicit or well articulated strategy. The management of such companies take strategic decisions intuitively rather than through a rigorous process of search and analysis. Further, the managements of some companies do not like outside directors to know enough about the new strategic decisions or postures. They may perceive the involvement of board members in strategic decision making as a threat to their power.

4.6 SIZE AND COMPOSITION OF BOARDS

Section 252 of the Companies Act says that every public company shall have at least three directors while others may have only two. In practice, the variations are very wide indeed. The size of BODs ranges between 2 or 3 in small private limited companies to 20 or so in large public limited companies (especially the sick ones) where numerous public agencies are involved. The Act, however, lays down that only individuals can be directors. The BODs can also appoint additional directors if authorised by the Articles of Association. One of the guiding principles for constituting BODs is to include directors representing key constituencies interested in the performance of the enterprise. Thus, 'worker directors' are now being elected or nominated to the BODs in an increasing number of public sector enterprises. Views on this issue are quite divergent. Even the most well-meaning worker director often faces the dilemma of reconciling the direct interests of the employees he represents and the overall interests of the enterprise, e.g., bonus award in a year of poor performance. So he has to resort to the policy of running with the hare and hunting with the hound. In the Board meeting he insists on getting his dissent minuted if the bonus decision is below the union's demand, while privately he tells the top management that he will go through the motions of protest along with the employees without really harming the functioning of the enterprise. In situations with much less trust and understanding, the Chairman or Managing Director and the Worker Director may engage in lengthy verbal fights in the Board over such contentious issues. In certain cases, inter-union rivalry may be so intense and prolonged that, in spite of the provision for a Worker Director, the BODs may go without such a person for years (e.g., LIC). One thing however is clear: such Employee Directors on Board are not considered by most as amounting to increased participation of labour in management.

The movement to place employees on the BODs in public enterprises has begun to

gain ground in India. The European experience reveals an increasing acceptance of workers participation on corporate boards. The Federal Republic of Germany pioneered the practice with Co-Determination Act of 1951. Workers' representatives in the coal, iron and steel industries were given equal status with management on policy making boards.

Although in public enterprise boards all the directors are the nominees of the President of India (as their shareholder), in private sector enterprises Nominee Directors (NDs) constitute a distinct and important category (although some people argue that even the other directors in most such companies are really the 'nominees' of the dominant controlling group). These NDs come to the board as representatives of the financial institutions who have large stakes in the enterprise through substantial term loans. Such large-scale term-loans arise either because of the financial needs for rapid growth and diversification of healthy firms or because of the sick firms engaged in the process of rehabilitation. A nominee-director is expected to take active interest in the overall management policies, without interference in the day-to-day working of the concern. While the ND has an obligation to safeguard the interests of his financial institution, yet he is not supposed to act merely as a watchdog on behalf of his organisation. Of course such balancing requires considerable maturity and integrity. It is also said that the NDs should help personalised management styles to be converted into professionalised ones.

Other kinds of constituency-based directors could belong to agriculturists, artisans, consumers, suppliers and so on. Bank BODs usually consist of most of these types. Besides, some academics also find their way into these Boards, as well as professional accountants and lawyers. These last three groups do not really belong to any interested constituency (although many people think that accountants and lawyers could use their directorships to promote their own business interests). The inclusion of academics of standing is advocated by many to lend a touch of high perspective and detachment to the complex socio-economic or value-oriented aspects of policy-making.

Of course, the opposite view also exists: BODs must not reflect a constituency-based composition. For then the BODs meetings may turn out to be battle-grounds for conflicting interests and decisions. The BODs should be constituted purely on the basis of expertise, knowledge and ability to see ahead etc., among the candidates for directorship. Perhaps, constituency-based BODs reflect bowing down to shortsighted populism which aims to please everybody.

The category of Government Directors (one from the concerned Administrative Ministry and one from the Finance Ministry) in the BODs of public enterprises is similar in nature to that of NDs in private sector companies. Although the Government Directors (GDs) are also nominated by the Government of India, yet they too are supposed to perform the same balancing act as the NDs. However, it appears that in practice the actual role played by GDs attracts relatively more criticism than that of NDs. Thus one ICS (retd.) had remarked a few years ago that these boards are susceptible to governmental influence and thus the autonomy is eroded. A few others, however, say that there are cases where GDs have worked harmoniously with the Chairman or MD of the enterprise.

In Central Government enterprises. MPs or politicians do not figure on BODs though in state-level public enterprises this is quite common. Often the experience is not too happy.

Activity 1

Analyse the top level body (by whatever name called e.g., Board of Directors, Board of Governors, Board of Trustees, etc.) of the organisation in which you are working or with which you are familiar in terms of:

i) Their academic qualifications.

ii) Their experience and professional attainments

iii) Strength of the Board

iv) Nature of Directorships
whether whole-time or part-time, part-time Nominee Directors, Directors representing particular interests, etc.

v) whether Chairman is whole-time or part-time

vi) total member of Directorships held by each member.

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4.7. BOARD STRUCTURE AND CORPORATE PERFORMANCE

This section is relevant to the BODs of private sector companies. By board structure we mean the ratio of Whole-time Directors to Total Directors (WTD/TD). In private sector companies, several directors could be executives from within who have been promoted to the board. Of course there can also be WTDs who have come from another company. But the true criterion is: they are on the regular payroll of the company.

The other set of part-time directors (PTDs) would be the ones who are elected to the BODs from outside to represent shareholders only at board meetings. Of course, like PTDs, WTDs are also formally approved by the shareholders at the Annual General Meetings of the companies.

Multinational companies in India like Hindustan Lever, ITC, IEL have BODs with a very high proportion of WTDs to TDs. On the other hand, companies like Larsen and Toubro and TISCO (an Indian company) have BODs with a nearly equal or one-to-one ratio of WTDs to TDs. And apparently both groups of companies have been performing consistently well over the years.

There is also a third category of BODs where the entire membership consists of PTDs. The Department of Company Affairs calls them as 'Board Managed Companies'. On the other hand, where the board has one whole-time employee MD and a few more WTDs, besides PTDs, the firm is viewed as a 'MD Managed Company.

An empirical survey in respect of companies with paid up capital of Rs. 50 lakh or above had shown that in 1979-80, 17 of the 22 Tata group companies were MD-managed and only 5 board-managed. For the Birla group, however, only 6 were MD-managed, whereas 24 were board-managed. In these latter companies not even the MD is on the BODs, although he may sit there on invitation. As mentioned earlier, this arrangement, however, seems to be more consistent with the Company Law definitions.

As for the effect of these alternative BODs structures on company performance (e.g. profitability of sales, or profitability of assets) there is some empirical evidence that mixed boards of MD-managed companies i.e., those with a mix of WTDs and PTDs generally perform better than purely board-managed companies.

Whole-time Directors Vs. Part-time Directors

Whether a company should have on its board only Whole-time-Directors (or Internal Executive Directors) or only Part-time Directors (or External Non-executive Directors) is a debatable question. A board consisting of only Internal Whole-time Directors may be too subjective in its thinking to be effective in its functioning. It can also become insulated from the environment. Similarly, a board consisting of only PTDs may not be able to bring the kind of realism to bear on the decisions that would effectively contribute to the functioning of the organisation. Such a board may not be fully conversant with the organisation's peculiar situation, its power structure, and its well entrenched ethos. It may follow "ivory tower"

approach in its decisions. Hence, neither of the two extremes are desirable. A judicious mix of the two types of directors is called for. While Whole-time (Internal) Directors bring to the deliberations of the board, their understanding and insights which they have developed as a result of their long experience of working in the organisation,the PTDs serve as a link between the organisation and the external environment (economic, social, legal and political). The External Directors are expected to initiate in the board meetings discussion on environmental developments and their implications for the organisation. The organisation would immensely benefit if people of eminence in society in the areas related or relevant to the organisation are selected for appointment as PTDs. People from the following walks of life can make significant contribution to the effectiveness of the board:

- an outstanding technologist with a considerable experience in a related field
- a renowned marketing expert
- an experienced person from the world of banking, finance or taxation
- an eminent person from legal profession
- a well-known business economist or a management consultant/academician who can contribute innovative ideas or generate fresh thinking
- a distinguished administrator who had his useful innings in the government administration.

A survey sponsored by the Financial Executive Institute (USA) found that an average of 72 per cent of the board members of nearly 800 responding publicly held companies were outside directors.

It would be appropriate if the board appoints a Nomination Committee which would identify the potential incumbents for PTDs for their eventual selection and appointment.

In fact, the role of whole-time and part-time directors is complimentary in nature. The secret of success lies in pooling together the strengths of the two groups so as to derive the maximum advantage of the mixed boards. In a large measure it would depend upon the Chairman who can create a sense of partnership, collective leadership, mutual understanding, respect and commitment to the common goals on the part of the groups. He also plays a key role in ensuring that outside directors identify with the board and the organisation. It will be no exaggeration to say that the effectiveness of the board depends on the effectiveness with which the Chairman manages the sensitive relationship between the executive and the non-executive members and develops a team spirit. He can convert this sensitive relationship into a synergistic one to the mutual benefit and satisfaction of both the enterprise and the individual directors.

Thus, the view that the composition of BODs should be neither wholly internal nor wholly external is increasingly gathering momentum. It should be a mixed BODs, with the PTDs being probably a few more than the WTDs. This should provide a safeguard against the BODs being used merely as a rubber stamp to approve the decisions of WTDs. This could also ensure better strategic, long-term management of corporate affairs.

4.8 BOARDS IN PUBLIC AND PRIVATE SECTOR ENTERPRISES

Some passing references to the differences amongst BODs in these two groups of enterprises have been made in the earlier sections. So far as public enterprise BODs are concerned, many observers comment quite adversely about their role Thus, one public servant has said that the supervisory system (BODs), by its sheer incompetence, has forced the functional Directors and plant level managers to acquire much superior exercise and a keen awareness of their tasks and responsibilities. Another management expert has discovered that in public enterprise Boards the Ministry representatives adopt the owner's perspective and, therefore, the final decision on important matters is rarey taken by the Board although it is legally responsible for it. Important decisions taken by the Ministry are automatically

accepted by the BOD. But another management expert who, like the previous one, has had personal experience of serving on public enterprise Boards, feels 'that it is neither fair nor feasible to draw any definitive conclusion about the institution of government directors'. For, there are cases where good support and understanding have flowed from the government joint secretaries. Of course, there have been cases, in his experience, where an undercurrent of tension has also prevailed between the Chairman or MD and the Government Directors. A seasoned bureaucrat of the ICS vintage has remarked that autonomous BODs are meant to insulate the public enterprises they manage from the variety of pressures which a parliamentary democracy is necessarily subject to. But, according to him, the present BODs functioning in public enterprises has not been able to fulfil this criterion.

Many informed people feel that the BODs in the private sector fare no better. Instead of the overriding influence of the Ministry in the public enterprise, it is the owning family or dominant controlling groups which play the decisive cards in evaluative or managerial roles in the private sector enterprises. The Board meets merely to clear the legal formalities. In multinational companies, at least in form and structure, the evaluative and managerial roles merge in the same set of Directors because practically all the Board members, including the Chairman, are whole-time insiders.

4.9 BOARD COMMITTEES

The proviso to sec. 292 of the Companies Act provides for delegation of powers by the BOD to a Committee of Directors of the powers regarding (a) borrowing money for the company otherwise than by debentures, (b) investing the funds of the company, and (c) making loans by the company. Other than this, the Act does not mention anything else about Board Committees.

In practice, however, Boards do appoint—probably more frequently in public enterprises—specific committees for indepth exploration of certain matters e.g., diversification project, shutting down a plant. These Committees work for a specified period and submit their views to the full Board. There are standing Committees of the Board as well e.g. Audit or Credit Committees in nationalised banks. These Committees meet in the interval between Board meetings, and are expected to devot greater attention to details in important matters arising from those functions. It is the outside directors who officially comprise such Committees. Usually a few top level executives of the enterprise are also associated with these Committees. At times it is found, however, that some Board members resent the use of smaller Committees of the Board. They apprehend that full information on important matters may thus remain hidden from the BODs as a whole. Some experts feel that, at least in private sector companies, there should be a 'Compensation Committee' of the Board to plan ahead for top management remuneration, and probably managerial succession too.

4.10 TWO-TIER BOARDS

Some experts, with a view to toning up board-room effectiveness, have in the recent past been referring to the system of two-tier boards in Germany and several other European countries. In this system there is a whole-time, non-executive Supervisory Board, and a wholly executive Management Board. No member is common to both the Boards. Thus, the policy and directing role of the Board is separated from the operational and management role. The Chief Executive Officer (CEO) is available to the Supervisory Board to present his analysis of performance and prospects. The Supervisory Board has the power to hire and fire the CEO and other inside Directors.

In the light of this background, it has been suggested that in India too we should have a 'Policy-Board' and an 'Executive Board'. The former should consist only of outsiders. However, the CEO of the company should be its member. These Policy Boards should comprise senior members of various professions, distinguished academics, one or two senior MPs, senior executives who are members of the Executive Boards of other companies (not competing with this company however), nominees from Workers' unions, and business leaders.

However, the Bullock Committee had examined this issue in the UK some years ago (1977). It had opposed its introduction on the ground that there was no easy way to distinguish between the functions of BODs (i.e., Policy Board) and those of senior executives. It felt that such artificial separation into two Boards could cause perpetual conflicts between the two-tiers—as in France. The Sachar Committee Report (1978) had also negated the idea of two-tier BODs for India. Few Japanese companies have outside Directors on their Boards; most of the Directors are wholetime employees.

4.11 CHAIRMAN VIS-A-VIS MANAGING DIRECTOR

The Companies Act does not refer to 'Chairman'. Yet, each board meeting requires, in practice, to be chaired by someone. The following combinations of Chairman and MD are noticeable in India:

a) Part-time outside Chairman, plus whole-time MD

b) Whole-time inside Chairman, plus whole-time inside MD.

c) Whole-time inside Chairman-cum-MD

Combination (a) seems to be more widespread in private sector companies, while (c) is more prevalent in public enterprises. Model (a) is defended on the ground that an MD, especially if he is relatively young can benefit from the mature guidance of a senior outside Chairman. Besides, if the real intent of the Act to make the MD/Manager function under the superintendence, control and direction of the Board is to be satisfied, an outside part-time Chairman has better potential to make this happen than combination (c).

As regards model (b) there seems to be a theoretical problem: that of the principle of 'unity of command'. Since the Act does not recognize the 'Chairman' as such, and casts the entire responsibility on the MD, could the existence of a separate whole-time Chairman cause conflicts? Where the personal equations between the Chairman and MD are healthy, the process might operate smoothly. Otherwise, this design can cause a lot of harmful frictions. In some companies a whole-time Chairman exists, while there is no MD (e.g. ITC or Hindustan Lever). The insider Directors are all chosen by such a Chief Executive. In this scenario, there is potential for 'yes manship' from the other directors.

Probably in recognition of the difficulty just cited, the majority of public enterprises in India have a single person who is the MD, assuming the additional temporary role of Chairman when the BODs meets. Against this arrangement also there is an important argument: it confers absolute power on one individual only. However, here again, the existence of Government Directors on such BODs probably is a safeguard against potential misuse of power by the CMD.

In the case of BODs of sick companies, a special category, it may always be better to either go for model (a) or (c). Divided accountability at the top, implicit in (b), is undesirable for the effective working out of revival strategies with speed. In such units the BOD has really to get down to managing' in a broad sense, and not remain satisfied with merely 'directing'. In fact, sec. 408 of the Act does envisage 'management' by the Board under special circumstances—even though they may not necessarily imply sickness. In such cases a whole-time non-employee Chairman and other Directors from outside could constitute the Board.

4.12 DIRECTORS' REMUNERATION AND FEES

Sec. 309 of the Companies Act provides the broad framework for Directorial remuneration, and the Articles of Association being left with the task of working out the details. Whole-time Directors and MDs can be paid in terms of monthly salary and/or a percentage of net profits (calculated according to sec. 198), provided that the total remuneration so paid does not exceed 5% of net profits if there is one such Director, or 10% for all of them if there is more than one such whole-timer. For part-

time Directors the sitting fee for each Board meeting does not usually exceed Rs. 250.

During recent years the Government has been fixing ceilings on Directorial remuneration in absolute terms, although increasing them over time. A major consequence of this has been that, since the remuneration for below-Board-level executives has not been so regulated, many erstwhile MDs and Directors have moved or are moving out of the BODs, and assumed or assuming the titles of President and Vice-President and thus protect their original remuneration. These people are now present in board meetings as invitees, while the formal board consists wholly of outside part-timers.

So far as part-time directors are concerned, it is widely felt that a paltry sum of Rs. 250 or so for each meeting is hopelessly inadequate for them to take such meetings seriously. For many experienced senior people, who take up the career of a 'professional' director, accepting up to 20 Directorships becomes a means of notching up a reasonable level of regular monthly income. In the West this is being changed. Handsome fees are now being paid to part-time Directors also for serving as the Boards with dedication and hard-work.

Activity 2

The notice of the Annual General Meeting of a public limited company sometimes contains a proposed resolution to be moved in the meeting purports which to fix the remuneration and perquisites in respect of a Whole-time Director of the company. Place possible values to the various perquisites mentioned in the proposed resolution. Find out the total compensation payable to a Whole-time Director including the value of perquisites, and comment upon it.

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4.13 MIS FOR BODs

This is a rather nebulous aspect of board functioning. So far as part-time outside directors are concerned, they normally receive a file of papers, one week in advance of the board meeting, from the company secretary. The agenda is prepared by the enterprise itself, consisting of certain regular features e.g., quarterly or monthly business performance, progress reports on projects etc., and certain non-recurring items e.g., decision to declare a lock-out. The initial agenda is drafted by the Secretary, and then the MD takes a hard look at it. Often he retains all the law-related issues as 'sacred cows', while axing down many crucial aspects on long-term policy matters which could have been aired in the full Board meeting. Outside directors are not requested to initiate agenda items on their own. While attending board meetings, if such directors ask for more or undisclosed information, it is not directly denied.

In those private companies which are board-managed (i.e. all board members are outsiders, with possibly a family member of the owners being the chairman, usually little information is available to the boards regarding the long-term strategy of the firm. In public enterprises, however, the situation is much better. More detailed papers are available on future projects and plans in such companies than in private sector firms.

However, during the intervals between board meetings there is absolutely no communication between the company and its part-time Directors—except may be with the Government Directors on public enterprise BODs. Some standing system should be evolved to fill up this MIS-gap, in consultation with the part-time directors. In the absence of a regular interim MIS, such people participate in Board meetings in a rather listless, haphazard and superficial manner. Much to their own dislike, they feel that they are not 'in it' as it were. Many of them do not have a

cursory acquaintance with even the plants and factories or other physical aspects of the enterprise they are supposed to direct.

4.14 BOARD MEETINGS : SOME PROCESS ASPECTS

A tremendous degree of responsibility rests on the person who chairs a board meeting for making it work purposively. He has to avoid wasteful debate and talking. He must be able to draw out the relatively quiet board member to share his views, and to stop judiciously the too vocal members.

If the chairman is a part-time outsider, elected so to say, by the other insider directors, then he should act his role with high integrity. Often it is found that such chairman begin to form cliques with certain members of the board—may be to ensure the renewal of their own term of appointment. Nor should chairman or other part-time directors approach or entertain lower level employees and develop informal communication links with them.

An important impediment in the effectiveness of Boards is that too much time is often taken up in law-related or routine aspects. As a result, little time is left for meaningful deliberation on key long-term aspects of enterprise functioning e.g. building a sound corporate culture.

All decisions in BODs are deemed to arise from consensus. Notes of dissent from any Director are indeed very rare. The minutes are taken down only for the final decision. But the crucial dimensions debated upon, before the decision is reached, are not at all noted. This is a drawback because at a later date, when present Board members may not be there, the genesis of a past decision in a given context would not be available to the new BODs.

Another crucial problem of board meetings relates to their dates. Very few enterprises see the practical merit of convening such meetings on fixed dates in each month or each quarter which all the directors can note for the year in their diaries, and plan other evolving commitments around those dates. In the absence of such a discipline, Board meetings—especially in the majority of public enterprises—are decided on the basis of dates suitable to the government directors. It soon becomes clear to the other part-time directors that they are after all not so essential to the decision-making process.

It is often observed that where a board meeting is held over a full day, and a lunch break intervenes, certain delicate or thorny issues, eluding frank airing and resolution within the board room, somehow get tackled through small informal parleys in the lunch room. So, when the Board meeting commences again after lunch, it may take a few minutes only to reach a decision on such matters. This kind of in-group solidarity of select members of the Board is crucial when contentious issues are on agenda. Of course, at times the reverse may also happen—attitudes across groups may harden further during the lunch interval, and the post-lunch spell could be more acrimonious.

4.15 ENHANCING BODs EFFECTIVENESS

The BODs as an institution at the corporate apex is there to stay. It has, however begun to be subjected to closer scrutiny only recently. Many of its weaknesses have already been mentioned from various viewpoints in the previous sections. In this concluding section we may think of some of the following ideas and plans to improve its effectiveness in the future:

1) Corporate shareholding should be widely dispersed. This will help the BODs to become more autonomous and self-directing. Public enterprises and companies belonging to family business houses suffer more on account of narrow base of investors.

2) Part-time, non-executive Chairman of BODs should not be just ornamental. They should accept the positive responsibility of welding all the Board members into a cohesive and forward-looking team. while allowing constructive debate to flow freely.

3) Functioning in a BODs as a director is different from working as a top executive. This change in the role of an insider should be deeply internalised to avoid the mentality of a functional head or a profit-centre head to dominate one's thinking in the board room too.

4) To be really useful in furnishing deeper and long-term insights, quarterly BOD meetings should last for two days in a row. Overnight rest intervening between intensive discussions on a single strategic aspect chosen for each meeting should be useful in crystallising valid and reliable solutions.

5) Fees for outsider Directors in each such meeting should be at least Rs. 2,500.

6) Number of Directorships held by one person, in the light of (4) and (5) above, should not exceed five or six at the most.

7) The BODs, especially those consisting wholly or nearly wholly of outside Directors, should care to renew and reiterate confidence and trust between themselves and the executive management of the company. This is vital because the BODs is a peculiar unit of corporate management: it has no line or functional authority, yet has all the responsibility.

8) While the BODs may not consciously own up public responsibility, yet safeguarding public interest must be its overriding value-orientation.

9) As a general rule, the BODs should refrain from interfering with actual operations and policy implementation after its decisions are passed on to executive management.

10) An Institute of Directors, providing a forum for regular interaction and interchange of experience amongst Directors who have high levels of professional experience, could be constituted. Such an Institute, over-time, could become a sort of certifying or screening body for inducting a professional into the Director's role for the first time.

4.16 THE EID PARRY BOARD TUSSLE—SOME INSIGHTS FROM A REAL CASE

Earlier we had quoted Indian Company Law on the subject of the role of the MD of a company, who has substantial powers to manage the company, subject to the superintendence, control and direction of the Board. With the resignation of EID Parry's MD in May, 1981, the MD vs. Board warfare exploded into the open. Unlike MD vs. Chairman (part-time or whole-time) conflicts cited earlier, this case was of a whole Board lined up against its Chairman-cum-MD. Let us summarise the key facts:

1) During the period 1976 to 1979 EID Parry had been incurring heavy losses. This was a nearly 200 years old company, and was amongst the top 100 companies of India in terms of sales and assets.

2) During this period the company had a non-Executive Chairman, and there was a Vice Chairman-cum-MD who had risen from the ranks within the industry.

3) About 60 per cent of its shares were held by the public, and about 30 per cent by various financial institutions.

4) The financial institutions decided to strengthen the management of the company, and in 1980 the Unit Trust of India nominee on the Board was chosen as the MD. After joining, the new MD felt that a part-time, non-Executive Chairman was not an answer to EID's problems. So he was made the full time Chairman/MD. The previous non-Executive Chairman, however, stayed on as an ordinary part-time Board member, but not before he had unsuccessfully brought a court injunction restraining such an appointment.

5) At the time when the internecine quarrels became public, the full Board of EID Parry consisted of 20 members—6 inside fulltime Directors (including the MD and three special Directors), 9 outside part-time non-institutional Directors and 5 financial institution part-time nominee Directors.

6) Nearly all the outside directors were aged above 65. The new Chairman/MD

was younger, had a Ph.D. in financial management from an American university, and had held senior executive positions in India and the U.S.A.

7) Some of the major steps taken by the new Chairman-MD, and that too at great speed without prior Board approval, were:

   a) A large number of previous special Directors (5 out of 7) were 'allowed' to resign.

   b) Two new special Directors were appointed from outside, and so were two General Managers.

   Both these steps were deemed necessary by the Chairman/MD to strengthen and revamp sloppy top management. Insiders resented this move because the convention was to appoint special Directors from within as an incentive to worthy aspirants.

   c) An internal audit was conducted; and a report highlighting several irregularities in financial and business matters was submitted straightway to the financial institutions, by passing the Board. The institutions, however, seemed to take no heed of the Report.

   d) In order to avoid labour unrest, the 1979 bonus issue was settled on the basis of a flat-sum of Rs. 750 to all employees, including those drawing a salary over Rs. 1,600 per month. This agreement entailed a total cash outflow of Rs. 12 lakhs, and 1979 was a loss year.

   e) The performance of the sugar division was boosted appreciably by an agreement with the sugarcane suppliers to supply maximum sugarcane to the firm's sugarcane factory. This deal was the outcome of personal visits and discussions made by the Chairman/MD with the sugarcane farmers.

8) The Board, including financial institution nominees, was refusing to approve or ratify any of the above steps of the Chairman/MD.

9) In early 1981 a group of 123 shareholders submitted a petition to the Madras High Court alleging that the affairs of the firm were being mismanaged, and that the Chairman/MD was being restrained by the Board, in his endeavours to improve things. So, an investigation ought to be conducted.

10) In March 1980 the Board had passed a resolution placing all executive or special Directors under the supervision and control of the Chairman/MD. However, contrary to this resolution, in March 1981 the Board decided to terminate the services of the Legal Adviser and a special Director, despite the Chairman/MD's disapproval. The Board contented that this resolution had to be read along with a subsequent clause which stated that the Chairman/MD shall exercise such rights and perform such duties as may be determined by the Board from time to time.

11) The High Court judge ruled in favour of the Board and the company, declaring that the Board of Directors was the supreme body to decide its destiny. The judge saw the Companies Act as contemplating the creation of a Board which should assume responsibilities for the affairs of the company, and the Chief Executive had to stand and serve according to decisions approved by the Board (an almost Miltonic verdict!).

The purpose of EID Parry during 1979-81 was to stem the erosion of its 'viability', and then to reinvigorate it. (This and the following paragraphs make use of some basic concepts in the two books by Stafford Beer, Brain of the Firm (1981) and the Heart of Enterprise (1979)—both published by John Wiley, England.) Viability is the capacity of an organisation to maintain its separate existence. For a firm to be viable Beer suggests the cybernetic framework of a 5-step systems model:

System 1— the various operational units or divisions of the firm;

System 2— the various common service departments which help to coordinate and create orderliness in the functioning of operational units, e.g., maintenance, accounting, purchasing and stores and so on;

System 3— the various specialist Directors who preserve the synergistic thrust in the functioning of operational units e.g., Marketing, Finance and

Manufacturing Directors who cut across various operating divisions which have their own functional heads in these areas (called Operational Directorate);

System 4— While system 3 is concerned with the 'inside and now' of the firm's operations, system 4 is intended to look after the 'outside and then' for the enterprise e.g. management development, R&D, corporate planning and so on (called Development Directorate);

System 5— to monitor and integrate the apparently polarised concerns of systems 3 and 4.

Although the above scheme seems hierarchical, it is not so in the purely mechanical sense of superior-subordinate implied in organisational charts. Individuals could, and should when conditions demand, switch roles across these systems.

Now, what the Chairman, Managing Director of EID Parry was doing, in terms of the major steps he took in his first few months in that role, was to step into system 2 (e.g. internal audit and his own report thereon) and system 3 (e.g. appointment of new special Directors). Let us remember, he had prior knowledge of EID and its problems as an ordinary part-time Board member. Probably EID Parry had no system 4 worth the name. So far as the Board is concerned, which could fit in with the concept of system 5, we have seen its composition and age mix already. A body as large as a score of members, meeting four to six times a year over a duration of three to four hours each, is supposed to decide policies for the firm, synthesising systems 3 and 4 ideas and deliberations. Anyone connected with any administrative or managerial job in any kind of institution would appreciate that policies for critical problems can never be evolved without close and continuous fine-tuning with the myriad aspects of any major issue at hand. Since a predominantly outside and over-aged Board can scarcely be expected to grasp the nettle (especially in the current milieu of Board room protocol of going by pre-selected agenda items), it may either turn into a puppet playing to the tune of whatever information is fed to or hidden from it, or it may take a pretentious stance of omniscience and pronounce irrelevant policies. (Of course this danger is even more severe for constituency-based Boards whose members may amongst themselves know everything about the world except the true nature of the business of the firm. Unlike in affluent, industrially advanced economies, the notion of constituency-based Board is an ill-conceived one for India today.)

Clearly, the important and urgent task for the Chairman-Managing Director of EID Parry was to plug the gaping holes for saving the organisation from rapid collapse. The legal purpose of the Board as enunciating policies for EID Parry often turned out to be a mere platitude. Instead of waiting for niceties about getting policies established at the Board level, and then taking action steps (meaning inevitable loss of time), the Chief Executive seemed to be catching the bull by its horn in a crisis situation. When the Board itself had appointed a particular person as the Chief Executive of the organisation—who is a professional by any standard—it would have been correct for it to show patience in regard to his decisions, except those relating to some alleged sackings at senior levels.

If a separate part-time Board Chairman was expected to play the role of system 5, along with the Board, evidently this had not happened in the past. The fusion of the Chairman's and Managing Director's roles into one individual could be seen as an attempt to integrate systems 3, 4 and 5 all into one vigorously active point. Crisis situations probably inevitably demand this fusion. But the old-style Board obviously had no perception about the need for a change in its stance when a Chairman-Managing Director of its own choice was put in place, and who had begun shaping his role, unknowingly perhaps, within a cybernetic framework.

We are aware of another case—that of the National Rayon Corporation—where the Government had appointed seven Directors in 1977, all outsiders—to manage the company under the provisions of section 408 of the Companies Act. This was a crisis situation too—even more severe than that of EID Parry. The Board here was fully part-time. Yet it worked wonders for NRC. Why? This is because while trying to play the system 5 role, it soon discovered that its members had to get involved deeply into the system of 4 and 3 levels also. Board members had to divide up specific areas of management amongst themselves, and become accountable for better results therein. And all this was done along with the existing executives of the

organisation. Thus, no glib talk of a policy-making Board was allowed to come in the way of reviving the firm. When system 5 policies evolved, they were born of intimate understanding gained through association with system 4 and system 3 levels. Here was truly a Board-managed firm. In the EID Parry case it was never a Board-managed firm. Nor was it later allowed to function as a Chief Executive-managed firm either.

Activity 3

Mention the main facts of a Board room drama which you might have come across or studied recently in a business Journal or newspaper. Critically comment on what went on and what ultimately happened? Do you think whatever happened was in the long-term interests of the company?

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4.17 SUMMARY

In this unit we began by first discussing the provisions of the Company's Act in regard to Board of Directors and their powers. We have seen that legal provisions are rather scanty. With mounting uncertainties and changes taking place in the environment, the role of BODs has begun to be viewed in a broader frame. There are perhaps inherent limitations of the legal provisions in capturing the vital ramifications of the changing role of BODs. Whether members of BODs should oversee the operations of the company from a distance or limit themselves to taking broad policy decisions, or should get themselves involved in detailed operational aspects of management continue to be debatable questions.

In terms of the involvement of the members of the board in strategic tasks, boards can be of varying types, ranging from phantom boards to catalyst boards. It is common knowledge that boards in India, in general, function rather passively. However, the importance of the role of the board has begun to be appreciated. A great responsibility lies on the Chairman of BODs to galvanise the members for a significant contribution.

The size and composition of the BODs varies from company to company. Recently, the practice of appointing a director representing the interests of workers' constituency in public enterprises has gained currency. This practice, however, has met with mixed reception. While all the directors on the boards of public enterprises are essentially Nominee Directors, such directors constitute a distinct and important category in private sector enterprises. In such enterprises these directors generally represent the interests of the financial institutions whose sizeable funds are often invested in the company. The views differ on the merits of the constituency-based directors.

An effective board is the keystone in a modern organisation. The BODs may consist of internal whole-timers or external part-timers, or both. The composition or structure of a BODs may have an important bearing on the performance of the organisation. The opinion seems to be converging on the desirability of having a balanced mix of internal and external directors. The roles of whole-time directors and part-time directors are complimentary in nature. It depends upon the Chairman of the Board to convert the relationship between internal and external directors into a synergistic one for betterment of the organisation.

In some European countries the practice of having two-tier Boards is quite common. However, whether this practice can be adopted in India remains controversial. The capacity of the board members to contribute to the welfare and progress of the

company, in a large measure, depends on the outlook of the Chief Executive/functionary of the company, the information provided to the members before and during the board meetings, and the manner in which deliberations are handled by the Chairman.

It is expected that there will be greater emphasis on systematically monitoring and appraising top management performance by the board in future. The board will also be more involved in the management succession process.

4.18 KEY CONCEPTS/TERMS

Board of Directors
Beer's 5-step System Model
Chairman-cum-Managing Director
Constituency-based Directors
Committee of Directors
Director
External Directors
Government Directors
Internal Directors
Managing Director
Nominee Directors
Part-time Directors
Two-tier Board of Directors
Whole-time Directors

4.19 SELF-ASSESSMENT QUESTIONS

1 What are the key provisions of the Indian Companies Act to regulate the functioning of BODs?

2 What are the pros and cons of having Directors who represent specific constituencies? Discuss in this light the role of 'nominee' and 'worker' Directors?

3 Offer a comparative assessment of 'completely outsider BODs', 'wholly insider BODs' and 'mixed BODs'.

4 Examine the major drawbacks of prevailing Board room functioning in India.

5 Examine the differences between Board room functioning in public enterprises and private sector companies.

6 Should the Chairman and MD roles be combined into one individual? Give your arguments for and against.

7 What are the legal and managerial roles of BODs?

8 How would you like to organise the information supplied to BODs to enable them to focus on strategic thinking in the choice of technology, business finance sources, competitive marketing and development of personnel?

9 What are the major lessons of the EID-Parry Board room affair of 1981?

10. What are the basic tasks of a Board of Directors in terms of strategic management? Analyse the Board of Directors of your organisation (or the organisation with which you are familiar) in terms of the involvement of its members in strategic affairs.

11. Examine the controversy relating to whole-time and part-time directors on a Board and offer your comments on a wide spectrum.

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UNIT 5 TOP MANAGEMENT: ROLE AND SKILLS

Objectives

The objectives of this unit are to enable you:

- to know who the members of top management are
- to understand roles usually performed by top management and their strategic styles
- to identify skills that facilitate performance of top management tasks
- to appreciate the importance of corporate values

Structure

5.1 Introduction
5.2 Chief Executive Officer
5.3 Role of Top Management
5.4 Functions of Top Management: Some Views
5.5 Skills Required
5.6 Corporate Values
5.7 Top Management and Strategic Styles
5.8 Summary
5.9 Key Concepts/Terms
5.10 Self-assessment Questions
5.11 Further Readings
References

5.1 INTRODUCTION

Who are the persons who constitute the top management in an organisation? In a relatively small organisation this may be a simple task. But in a large organisation it may not be simple to identify the persons belonging to top management if their roles are not clearly defined. What is at the back of our mind when we identify top managers? Obviously, it is the tasks which are performed by them. We single out those who perform such tasks. But then, what are the tasks usually performed by top managers?

It is relatively easy to identify top management in the above manner than to define it. Even practising managers, who are usually better informed about the functioning of organisations, are not so clear as to what constitutes top management. If such is the confusion, one might ask why does one need to define top management. Nonetheless, it is widely agreed that top management provides direction to the organisation and moulds its future. People generally look to such persons in case of need. Thus, top management provides leadership to the organisation.

Activity 1

a) List the name of persons who constitute the top management in your organisation.

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b) Try to recollect if your organisation has changed its main areas of operations, and the persons who suggested such a change. Also recall who is responsible for setting targets, not for the current year but over a longer period.

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Let us be a little more specific now. The top management function is usually performed by the Chief Executive Officer (CEO) of the organisation, by whatever name called, in coordination with the Chief Operating Officer (COO) or President, Vice-Presidents, and divisional and departmental heads. The top managers are also known as general managers.

Top management especially the CEO is responsible to the board of directors for overall management of the organisation. The job of the top management is multi-dimensional and oriented towards the welfare of the total organisation. Though the specific top management functions may vary from organisation to organisation, one could have a good idea about it from an analysis of an organisation's mission, objectives, strategies and key activities.

In this unit, we will first talk specifically about the role of the Chief Executive Officer (CEO) of a corporate body. This will be followed by a discussion on the role, skills and values of top management in general.

5.2 THE CHIEF EXECUTIVE OFFICER

The Chief Executive in most of the companies is called the Managing Director (Chairman-cum-Managing Director) or President. In the discussion that follows we will be concerned with the role of the principal executive leader of the entire organisation. Where the executive head of the organisation is the Managing Director or Chairman-cum-Managing Director, the President is usually in the position of the Chief Operating Officer (COO). The Executive leader of a major segment of the organisation such as a division, department or unit is typically called a general manager.

The Chief Executive Officer (CEO) is a **strategist, organisational builder** and **leader**. The CEO is the principal strategist of his organisation. Although the BODs and other members of the top management play an important role, the CEO cannot really delegate all his strategic responsibilities to anyone else. He is in fact a strategic thinker. He is the person who links the internal world of the corporation with the external world. This role can be described as the "gate keeping" role of the CEO; it is both "flag flying" and "transmitting" to and receiving signals from the external environment. It is he who has both the corporate understanding and the vantage point perspective which is required to translate the signals from the outside world. These signals may often be subtle, and not very perceptible. He has to sow seeds for new thoughts within the organisation and has to nurture and sustain those which come from outside.

Many CEOs are so involved in the day-to-day operations that they hardly have any time left for strategic matters. It has been rightly said that routine drives out creativity. The CEO has to see to it that he is left with sufficient time for strategic responsibilities. An American Survey[1] indicated that the executives who reached to the top allocated the largest part of their time to long range planning and policy setting. They even wished that they had more time for long range planning and human resource management.

While operating within the environment and the resources at hand, the CEO has to **build** the organisation. Organisation building is a continuous process involving organisational change. Some of organisational building responsibility can certainly be delegated but the CEO, being at the helm of the affairs, has to remain the initiator for experimenting with new ideas, approaches and systems. He is the key person in the organisation. The organisational changes should be made gradually and regularly, and not suddenly or sporadically. It is a human tendency to resist change for a variety of reasons, the main being uncertainty. It is therefore important to recognise resistance to change prior to attempting to make organisational changes.

The common reasons for people resisting change are: vested interests, differing perceptions, misunderstanding and lack of trust, and low tolerance for change. Some useful ways to deal with resistance are: education and communication, participation and involvement, and facilitation and support. All these ultimately lead to the creation of a climate of better confidence.

The CEO is the first among leaders of his organisation. He must have the will to manage. "To manage well a person has to want to manage; he has to really love it". How a Chief Executive can turn around a company is amply revealed in a case history[2]. An expatriate was called to India to boost the performance of an Indian subsidiary in the processing-marketing industry. The company had tremendous goodwill in the market but its performance was wholly out of alignment with its image. In spite of good products, the company was not able to do well because of traditional management which was characterised by lethargy and lack of articulation. The new CEO, who was gentle in his speech, sensitive to human relations and had charming social manners, was often perceived by company executives as an academic who had somehow strayed into the world of business. However, soon after joining his new position, the new CEO started questioning the current assumptions relating to product strategies, marketing and distribution. He started the system of target setting and performance appraisal.

It soon became clear that the velvet glove concealed an iron fist. He left nobody in doubt about his conviction that if the company had to move forward it had to be sensitive to the environment and regulatory policies, and pull itself up by the organisational boot straps. He redefined product-market posture and reconstituted product groups into divisions with profit responsibility, after taking into consideration the technological, marketing and managerial dimensions which have an impact on performance. He selected the heads of the new divisions carefully. Planning systems were streamlined, targets regarding sales, cost, profit, product development etc. were developed on the basis of open discussion and information sharing. Considerable autonomy was devolved upon the divisional heads with regard to staffing, resource allocation, and marketing strategies.

Many eyebrows were raised about his style of tough minded behaviour, quite unknown in the history of the organisation. Within a period of less than two years the organisation turned the corner and was found attempting for market leadership in the industry.

Mentoring and helping others along the road to success is an important activity of managers and more so of CEO. The higher a manager gets in an organisation, the more responsibility he has for such helping activities. It is a characteristic of a really genuine leader at any level to lift others up, even beyond his own level at every legitimate opportunity.

Thus, a CEO is simultaneously a strategic thinker, an organisational builder, and a leader. He is also a spokesman, an innovator, a father-figure and a prime decision maker, as will be borne out in our later discussion.

5.3 ROLE OF TOP MANAGEMENT

You will now appreciate that top management comprises a team of people, including the CEO, who perform certain vital tasks. Although there may be differences among writers as to whether people holding certain positions in a body corporate can be regarded as members of top management or not, yet there is a good deal of agreement on tasks performed by them. The tasks performed by the team or group of people who can be regarded as constituting top management are:

- Providing direction
- Setting vision
- Setting standards.

Direction

Top management, undoubtedly, is expected to give direction to the organisation. Should the organisation continue to produce goods and services provided hitherto?

Should there be a change in products supplied? What are the areas from which the organisation should withdraw? What are the new areas into which it should enter?

In a reasonably stable environment these questions are not that relevant. But in a changing environment there is a need to keep a close watch. Some products/businesses which were doing well in recent years may not continue to do so. What should the organisation do? Disinvest, but what are the new areas into which it could go? Most big industrial houses have gradually withdrawn from textiles or are in the process of doing so. These include Birlas, Tatas, Shri Ram Group, Modis. They have entered into new areas such as chemicals, automobiles, tyres, electronics, reprographics. Who decided about these? Of course the top management or more specifically top management team.

Vision setting

Having given the direction to the organisation, top management team is expected to set standards for the short run and the long run. What is to be achieved, say 5 to 10 years from now? What are the targets for the given years?

Can you guess which task is more important—setting standards for the short run or the long run? Of course, both are equally important and are interconnected. An over-emphasis on the achievement in the short run may mean that the organisation is not able to initiate action in time for moving into more promising areas in the long run. Similarly, an overly concern for achievements in the long run may put the organisation in difficulty for meeting the short term requirements of cash and other facilities. Evolving a balanced perspective of the short term and long term interests has been emphasised in the literature. It is argued that the top management needs tc have bifocal glasses which help it in managing the short term as well as long term interests of the organisation simultaneously.

Standard Setting

Top management not only sets standards but evaluates the performance of various units or groups of businesses. Setting standards has no meaning without some system of control. Developing a system of control is one of the tasks of top management. The frequency of such exercise on evaluation differs from situation to situation. However, the evaluation should provide scope for initiating corrective action.

One of the formal ways of having a system of evaluation is provided by Management by Objectives. In this approach an attempt is made to arrive at an agreement on what is to be achieved. These targets, then constitute the basis on which evaluation is attempted.

5.4 FUNCTIONS OF TOP MANAGEMENT : SOME VIEWS

Reilly[3] describes the functions of top management as:

- setting the objectives of business
- establishing policies
- assigning responsibility
- selecting and developing key personnel
- integrating people's efforts in achieving company's objectives
- stimulating creative thinking
- measuring and evaluating results

Mintzberg[4] identifies three sets of behaviour—**interpersonal, informational** and **decisional**. The interpersonal roles he designates as figurehead (primarily for ceremonial duties), leader (to provide direction) and liaison agent for contracts outside his unit. Informational roles can be described as **monitor** (of information), disseminator (within the organisation) and spokesman (to the external organisations

Decisional roles are called entrepreneur, disturbance handler, resource allocator and negotiator.

Steps given by Reilly have a lot in common with the steps in formulating corporate strategy. It may be worth the effort to refer to these steps. A few distinguishing steps relate to (i) planning for succession and (ii) encouraging creative thinking.

Planning for Succession

Small organisations and closely controlled organisations may have more clarity in this respect. It is fairly well established that the eldest son shall take the position of the father. However, at times, the sudden demise of the head of the family may create a void and the organisation may experience great difficulties during this period.

Contrast this phenomena with the experience of the more mature organisations. The exit of individuals does not create such a void and hardship. One way of planning for succession is to make the next in command as the incharge during the absence of the chief executive. Possibly, a better way may be to run the organisation by a team. A meeting of the team may be held every week.

The reasons for not giving sufficient attention to the training for succession may be because of:

- **inferiority complex** on the part of top manager. This also includes the fear that the person so trained may excel and thereby reveal the shortcomings of the present incumbent, and
- **lack of time.** Top managers are usually busy in day-to-day fire-fighting.

Both factors are a manifestation of malfunctioning of the organisation. Experience indicates that the organisations doing well (above average performance according to accepted norms) are the ones where top management attaches considerable importance to the training of young managers and planning for succession. Multinationals are known to give high importance to training. Organisations belonging to big industrial houses also attach importance to training. Reilly is of the opinion that selecting and developing key personnel is one of the most important tasks performed by the top management

Encouraging Creative Thinking

The second distinguishing characteristic i.e. stimulating creative thinking is an aspect which determines the long-term success of any organisation in the fast changing environment. The products generating profits presently may cease to be so once they arrive at the declining phase of their product life cycles.

A look at the functioning of successful organisations reveals that they have a system of phased withdrawal of products. This is particularly true of organisations in consumer non-durable goods where the brand loyalty is an important factor. The introduction of new brands of cigarettes and soft drinks by different companies confirms this point. At the level of strategy formulation, it means the introduction of new businesses, though the rate of natural obsolescence of the business or industry may be relatively slow.

What is important in this context is the system that exists in the organisation to encourage creative thinking. A chief executive who has a dominating personality may in general be an obstacle in encouraging creative thinking.

To quote a phrase used by Drucker, the real task of top management is to identify the 'bread-winners of tomorrow'. The other tasks are auxiliary which facilitate the realisation of the expectations of the organisation. These include:

i) maintaining contacts with important people,
ii) portraying a good image of the company, and
iii) ensuring that the organisation discharges its responsibilities to society.

Thus, the tasks performed by a chief executive include attending ceremonial functions, maintaining liaison with government, attending meetings of different types,

and portraying the right image of the organisation.

Pareek[5] identified the tasks of top managers as institution builders. The tasks the top managers perform include several roles:

- **identity creating role** by creating special position
- **enabling role** by creating men, material and other facilities
- **synergising role** by creating overall favourable effects
- **balancing role** by creating a proper balance between conformity to rules and to creativity
- **linkage building role** by maintaining proper contacts
- **futuristic role** by identifying alternative businesses of tomorrow
- **impact making role**
- **super-ordination role for employees**

According to a study[6] it may be interesting to know how a change in the chief executive brought about a change in one of the public sector undertakings. Some of the changes introduced by him are tabulated under "situation after change" in contrast to the situation that existed before change.

Situation before change	Situation after change
role ambiguity	role clarity in assigning responsibility
impersonal touch	personal touch
fault-finding culture	supportive culture (imaginative direction)
doing things right	doing the right things (a component of providing direction)
centralisation	decentralisation
blocked communication	free flow of communication
secrecy	openness
anonymity	public identity
distancing the subordinates	closer interaction with subordinates (sense of belonging)
inward looking orientation	outward looking orientation
indifference towards human resources	treating human beings as assets
indifference	appreciation
government department	trading house
stagnation	innovation

Probably, the factors listed above may have emerged on account of the framing of questionnaire in a particular way. But, what is more significant is the fact that managers belonging to all the three levels (top, middle and supervisory) gave a similar feedback.

Activity 2

a) What are the main functions performed by the top management in your organisation? Are they different from the functions described in the above section? What three functions, in your view, are the most important ones? Rank them in order of priority.

b) Does the top management ... your organisation believe in succession planning and encouraging creative thinking? Cite evidence and give reasons in support of your answer whatever it is.

c) If you were the Chief Executive of an organisation (describe your organisation), how would you encourage a climate of creative thinking.

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5.5 SKILLS REQUIRED

If the task of top management is regarded as fulfilment of the objectives of the organisation, then top management must have the skills which enable it to carry people along with it to attain the goals and objectives of the organisation. This calls for some special skills, such as :

i) leadership qualities,

ii) ability to formulate organisation's purpose

Leadership qualities embrace all those characteristics which make people cooperate whole-heartedly with the top management. Some of the important characteristics are:

- Dynamism
- Decisiveness
- Humane approach
- Conscientiousness
- Ability to understand worker's needs
- Appealing personality
- Objectivity
- Ability to communicate

The above mentioned characteristics are quite self-explanatory. Dynamism, for example, will enable the leader to develop a new point of view to the various problems. This also represents the ability to take a stand other than the expected one. People with such a characteristic are not averse to a change. This, in part reflects their confidence in themselves. Decisiveness will impart spontaneity to his responses to various situations that he may experience. Some people are so meticulous that they are unable to decide. In the process, the decisions get postponed. This may mean loss of opportunity. In general, people who lack competence and confidence are indecisive.

Human approach enables the leader to appreciate the point of view of the workers. This characteristic is also known as empathy, meaning "the imaginative projection of one's consciousness into another being". Humane approach would reflect in the behaviour of the person who then will be viewed as a sympathetic person. However, human approach does not mean tolerating indiscipline or injustice. Empathy represents the attitude of a person, for instance, his interest in finding out the cause of misbehaviour of an erring employee, and his willingness to give benefit of doubt, etc.

Next, the leader is expected to set an example for others by working hard. Top management should appreciate the workers' requirements, both at the individual and the group levels. A visit to the plant, in the case of production units, and office, in other cases, can provide some information on their grievances and difficulties. Informal get-togethers where workers, both skilled and unskilled, are present, can provide additional information on their requirements. Farewell functions for retiring employees and functions organised to accord them recognition for excellent work provide such occasions. A pleasing personality is always an added advantage.

The workers and the other employees expect their leader to be impartial. Absence of objectivity may create groups within the organisation and the leader may lose the respect and cooperation of all the employees. Maintaining objectivity, however, is most difficult to manage. Knowingly or unknowingly, some people tend to come closer to top management. It requires more than a shrewd person to take harsh action against such employees. Another important quality of good leader is to communicate effectively so that his commands are understood without any ambiguity. Katz and Kahn[7] describe leadership as "the influential increment over and above the mechanical compliance." It is acknowledged by practising managers that the ability to communicate effectively is a great strength: This, however, has to be distinguished from oratory. An ex-president of Ford Motor Company once acknowledged that the ability to put one's viewpoint effectively and clearly wins half the battle.

Rarely will an individual or his team possess all the characteristics of good leadership. However, deficiency in some characteristics may be compensated by superiority in some other characteristics. Unfortunately, there are no empirical studies on the relative importance of various qualities. A top manager requires skills to deal with human beings, both within and outside the organisation. Since top manager can draw on the support and assistance of other managers who can provide him technical advice, he does not need to know the technical details of different aspects. But, a familiarity with them is always an added advantage.

Contrary to the skills required of top managers, middle and supervisory level managers require more competence in technical aspects, and a lot more ability to deal with human beings. The need for conceptual skills, especially of the supervisory levels, may not be as marked as in the case of top management.

Activity 3

a) In view of your organisational experience, what skills you think are the most important for the top management to possess? Rank those skills.

1...

2...

3...

4...

5...

6...

b) Narrate some situations/incidents which were the direct consequence of your immediate supervisor's lack of skills which you think he ought to possess. If you were an outside consultant to your immediate supervisor (or boss), what would you suggest to him to develop those skills?

1...

2...

3...

4...

5...

6...

c) A manager in the years to come will have to increasingly deal with changes in organisation, methods, processes, technology, etc. In the light of these likely

changes, what skills should the top management possess or acquire? How can top management prepare itself to deal with these changes effectively?

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5.6 CORPORATE VALUES

Corporate values reflect the values of its managers, especially the managers at the top level. What esteem or place the business enterprise will have in the community and whether it will be successful in the long run depends, to a large extent, upon the values held dear by its managers. Values are the beliefs held by members of an organisation concerning what is desirable or good. Values result from choices between competing human interests in pursuit of goals. For example, one organisation may emphasise integrity, independence, hard work and internal competition while another may underscore interdependence, awareness and cooperation.

Values consistently held by the top management result in organisational norms. When actions of the members of the organisation are in accordance with the norms, they are supported and approved by the superiors. This in turn reinforces the norms. Actions which are not in tune with the norms receive reproval and hence are sanctioned. The values held by the corporate management sometimes are reflected in slogans like "customer is always right", and "our motto is excellence in whatever we do".

Some organisations may have many stated values while others may have few. The strength with which corporate managers hold values may also vary in different organisations. In examining values we have to recognise that different managers may value a thing from different perspectives. For instance, if senior managers in a business enterprise are asked to rank in order of importance objectives or goals like organisational effectiveness, high productivity, profit maximisation, growth, industrial leadership and organisational stability, their ranking might differ. One could, however, deduce corporate values from the views held by a majority of its senior managers. If a survey covering large number of industrial enterprises were to be conducted, this would give us some idea regarding corporate values (as held by the executives). A study[8], in which 65 large companies in the Indian private corporate industrial sector responded and in which 45 per cent of the respondents had their objectives explicitly defined, indicated that "growth" and "maximisation of profits" were the most valued objectives in terms of the strength of the responses and the priority (or preference) accorded. 92 and 75 per cent of the companies respectively held "growth" and "maximisation of profits" as one of their objectives. 64 and 33 per cent of the respondents respectively gave "growth" and "maximisation of profit" as their first ranking objectives. As many as 39 per cent of the companies gave "maximisation of profits" objective as their second preference. Supply of quality products, employee satisfaction and other objectives like increasing returns to shareholders, employee and community welfare, funds management etc. were polled by 58 per cent, 50 per cent and 42 per cent respectively. It is interesting to note that most of the companies accorded these objectives a lower ranking (3rd or 4th rank). Thus growth seems to be the preoccupation or almost an obsession with our corporate managers. Though the finding that only one-third of the respondents gave "maximisation of profits" as their first ranking objective may sound somewhat paradoxical, yet it is quite understandable. Emphasis on growth in itself is an emphasis on long-term maximisation of profits. Growth through expansion in the existing product lines or diversification into new lines of business is considered as a very important means for maximising profits in the long run. It is also quite likely that some companies might have underplayed the importance of maximisation of profits lest they are misunderstood. Unfortunately, with some people maximisation of profits is still a dirty phrase with an unpleasant connotation. A company

maximising profits is considered as a company necessarily following undesirable practices.

The above findings reflect the intended values of the responding corporate managers as reflected in their objectives. One however needs to distinguish between intended values and operating values which may be at variance with each other. One would imagine however that both these values would mesh with each other in course of time if the intended values are held and pursued consistently.

There is another group of values which relates to people and their relationships. Ability, ambition, skill, loyalty and trust may be considered to be very important as they are often connected with success. This set of values describes a person's individual characteristic and the way he carries out his tasks. Another set of values related to relationships among people is concerned with values like cooperation and aggressiveness. Though both these values may seem inconsistent and self-cancelling, yet the managers usually have to have both these at the same time. A manager needs aggressiveness in advancing the interests of his company, and cooperation with those within the company or outside who can contribute to getting goals accomplished. Without both these values a manager may not be fully successful in the long run.

Values like tolerance, compassion, willingness to take risks, willingness to change, delegate and trust subordinates, in a large measure, percolate from the upper levels to the lower levels. If senior managers display these characteristics in their managerial behaviour in dealing with their subordinates, such a behaviour is emulated and imbibed by the rank and file.

Activity 4

a) Enumerate the values the organisation in which you are working or with which you have been associated cherishes in order of priority or preference:

1)

2)

3)

4)

5)

b) The above were the values intended by the organisation. Are the values in actual operation different from the ones intended by the organisation. Mention these operating values (in order of priority).

1)

2)

3)

4)

c) Which values are encouraged by the organisation in so far as the people and their relationships are concerned.

Values	**Rank (in order of Importance)**
1)	
2)	
3)	
4)	

5.7 TOP MANAGEMENT AND STRATEGIC STYLES

In the previous unit you had noted that from the standpoint of involvement in the strategic management process, the BODs may vary widely on the continuum. A similar situation can also be observed with regard to top management's involvement

in strategic management. Often, it will be observed that functionally oriented top management tends to have a low involvement in strategic management. It will focus more of its energies on day-to-day operating problems. This type of top management is likely to have a dominant CEO who continues to identify with his old functional unit. In contrast to this a top management group with high involvement with strategic matters will be active in long range planning. It will try to involve functional or unit managers in forward planning so that it will have more time to scan the environment for challenges and opportunities.

Both BODs and top management can be placed on a matrix to reflect four basic styles of corporate strategic management. These styles can be depicted in Figure 5.1.

Figure 5.1 : Strategic Management Styles

DEGREE OF INVOLVEMENT BY TOP MANAGEMENT

High	Entrepreneurship Management	Partnership Management
Low	Chaos Management	Stipendiary Management
	Low	High

DEGREE OF INVOLVEMENT BY BOARD OF DIRECTORS

(Adapted from Wheelan, Thomas. J. and J. David Hunger. *Strategic Management and Business Policy*. Addison-Welsey, 1983. p. 61)

Partnership Management

The most effective style of strategic management, probably, is the partnership management which is characterised by a highly involved board and a highly involved top management. The board and the top management team work closely to establish mission, objectives, strategies and policies. Board members are active in committee work and provide useful feedback to top management on its actions in implementing strategies and policies. Many successful corporations owe their success to this style of managing corporate strategy.

Stipendiary Management

Stipendiary management occurs when the BODs is deeply involved in strategic decision making but the top management is primarily concerned with operations. Though a rare form, this style evolves when a Board is composed of key shareholders who refuse to delegate strategic decision making to the CEO or the President. In such conditions CEO in fact is working as a COO (Chief Operating Officer). He can do only what the board allows him to do. In some cases the board may be so involved in management that CEO has even to take the permission from the board for using a particular paint and a particular colour for offices.

Entrepreneurship Management

The company with an uninvolved Board of Directors but with a highly involved top management has entrepreneurship management. The Board allows itself to be used as a rubber stamp by the top management. The CEO, with or without his team of other top managers, dominates the company and its strategic decisions. Whatever the CEO desires and whatever changes he wants to initiate are fully endorsed by the board and nobody raises an eyebrow.

Chaos Management

When both the Board of Directors and top management have little involvement in the strategic management process, their style is referred to as chaos management. The Board and the top management are both inactive in initiating new strategic decisions. They keep on looking at each other for initiatives. The top management is operationally oriented and suffers from the hangover of the past. They continue to carry out strategies, policies and programmes initiated or started by the founding father who died years ago. The basic philosophy seems to be, "if it was good enough for GDB, it is good enough for us". Virtually, there is no strategic management in

the company worth the name. In a competitive environment, companies with this strategic management style often perform poorly and lag behind in the race for success. In the long run they often get pushed to one of the back seats.

Activity 5

Examine the relationship that has existed between the Board of Directors and the top management over the five years in the organisation in which you have been working or with which you have been associated. Identify this relationship in terms of the four styles of strategic management discussed in the above section. Do you expect any change to occur in this relationship in near future?

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5.8 SUMMARY

In this unit we discussed what constitutes top management. It is easier to identify persons belonging to top management by reviewing the functions usually performed by them. An attempt was made to present the tasks traditionally performed by top managers. Though the views on relative importance of different functions of top management differ, yet there is a good deal of agreement on what tasks top managers perform. Providing direction, setting vision, and setting standards are the three main tasks performed by top managers who are also known as general managers. Different authors have given different views on specific functions performed by top management. We described some of these views. Next, the skills required to effectively perform top management tasks were identified. The values held by top (general) managers in a large measure reflect the values of the body corporate. The broad objectives pursued by a business enterprise and the priority assigned to these objectives may give some idea about its corporate values. Values also relate to people working within the enterprise and their relationships, e.g., loyalty, trust, cooperation and aggressiveness. If senior managers set an example by imbibing and practising certain values consistently in their conduct, this has a permeating effect on the junior or subordinate staff.

The strategic involvement of top management may vary from company to company. While in some companies, the board of directors may be more involved in strategic decisions, in others the top management may be more active. From the standpoint of the relative involvement of BODs and top management in strategic affairs, we identified four types of combinations, viz., partnership management, stipendiary management, entrepreneurship management, and chaos management.

5.9 KEY CONCEPTS/TERMS

Chaos Management

Creative thinking

Decisional role

Directing

Entrepreneurship Management

Informational role

Interpersonal role

Partnership Management

Standard setting

Stipendiary Management

Succession planning

Vision setting

5.10 SELF-ASSESSMENT QUESTIONS

1 Who is the Chief Executive Officer (CEO) of the company? Discuss his role. How important you think his role is? Cite some real life examples of which you might be aware in support of your answer.

2 What are the main tasks of top management? Describe briefly some functions top managers perform. Rank these functions according to your priority.

3 Which skills are required of top (general) managers? Briefly explain.

4 What do you understand by "Corporate Values" and why they are important? How would you judge the values of a particular corporate entity?

5 What are the four basic styles of corporate strategic management? Explain briefly.

5.11 FURTHER READINGS

Christensen, C.R., et al, 1987, *Business Policy: Text and Cases,* Sixth Edition, Irwin:

Drucker, Peter F., 1981, *Management: Tasks, Responsibilities and Practices,* Allied Publishers Private Ltd: New Delhi.

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NOTES

Uttar Pradesh
Rajarshi Tandon Open University

MBA-3.1
Corporate Policies and Practices

Block

3

SWOT ANALYSIS

UNIT 6

Environmental Analysis 5

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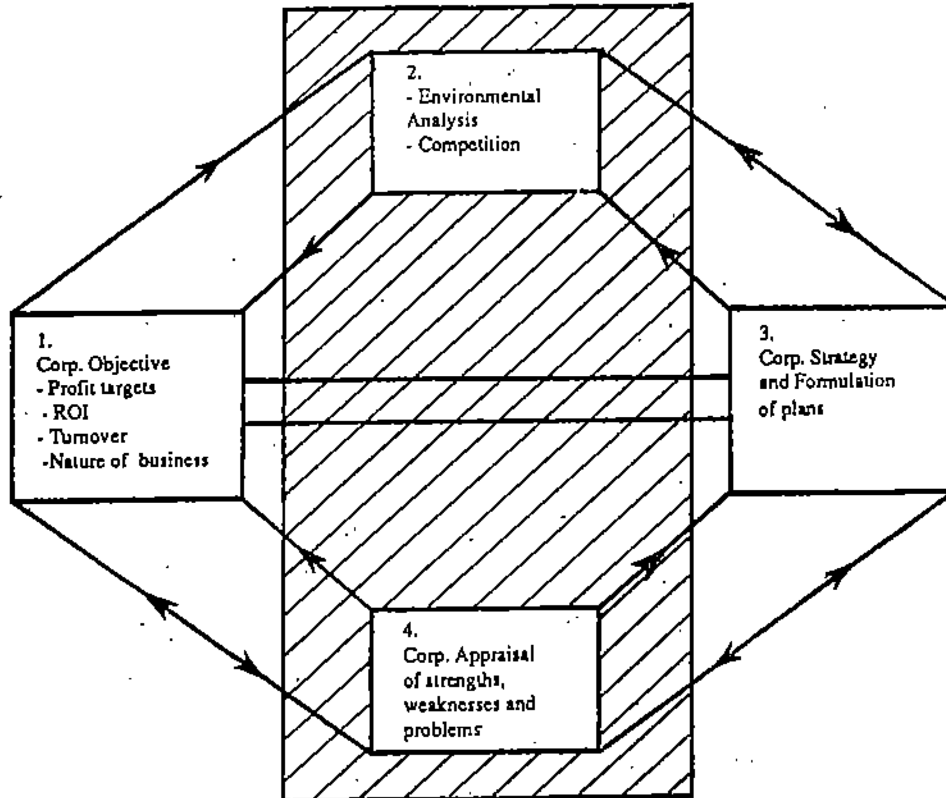
Internal Corporate Analysis 32

BLOCK 3 SWOT ANALYSIS

The strategic planning process can be seen as a four step iterative exercise as shown below:

The Total Planning Process



In this block, our concern would be with Cells 2 and 4 of the above Exhibit, i.e., **environmental analysis, competitive analysis and analysis of corporate strengths and weaknesses.** This kind of analysis is also known as SWOT analysis, i.e., analysis of Strength, Weaknesses, Opportunities, and Threats.

This block is divided into three units.

Unit 6 deals with environmental analysis. The environment is classified into various types and components. How to assess the impact of opportunities is discussed and the utility of certain matrics is explained.

Unit 7 is concerned with analysis of competition. The importance of competitive analysis is highlighted. Various approaches to underlying competition in general and immediate competitors in particular are explained. This is followed by a discussion of the ways and means by which a firm could gain a competitive advantage.

Unit 8 deals with internal analysis of a corporate entity which is usually done in terms of its strengths and weaknesses. How do we determine strengths and weaknesses, how do we measure them and how do we identify them are explained. In what ways we can match the strengths and weaknesses is also discussed. Lastly the concept of synergy is explained.

UNIT 6 ENVIRONMENTAL ANALYSIS

Objectives

After reading this unit you should become familiar with:

- taxonomy of the environments
- constituents of 'Mega' and 'Micro' environments
- methods of identifying environmental threats and opportunities
- methods of analysing the impact of environmental threats and opportunities.

Structure

6.1 Introduction
6.2 Environmental Threats and Opportunities: Definitions
6.3 The Environment: A Taxonomy
6.4 The Environment: Constituents and Impacts
6.5 Assessing the Impact of Opportunities
6.6 Summary
6.7 Key Concepts/Terms
6.8 Self-assessment Questions
6.9 Further Readings
Appendix 1
Appendix 2

6.1 INTRODUCTION

No organisation operates in a vacuum. It derives its existence from the environment. The formulation of corporate strategy, the identification of its business mission and purposes are largely governed by the top management's views of environmental opportunities and threats. A number of forces and factors combine to form an opportunity or threat. Scanning the external environment thus becomes a prerequisite in any strategic decision. In your MS-3 package (Economic and Social Environment), you had an exhaustive exposure to the mega environment of an organisation. In this Unit our focus is on individual organisation and its interface with the external environment. Though the discussions are biased towards business organisations, conceptually, however, these would also be relevant for non-business organisation.

6.2 ENVIRONMENTAL THREATS AND OPPORTUNITIES: DEFINITIONS

Kotler defines environmental threats and opportunities.

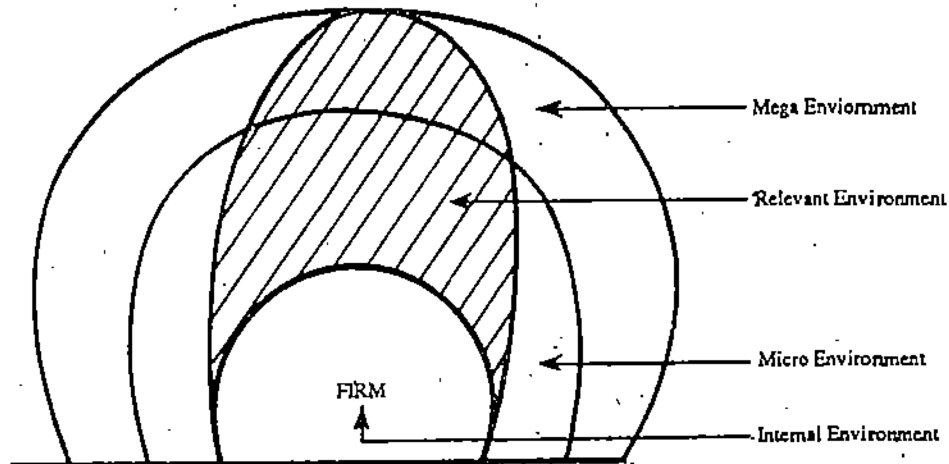
Environmental Threat: An environmental threat is a challenge posed by an unfavourable trend or development in the environment that would lead, in the absence of purposeful action, to the erosion of the company's position.

Environmental Opportunity: A company's environmental opportunity is an attractive arena for company's action in which the particular company would enjoy a competitive advantage. A message which emerges from these definitions is that the threats and the opportunities are to a large extent functions of managerial viewpoint and action.

6.3 THE ENVIRONMENT: A TAXONOMY

Our purpose, from the perspective of Corporate policies and practices, is to identify opportunities and threats present in the environment. It may therefore help if we can project the total environment into three segments. We would call these classes: (i) Mega Environment (ii) Micro Environment and (iii) Relevant Environment. Exhibit 6.1 provides a graphic view of this classification.

Exhibit 6.1: A Taxonomy of the Firm's Environment



You will notice that the 'mega' environment, skirts the 'micro' and the 'relevant' environments.

The Mega Environment

The major constituents of mega environment are technological, social, political and economic environments. These environments can further be classified into international, regional, national, etc. Thus, depending upon the situation, an analyst may refer to the global economic environment, the regional political environment or the national social environment. The trends in mega environment, from the viewpoint of a company, have long-term implications.

The Micro Environment

This environment has a substantial impact on an organisation's current business. Consequently, developments in micro environment become the dominant preoccupation of the management for strategic decisions. The constituents of the micro environment are competition, suppliers, customers, financial institutions, regulatory organisations and channels of distribution, etc. To a large extent, 'micro environment' is similar to what economists describe as industry environment, e.g., 'soft drink industry', 'textile industry', 'computer industry'.

The Relevant Environment

As indicated earlier our primary focus is on the business firm e.g. BHEL, TISCO, L&T, ITC or TELCO. A firm like L & T for instance has a diversified product mix which includes product lines like machinery for cement plants, electrical switchgear, material handling equipment, machinery and equipment for dairy plants, computer peripherals and so on. Each product line belongs to a specific industry implying many micro environments; one for each specific industrial group. However, due to limitations of range and specifications, entire micro environment of an industry may not be relevant for each of its specific product lines. Similarly, at the 'mega' level, in spite of being an engineering company, it may find only a limited portion of 'mega environment' relevant to it as compared to another engineering unit like BHEL. Equally important to recognise that all those opportunities which may exist in mega and micro environments may be beyond the capabilities of one organisation like L & T, BHEL or TELCO.

In this sense, a firm has to restrict the scope of its search for business opportunities as well as safeguard against threats present in what we would call a 'relevant environment'. It should, however, be kept in mind that environmental changes are frequent and unpredictable. No firm or organisation can ever assume the environment to remain static throughout its life. Thus, over a period of time, both micro and relevant environments may change for a firm along with the changes in the mega environment. By now you should begin to sense that though all firms operate within same mega environment, yet each firm operates in an environment which is unique to itself. No two firms, unless they are mirror images of each other, would ever have the same 'relevant environment'. As a student of corporate strategy you should also begin to appreciate the strategic importance of defining

a firm's 'relevant environment' as on it rests the most fundamental question for any organisation: "What business we are in and what business we want to be in?"

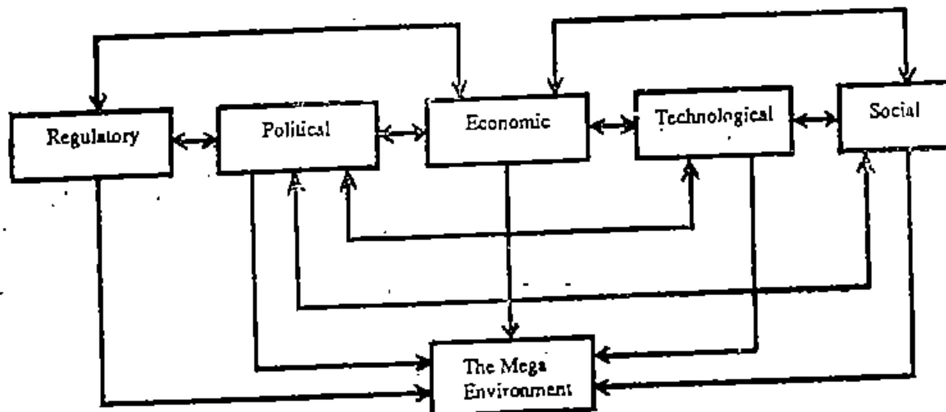
6.4 THE ENVIRONMENT: CONSTITUENTS AND IMPACTS

In this section, we will discuss in some more detail the constituents of environment and their impact in terms of opportunities and threats.

The "Mega" Environment

Traditionally the constituents of the 'Mega Environment' have been social, political, economic and technological. Over a period of time, authors have added areas like knowledge/information, regulations, and geographic considerations as constituents of the mega environment. Exhibit 6.2 provides the conceptual framework.

Exhibit 6.2: Constituents of the Mega Environment



Technology

From the viewpoint of corporate strategy, as stated by Andrews, technological developments not only the unfold fastest but they are the most far-reaching in expanding or contracting opportunities for an organisation. There is no evidence of decline in the pace of technological advances which have ubiquitous impacts on all the constituents of the environment. An idea of this pervasiveness and rapidity of developments can be had from a few examples. The overwhelming majority of all materials consumed today in our daily lives has been developed within the present century. This proliferation and rapidity of product development is not limited to an industry like electronics which is subject to rapid obsolescence, but has extended even to stable industries like food and textiles. It is being speculated that the future is likely to see more inventions and faster pace of technological developments. According to some authors this will occur due to the presence of a large number of scientists and engineers in the decades ahead. Way back in 1963, Bright had identified seven major areas for technological advances:

- Increased transportation capability
- Increase mastery over energy
- Increased ability to extend and control life and serviceability
- Increased ability to alter characters of materials
- Extension of man's sensory capabilities
- Growing mechanisation of physical activities
- Growing mechanisation of intellectual processes.

Most of the above have become realities in the affluent and developed economies. In India, however, the pace and impact of technological developments which have so far been comparatively slow are likely to pick up in the next decades. Increasing popularity of personal computers, industrial electronics, electronisation of telecommunication systems are a few examples.

The Indian government's new "technology missions" is likely to heighten the impact of technology in India in recent years. These missions are:

- Providing drinking water

- Promoting literacy
- Stepping up child immunisation
- Hiking up production of oil seeds, and
- Linking remote rural areas with the country's telecommunication network.

An intelligent corporate response to the ever increasing technological advances should be entrepreneurial rather than reactive. This would require a different outlook and risk-taking capabilities. Failure to do so may have serious implications on survival and growth. Thus, failure to modernise and include in its product-mix the clothes made from man-made fibres have been identified as the major reasons for the decline and sickness of the textile industry in India. It is, therefore, important that certain minimum technological considerations should always incorporated in the environmental analysis for strategic decisions.

- Future Form of Product Group
- Future Processing Technology
- Future Form of Raw Materials
- Technological Developments in unrelated Areas
- Stages of Technological Development in terms of invention, innovation and diffusion.

The Social Environment

Unlike technology, changes in social area occur gradually and not overnight. Further, it is not easy to predict the timing as to when changes in the social environment would have substantial impact on the corporate strategy. Unit 2 of MS-3 provides a comprehensive view of the socio-cultural environment. Some areas where social changes may have strategic implications especially for business in the foreseable future are:

- Population on Demographic characteristics
- Pace of urbanisation and its impact on Family and Societal values
- Spread of literacy
- Health and its impact on average life
- Income distribution
- Social values and expectations from business
- Ethical standards.

Social values play a preminent role in strategy and policy formulation of any firm. Since organisations exist in society, they must modify or change their goals as society demands. Unfortunately, instead of conforming to the desired values of the society, the general ethical standards in our country are falling rapidly. This has led J.R.D. Tata, Chairman, Tata Sons to comment as follows[1]:

> The fact remains, however, that under economic, political and other pressures, the general ethical standards in our country have been falling rapidly in recent years and tax evasion, giving and taking bribes, the widespread use of black money and other anti-social devices are corrupting the whole fabric of our society. Unless, we find a way, and soon, to clear the Augean stables in which we wallow today, there will be one day such a public outrage as to lead to the kind of chaos and revolutionary action as has overwhelmed so many other countries and, in the process, snuffed out individual freedom and democracy.

Such practices lower ethical standards and generate severe pressure and frustrations for the honest, law abiding, socially conscious and conscientious bussinessmen. They challenge the basic tenets and long cherished values of honest business men. The dilemma is whether to use unethical means for business gains or stand by the values and lose the business. As can be sensed, lower ethical standards can become a threat to a business organisation which wants to be honest.

Besides ethical standards, other factors like population characteristics, attitude of people, income distribution, spread of literacy also throw up newer opportunities and threats. Thus, increased concern for health is opening up newer opportunities for service organisations like health parlours, 'yoga centres', and the like. Similarly, the fact that nearly 50% of our population is below twenty years of age provides tremendous opportunities for products and services of use to youth and children.

The Economic Environment

Continuous monitoring of the economic environment is a pre-condition for any strategic decision. A close look on some commonly used economic indicators like GDP and its

growth rate, proposed planned outlays, capital output ratios, money supply, balance of trade between imports and exports, movement of wholesale and retail prices, interest rates, per capita income and its growth can give a good idea about the health of the economy. Today, there are several organisations which are involved in analysing and publishing information relating to the Indian economic environment. Some of the sources on economic environmental trends, information and views are mentioned in Appendix-2. What is important from the viewpoint of an organisation is to collate the relevant information which may aid in the identification of opportunities or threats. The environment of a developing country like India is full of opportunities which to a large number of people might appear as problems. With entrepreneurial courage these problems can be converted into opportunities. The last decade has seen the emergence of new entrepreneurs who virtually had no business background. The *India Today* in talies issue of October 31, 1987 makes an interesting readings of these new multimillionaires. In India, a critical aspect affecting strategic choices relates to the government's economic policies and regulatory mechanisms. The model of mixed economy had its root in the desire to make a welfare state. It reserved certain areas for government organisations and also restricted entry of big and large business houses in certain areas. These restrictions and reservations constraint the flexibility and choice for strategic decisions, and may prevent business from becoming efficient and effective.

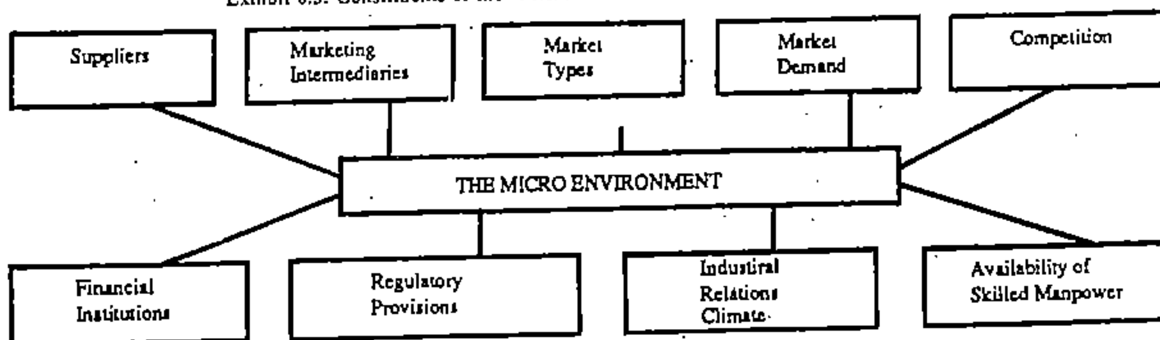
The Political Environment

At this point of our discussions, you might begin to feel uneasy due to the overlapping of the issues. What appears to be a political issue may essentially be economic and vice-versa. This should not worry us so long as we are able to decipher the total impact of a trend or development in terms of threats and opportunities of the external environment. To us the precise semantical classification is not as important as is ability to comprehend the complexities of the exercise in environment scanning. Political environment, for a country like India starts from our constitution, the directive principles, the fundamental principles and the democratic process to maintain a parliamentary form of government. But from the viewpoint of a business organisation, the regulatory and legal provisions which after its day-to-day as well as long-term operations are perhaps more relevant than the provisions fine prints in the constitution. In Unit 3 of Block 1 of MS-3 you had a fairly good exposure to the Politico-legal environment of India. We would not repeat all this. For a corporate strategist what are more important are the actions of the functionaries of the political system rather than the provisions of the written laws and constitutional provisions.

The "Micro" Environment

Some important constituents of the "Micro Environment" are shown in Exhibit 6.3

Exhibit 6.3: Constituents of the "Micro Environment"



In our discussions on taxonomy, we had explained micro environment as having substantial impact on the present business of an organisation. "Competition" is an important area from the viewpoint of business performance. Even in India it is becoming an important consideration in shaping corporate strategies. We will, therefore, discuss in detail, the issues related to competition in the next unit.

Here, we will confine our discussions to some areas which affect the micro environment. The analysis of the micro environment will lead to:

- an indication of where opportunities in the industry exist
- a grasp of the major sources of threats to the industry
- an indication of the critical requirements for success in the industry.

We will now discuss the implications of various constituents of micro environment.

Suppliers

Here the "suppliers" would include all business firms and individuals who provide resources like raw material, components and parts, machinery, expert services, fuel, electricity, i.e. basic inputs which help in the production of goods and services. A ban on the mining of limestone in Dehradun-Mussoorie hills created problems for certain lime users who, based on the specification of such high quality limestone had installed plants and machinery. Dependence on single source for supplies always poses threats to continuous production. The acute power shortage and shortages for long periods in many states in India have become a major threat to industrial units. Likewise, high cost of power can become a major disadvantage for aluminium plants.

Till the recent past, in a shortage economy like India, a firm which had control on the regular flow of supplies also had a major strategic advantage over its competitors. To obviate the threats from an upcoming competitor, some large marketers have used their purchasing muscle to prevent their competitor receiving supplies regularly and at competitive rates from their existing suppliers. Similarly, proximity to supplies can also be a big strategic advantage. In short, a firm's management of the inflow of inputs determines the areas of threats or opportunities.

Marketing Intermediaries

Primarily, marketing intermediaries include distribution channels, physical distribution firms like transporters, marketing services agencies like advertising and marketing research firms. Some fifty years ago, the non-availability of right channels, persuaded tea companies to have their own depots in remote areas. This helped in deep and wide penetration of the market. But over a period of time, with the development of infrastructure, this way of direct distribution has become very uneconomical. A big managerial challenge therefore is to reduce the strength of this large sales staff. Limited retail outlets are becoming a serious threat to a large number of new and unknown brands. On the other hand, an old and loyal distribution system of a company like Hindustan Lever, gives it a tremendous advantage to distribute its products. Even though not permitted by law, firms with strong market positions prevent their dealers/distributors from dealing with competing brands. Absence or presence of marketing intermediaries can become both an opportunity or a threat for a firm.

Market Types

Conceptually the markets for goods and services can be one of the following customer markets:

Consumer Markets: Individual and households that buy goods and services for personal consumption.

Industrial Markets: Organisational customers which buy goods and services for producing other products for the purpose of making profits or achieving other objectives.

Institutional Markets: Organisational customers who buy goods and services either for their own use or transfer these goods and services to those who need them.

International Markets: Foreign buyers including producers, resellers, government, etc.

Reseller Markets: Organisational customers who buy goods and services for the purpose of reselling at profits.

A large number of products may be purchased by customers belonging to more than one markets. For instance, many household customers may buy goods from resellers. However, certain commodities raw materials, chemicals, like plant and machinery are essentially required by industrial customers. A firm's opportunities and threats would be closely related with the vicissitudes of the markets it depends upon. Relation with volatile markets like high fashion goods would also imply wide fluctuations in the earnings of a firm. On the other hand, association with stable markets may imply slow and steady growth. Linkages with different markets also determine the marketing effort. Failure to recognise this can become a major threat.

Market Demand

Market demand characteristics may also unfold opportunities or pose severe threats. From the viewpoint of corporate strategy, the quantum, behaviour and structure of demand become important strategic considerations in investment decisions and business

performance. **'Quantum'** refers to the sum total of the demand (in terms of rupees and units) that would be purchased in a given period of time. You must have heard statements like: demand for two wheelers is 2 million units in 1988, or demand of ice-creame was around Rs 40 crores in 1987. This is the indication of the market size. **'Behaviour'** refers to seasonality, cyclicality and trends in demand for production. You might have heard executives stating market reaching saturation (indicative of slow to no growth) for product X and market growing at 25% per annum for product Y. The low growth rate may be seen as a threat by some; and faster growth rate as an opportunity. Similarly, seasonal and cyclic situations can make firms vulnerable at times of lean periods. Fertilizers, pesticides, cement, woollen clothes, fans, air-coolers, diesel generators are a few examples. **'Structure'** of demand implies the kind of markets a firm has. Some products like ball bearings are required by both, Original Equipment Manufacturers (OEM)—an example of industrial customers, and also for replacement markets. The total requirement may be 50% for OE and 50% for replacement. On the other hand, 'toys' may have only household customers. Similarly, geographical concentration of customers may mean a different market structure than the one made by an evenly distributed demand over the entire country.

The books on Economics are full of discussions on demand. From the viewpoint of corporate strategy in the Indian context it is important to remember that:

- In case of developing and poor economies the market behaviour for a large number of products is highly unpredictable and unforcastable.
- Inspite of perpetual shortage situations, market sizes are very small. This prevents the Indian entrepreneur from seeking 'scale benefits'. On the other hand, creation of large capacities to avoid shortages, at times, may lead to idle capacity, causing losses for considerable period.
- The life cycle curves of large number of products may have two to three growth phases, before the final maturity of markets is reached. Strategic decisions like expansion or diversification would require a mature thinking distilled over a long period of time.

In short, opportunities and threats would be more a function of the mental frame and outlook rather than statistical records of the past. The old adage 'convert problems into opportunities' may reveal several opportunities. Magnifying problems and threats may mean decay or doom.

Financial Climate

Attractive opportunities in stirring up are caused by entrepreneurial activities availability of easy term loans, easy availability of working capital limits, exemptions and concessions on certain duties and taxes for setting up industries in certain specified areas, incentives for exports and import substitution and availability of funds for modernisation and rehabilitation. A positive climate for rapid industrialisation can be created in a developing country like India, through the policies and provisions of term lending institutions like IDBI, ICICI, and commercial banks like SBI and PNB. The recent consumer loan schemes of commercial banks for durables like two wheelers, TV sets etc. would spurt the demand for these durables. Provisions like these become opportunities for marketers. Absence of these can glut the markets and cause major threat to marketers.

Regulatory Environment

The regulatory environment, at the micro level, varies from industry to industry and also from location to location. You must have heard of the 'excise heaven' which existed in Sikkim and certain north eastern states to promote industrialisation. Similarly, you may be aware of free trade zones like Kandla and Santa Cruz (Bombay) to boost exports. Provisions like these unfold attractive opportunities. The structure of commercial taxes like Sales Tax, Octroi is also an important area of opportunities and threats. Thus, absence of first point sales tax has made Delhi one of the biggest re-distribution centres in the country for a large number of industrial and commercial products. Thus, goods from the factories of Bombay and Madras began to be despatched back to the markets of Bombay and Madras. Some State Governments, in order to promote local industries, also give tax rebates which makes the price of these products attractive compared to the prices of competitors in other states.

Industrial Relations Climate

A peaceful or disturbed industrial climate can make or break an organisation. It has had strategic implications on the corporate strategies of a large number of business organisations in India. The disturbed industrial relations in West Bengal during late sixties led to the flight of industries and stifled growth. Similarly, the hostile labour relations climate of late seventies and early eighties in and around Bombay-Pune belt, affected the performance of the companies. On the other hand, an excellent industrial relations management has helped TISCO to maintain more than 100% capacity utilisation inspite of the old age of the plant. A disturbed industrial relations climate affects both the productivity and the morals of both workers and managers. Peaceful climate can be a major opportunity and absence of it a major threat.

Availability of Skilled Manpower

You must have heard of the high ingenuity of mechanics of Batala and Ludhiana in Punjab. You must have also known about the famous craftsmen of Jaipur producing attractive handicrafts, printed fabrics, jewellery, brassware and paintings. Presence of the needed skills helps a great deal in boosting the economic and entrepreneurial activities in an area. Due to the availability of skilled labour, Agra has become a big source of supplies for shoe uppers, and Calcutta has become a big exporting centre for industrial gloves, leather bags and garments. Howrah belt boasts of its engineering skills; but only 120 km. away, industries in Kharagpur suffered due to lack of skilled labour. Like other factors, the availability of skilled labour can be seen as an opportunity.

6.5 ASSESSING THE IMPACT OF OPPORTUNITIES

So far, we have discussed the constituents of environment and how an issue within these constituents can become a threat or an opportunity. As a corporate strategist, you have to identify the impact of threats or opportunities. Some framework to analyse their impact are suggested in this section.

The Opportunity and Threat Matrics

The Threat Matrix: Exhibit 6.4 shows the threat matrix.

Exhibit 6.4: The Threat Matrix

Seriousness	High (Probability of Occurrence)	Low (Probability of Occurrence)
High	1 Major Threat	2 Moderate Threats
Low	3 Moderate Threats	4 Minor Threats

A company, after identifying various threats, can use its judgement to place the threats in any one of the four cells. Thus, for an aluminium plant erratic availability and high cost of electric power can become a major threat if the probability of its occurrence is high. Placing of this threat in cell-1 would imply strategic decisions like setting up of captive plant or shifting the plant to another location.

The Opportunity Matrix: Similar to threat matrix, we can have an opportunity matrix as shown in Exhibit 6.5.

Exhibit 6.5: The Opportunity Matrix

Attractiveness	High	Low
High	Very Attractive	Moderately Attractive
Low	Moderately Attractive	Least Attractive

A company's success probability with a particular opportunity depends on whether its business strength (i.e. distinctive competence) matches the success requirement of the industry (remember our discussions on the relevant environment). For instance, entry into light commercial vehicles was an attractive opportunity for TELCO in which it had distinctive competitive advantage. A company based on its own assessment and judgement, can place the trends in various cells.

The Impact Matrix

We can also visualise the impact of the trends (opportunities and threats) on various strategies with the help of an impact matrix. This is shown in Exhibit 6.6. After identifying the emerging trends in mega, micro and relevant environments, the degree of their impact can be assessed with the help of an impact scale. The matrix enables us to have a consolidated view of the impact on different strategies which a firm may be following. The strategies may relate to various functional areas (e.g. marketing, production) within a specific business unit or they may relate to overall company for all its business units e.g. diversified company.

Exhibit 6.6: The Impact Matrix

Trends	Probability of occurrence	Impact on Strategies			
		S1	S2	S3	S4
T1					
T2					
T3					
T4					

The Impact Scale

We can use a five-point impact scale to assess the 'degree' and 'quality' of impact of each trend on different strategies. The pattern of scoring can be:

+2 Extremely favourable impact
+1 moderately favourable impact
0 no impact
-1 moderately unfavourable impact
-2 extremely unfavourable impact

We can, like the 'threat' and 'opportunity' matrices, assign probabilities of occurrences for each trend. You would observe that the above frameworks help a great deal in maintaining objectivity towards various developments. You are encouraged to development similar frameworks which may abet objectivity.

A futuristic orientation and an ability to synthesise are two critical requirements for strategic decisions affecting the whole organisation. Now we will do some activities to identify the threats and opportunities, for sharpening our analytical abilities. The first activity focuses on the 'mega' environment while the second on a specific firm situation.

Activity 1

Reproduced in Appendix 1 is one of the several addresses of J.R.D. Tata [Sabavala S.A. and R.M. Lala, Keynote : J.R.D. Tata, Excerpts from his speeches and Chairman's Statements to Shareholders, (Eds.), Tata Press Ltd., Bombay, 1986]. After a careful reading, you should do the following:

a) Isolate the trends in social, political, economic and technological areas.

b) Use your own judgement to assess the probability (you may express it in terms of 'high', 'medium', 'low') of occurrence of these trends.

c) Identify the impact of each trend with the help of an impact scale or threat or opportunity matrix for an industry with which you are familiar with.

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Activity 2

Reproduced in Appendix 2 is the success story of 'Skypak' (The Skypak Story, *India Today*, Oct., 31, 1987). Use your knowledge of the Indian environment in assessing the business 'Skypak' is in; identify the threats and opportunities which the management of 'Skypak' may face in future.

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6.6 SUMMARY

A firm operates in an external environment full of opportunities and threats. From a firm's viewpoint, it is helpful to visualise the total environment comprising mega, micro and relevant environments. Though the 'threats' and 'opportunities' of 'relevant environment' are normally the major preoccupation of a firm; it is equally important to monitor the other two environments. There has to be a continuous distillation from mega and micro environments as they have an impact on the 'relevant' environment. This implies a look beyond the 'relevant'.

As you go along with the other units of this Block, you will realise the importance of 'strategic advantage'. A successful firm distinguishes itself from not so successful firms on its ability to identify opportunities much earlier than others. By analysing and synthesising the threats and opportunities in a systematic manner this can be made possible.

6.7 KEY CONCEPTS/TERMS

Environment Opportunities
Environmental Threats
Impact Matrix
Market Types
Marketing Intermediaries
Mega Environment
Micro Environment
Opportunity and Threat Matrix
Relevant Environment
The Impact Scale

6.8 SELF-ASSESSMENT QUESTIONS

1 Classify the total environment into its various segments. Which segment of the environment, you believe, has the most impact on the organisation?

2 What are the constituents of Mega environment and how are the various constituents inter-related? Why is it important for a business firm to study demographic characteristic of the population and the changes taking place in them?

3 Briefly explain the constituents of the Micro environment of a business firm. What can a firm do, individually and collectively along with other firms, to improve industrial relations climate within and outside in a particular locality?

4 How would you identify the impact of opportunities and threats? Have a conversation with the officials of your organisation concerned with strategy formulation? Identify the strategies decided upon and the trends in the environment for the next few years. Prepare the impact matrix and then interpret and draw some inferences.

6.9 FURTHER READINGS

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APPENDIX 1

India 2030 A.D.
Address at the Special Convocation of the University of Bombay held to confer on J. R. D. Tata, the Honorary Degree of Doctor of Laws (LL.D.), April 10, 1981.

Let us try to visualise through the eyes and hopes of the young men and women of today what the India of 2030 will or might be.

Politically, we may, I think, assume and must firmly intend, that India will adhere to the democratic form of government and ideals it adopted from the start, even though the continuous deterioration taking place in our political life may raise doubts in the minds of some of us. On the economic front, however, there is clearly more than one road ahead, and what we shall find at the end of our journey will depend on the road we choose to take. If it is substantially the same as the one along which successive Governments have led the nation in the past thirty years of planned development, we need only project the rates of economic and population growth and current trends actually experienced to see at the end of that road an India of about one and a half billion people who will earn at best twice what they earn today, and will still be amongst the poorest in the world. Perhaps the poorest, because, by then, other developing countries will have climbed to still higher levels.

Can we believe that our people will patiently accept such a prospect of doom? I for one am convinced that they will not, for the time has long gone when they were ignorant of the conditions of life elsewhere to compare with their own. Thanks to the many media of today, they are well aware of the immensely higher standards enjoyed by their counterparts in other countries and by a minority of their own countrymen in India.

There is surely a limit to the endurance and patience that can be expected from them and is it not reasonable to fear that their frustration and anger would explode and lead to chaos? I submit, therefore, that we cannot possibly follow that same road and must imperatively choose one which will lead us more quickly to higher levels of economic life.

It is often argued that economic progress and the achievement of material well-being should not be the main objective of growth; that in the affluent countries of the West excessive concentration on personal consumption has led to overindulgent, spiritually barren and unhappy societies. That may well be true, but surely in a country like ours,

where the bulk of the people still live in deep poverty and a perpetual struggle for a better life, fear of moral decay due to over affluence would be a cruel excuse for perpetuating their misery.

If we accept then that the quickest possible climb to higher levels of employment and income is an absolute prerequisite of a better and happier life, what are the possibilities of a rate of growth faster than the miserable 1.4% per capita achieved during the past thirty years? Our low per capita income is clearly due to our producing too little for too many. It is therefore equally clear that to increase our per capita income we must not only accelerate economic growth but also decelerate the birth rate which is still about thirty-six per thousand, as against the twenty-five per thousand which twelve years ago the Planning Commission had targeted for 1980. Here then lies the problem of our time. And yet, believe it or not, the total allocation to family planning in the Plant outlay was actually reduced from 1.8% during the Fourth Plan to 0.9% in 1979-80, while the provision in the Sixth Plan is still a mere 1%!

It is to me a matter of dismay and despair to find that this grievous threat to our very survival as a nation is still largely ignored in our country and that most people, including perhaps many of those present in this hall, seem to be reconciled to the inevitability of the continued excessive growth of our population in the belief that there is no practical way to reduce it. Such pessimism is in my view, totally uncalled for.

To start with, the birth rate in the seventies did show a reduction from forty-one per thousand in the sixties to thirty-six in the seventies. If despite that the total population still rose at practically the same rate as in the sixties it was because of a corresponding decline in the death rate.

Secondly, there is growing evidence that the women of India, even the poorest and most uneducated amongst them, have begun to see the benefit of smaller families to themselves and their kin, and are becoming increasingly responsive to family planning when the necessary means and facilities are made available to them.

Thirdly, recent spectacular and accelerating developments in the fields of molecular and microbiology, biochemicals, genetics and allied sciences open up promising new avenues of successful research in the field of fertility control. I therefore urge Government to launch in India a massive programme of concentrated scientific research in that field and call upon foreign science and industry to participate in it.

Fourthly, I believe that a breakthrough could be achieved by exploiting to a much greater extent than up to now the potential of monetary incentives. Sadly, but factually, experience has proved that because of the widespread poverty of our people, such incentives are indeed a potent means of motivating people to submit to the minor surgery involved. Up to now, even such small sums as Rs. 200 have produced appreciable results. A much larger figure might well produce spectacular ones. The present capital cost to the nation of providing to every additional citizen the required minimum of food, goods, services and other necessities has been estimated to be over Rs. 7,000 even at the low levels of present consumption. The cost would be significantly higher in practice in later years.

As the average number of children born per couple in India is known to be at least four, the prevention of one birth today would save at least five more births during the next two generations or so and therefore save a capital expenditure of Rs. 42,000 in today's rupees. An offer of, say, Rs. 2,000, or even Rs. 5,000 per vasectomy or tubectomy would give a very high return indeed.

If in response to such enhanced monetary incentives fifty million births could be prevented in the next five years, our population could be reduced by this means alone by about 300 million by the year 2030. These are obviously tentative figures but they surely justify, I suggest, urgent consideration by Government of the possibility of introducing without delay a major scheme of incentives. The possible inflationary consequences in the short term of such a programme, if it proved exceptionally successful, would in practice be more than offset by the drastically reduced demand in later years.

Better Management for Higher GNP

If we continue at the present rate of our GNP growth at 3.5%, the per capita income of our people in fifty years will be only twice the current Rs. 1,800 per year.

Considering that the average rate of annual GNP growth in the three decades between 1950 and 1980 was well over 8% in Japan and nearly 8% in South Korea, and the economic base already built in India, it would be, I submit, within our power and capacity, with better management and a lower capital-output ratio, to achieve an average growth rate of 6% during the next fifty years.

Such a rate of growth would require India to open its doors more widely to foreign investment, which as we all know, our successive Governments have been reluctant to do, backed by many of our own entrepreneurs, basking happily in a protected market.

There would be little risk and much to gain in allowing foreign capital to contribute to this great adventure of ours. The process would be throughout under the control of our own Government; all the assets and jobs created by it would be Indian; the improved technologies brought by the foreigners would automatically advance our own, and, last but not least, it would release a larger proportion fo our own resources for employment-intensive development, particularly in agriculture and agro-based activities essential to the rapid development of our rural areas.

Even after fifty years of industrialisation, India will remain a country in which the land, the forests, the rivers, the sea and the sun will provide a large part of the national income. In fact, if in these fifty years we take full advantage of our tremendous agricultural potential, we could, apart from feeding ourselves, become a major supplier of food to the world, earning enormous foreign exchange in the process.

To sum up, India has come a long way and has achieved much in the past fifty years: Independence was won in a magnificent and unique struggle; the tragic problems of Partition were resolved; the country was united; democracy was established and staunchly preserved in contrast with many newly-freed countries now under dictatorship.

But despite immense efforts and resources spent on economic development, our people have remained amongst the most deprived in the world owing in large measure to the galloping growth of our population, but also to the restrictive and poorly implemented economic policies followed by our successive Governments. If we cannot do better in the years to come the future will be bleak indeed. We must do better; we must curtail our birth rate, come what may. We must stimulate the growth of our GNP by all possible means and be prepared to shed in the process the preconceived ideas, prejudices and holy cows which have up to now severely restricted growth and initiative at enormous cost to the country.

If we achieve an annual GNP growth of 6% and hold our population down to no more than a billion, both of which I firmly believe we can with determination and the right policies, we could ensure to our people by the year 2030 an annual per capita income of over Rs. 22,000 at present prices, or twelve and a half times what it is today. This, though still only about half of that enjoyed by the people of Europe today, will meet all the necessities of a decent and fruitful life, free at last from want and squalor.

Only then will the youth of today be able to look into the future and see a rainbow in the sky instead of a dark cloud they see today, and at the end of that rainbow not the proverbial pot of gold but a life for themselves and their children in which the tears and poverty which are the lot of most of them today are replaced by happiness and growing prosperity.

APPENDIX 2

A Courier Takes Wing

Cars sometimes matter more than money. And Dilip Mahibal Kulkarni loves cars. He drives around in a Honda Accord, and owns two Peugeot 404s, a Mercedes 230, a Maruti Deluxe and a Maruti Gypsy. He has driven in car rallies, and clearly likes being in the fast lane.

Out of engineering college in 1974, Kulkarni decided that being in someone else's employ was a mug's game: you would always be paid less than your worth. So he went into business, and ran into repeated failure. As an agent for textile exporters, he found the margins too low. Engineering exports were no better. And a unit he set up in Goa to make pilfer-proof caps was shot through with holes because aluminium was in short supply.

Finally, real opportunity presented itself. DHL had just come to India, and Kulkarni was keenly aware of the vital importance of speedy communications. He flew to Singapore, with a friend Dinesh Arya, to persuade DHL's rival Skypak, to strike a deal for India, arguing that "we have no other interests, so we'll give this all we have"

Till two years ago, they worked out of a 500-sq ft Bombay office, and the business was mostly international. No one had realised there was a vast domestic market available. Then Kulkarni and Arya turned inward, opened 20 new offices in the country (in Moradabad, Ujjain, Bhilai and Erode, for instance), and the turnover shot up from Rs 45 lakh in 1983-84 to Rs 15 crore this year. Just five years ago, the business was only Rs 5 lakh.

"And yet, we've just scratched the surface. I tell my people that we're like Columbus, charting a new course," Kulkarni says in childlike excitement. He has had his set-backs in the courier business too, of course: an arrangement to charter four Vayudoot aircraft every night for inter-metro runs — for a nightly bill of Rs 4 lakh — kicked up a storm from rivals and didn't work because, says Kulkarni, Vayudoot missed too many flights and the service became unreliable. But he has recovered from that set-back.

Still only 36, Kulkarni says: "I don't see Skypak merely as a point-to-point delivery system. I look around this immediate function to see what else we can go into." That's straight out of Harvard Business School. So he is already running a Rs 4-crore travel agency, and arranging visas for clients outside Delhi. Using 8,000 sq ft of new commercial space in north Bombay, he will soon provide companies with archives space away from expensive downtown areas. So the millions are now his; and quite clearly, he isn't getting less than what he is worth.

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UNIT 7 COMPETITIVE ANALYSIS

Objectives

After reading this unit you should be familiar with the:

- importance of studying competition
- alternative views on competition
- means of analysing the competitive environment
- ways of gaining and maintaining competitive advantage
- approaches for formulating competitive strategies.

Structure

7.1 Introduction
7.2 Why we need to study competition
7.3 Competition: Some theoretical constructs
7.4 Competitor Analyses: A closer look
7.5 Routes to Competitive Advantage
7.6 Generic Competitive Strategies
7.7 Competition: A Marketing Warfare View Point
7.8 Summary
7.9 Key Concepts/Terms
7.10 Self-assessment Questions
7.11 Further Readings

7.1 INTRODUCTION

One of the important considerations in formulating corporate strategy is the competitive advantage. As mentioned by Ansoff, unless a firm has a "Competitive Advantage" it will fail to achieve its goals of market share and profitability. For years, Indian economy has been plagued with shortages. Whosoever had the capacity had the market. The Indian firms which have operated for long in sheltered environments have now to gear up to operate in the competitive environment. This requires a new set of competencies and outlook. In this section we will discuss the issues related to the understanding of and gaining competitive advantage for a firm.

7.2 WHY WE NEED TO STUDY COMPETITION?

Competition implies rivalry between two or more interested parties for similar goals. In business it refers to the drive for the share of market consisting of similar customers. The traditional view of the competition has been around the variables of market strategy like product quality, adherence to delivery schedules, attractive prices and aggressive promotion. This view or knowledge about the performance of competitors on various elements of marketing mix is useful but not sufficient. There is a need to go beyond the 'product-service' offerings to the deep rooted 'whys' and 'hows'.

This would be possible only when we are able to make a conscious attempt seeking answers to some of the following questions:

- What is driving competition in a specific industry?
- What actions the competitors are likely to take in the wake of increased competition?
- How can a firm position itself to maintain competitive advantage in over the long run?

Authors like Ohmae[1] distinguish between 'operational' competitive advantages which may be of short duration, the 'strategic' competitive advantages which enhance and ensure long term profit potentials. At the level of corporate strategy, our emphasis will be for 'strategic competitive advantages'. This calls for a comprehensive and wholistic approach. This is possible only if we have a sound theoretical and conceptual understanding of forces and factors creating the competitive environment. This also requires a different frame of mind and deeper insights. An excellent illustration of the practical application of strategic competition is Henderson's comparison of Japan and the U.S.A.[2]

The difference between Japan and the U.S. deserve some comparative analysis. There are lessons to be learned. These two leading industrial powers came from different directions,developed by different methods and followed different strategies.

Japan is a small group of islands whose total land area is smaller than a number of our 50 states. The U.S. by comparison is a vast land.

Japan is mountainous with very little arable land. The U.S. is the world's largest and the most fertile agricultural areas in a single country.

Japan has virtually no energy or natural resources. The U.S. is richly endowed with energy, minerals and other vital resources.

Japan has one of the oldest, most homogeneous, most stable cultures. For 2,000 years or more, there was virtually no immigration, no dilution of culture or any foreign invasion. The U.S. has been a melting pot of immigrants from many cultures and many languages over one-tenth the time span. For most of our history, the U.S. has been an agrarian society and a frontier society.

The Japanese developed a high order of skill in living together in co-operation over many centuries. We Americans developed a frontier mentality of self-reliance and every man for himself.

The evolution of the U.S. into a vast industrial society was a classic example of natural competition in a rich environment with no constraints or artificial barriers. This option was not open to Japan. It had been in self-imposed isolation from the rest of the world for several hundred years until Commodore Perry sailed into Tokyo harbour and forced the signing of a navigation and trade treaty. Japan had been unaware of the industrial revolution already well underway in the West. It decided to compete in that world. But it had no resources.

To rise above a medieval economy, Japan had to obtain foreign materials. To obtain foreign materials, it had to buy them. To buy abroad required foreign exchange. To obtain foreign exchange exports were required. Exports became Japan's lifeline. But effective exports meant the maximum value added, first with minimum material and then with minimum direct labour. Eventually this led Japan from labour intensive to capital intensive and then to technology intensive businesses. Japan was forced to develop strategic business competition as part of national policy.

You must have noticed Henderson's use of the terms 'natural competition' for the U.S.A. and 'strategic competition' for Japan. This is an important distinction. Natural competition implies survival of the fittest under given circumstances. It is growth for growth sake. Strategic competition aims to achieve what we want to achieve. In subsequent section we will discuss various issues which may help in moving towards strategic competitive advantages.

7.3 COMPETITION: SOME THEORETICAL CONSTRUCTS

Gaining strategic competitive advantage requires a thorough understanding of the forces and the circumstances underwhich they combine and operate. Over a period of time, a number of views have been developed to provide alternative theoretical frameworks. We will discuss some of these in this section.

The Economists' View Point

The economic theory provides useful insights into the nature of industry structure. This, to a large extent, determines a firm's behaviour (belonging to an industry) in market place. Exhibit 7.1 provides the conceptualization of this view point.

Exhibit 7.1: Types of Industry Structure

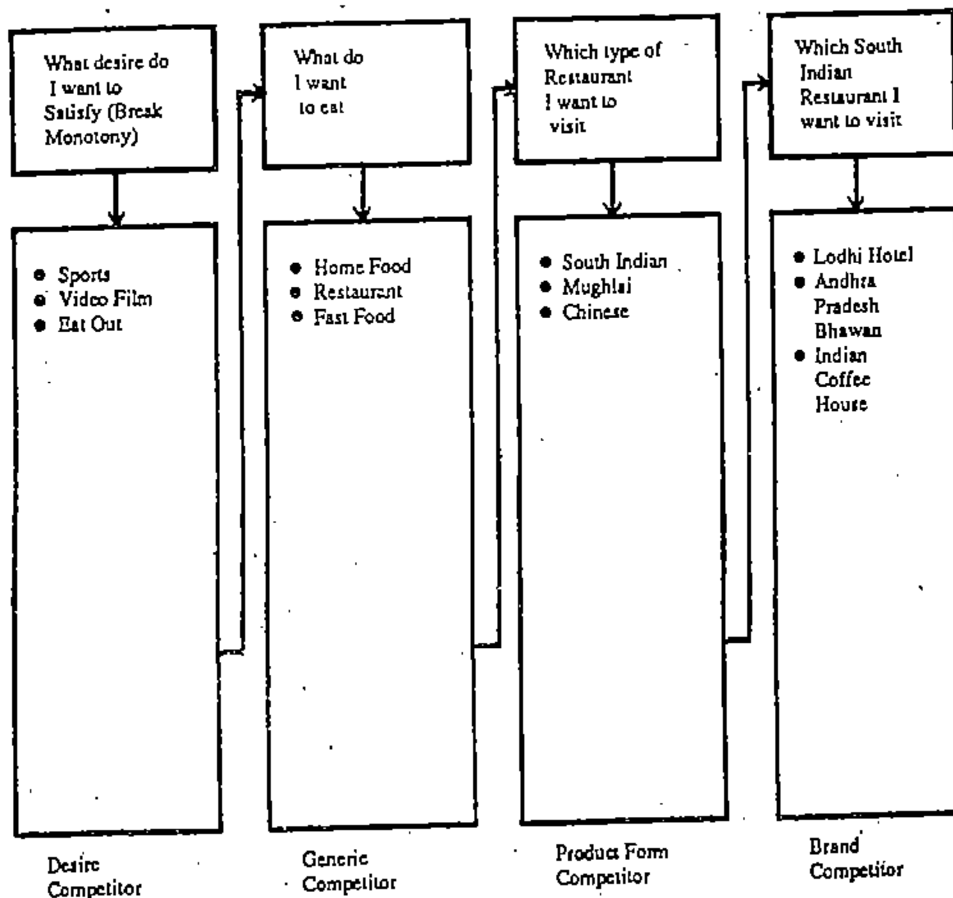
Factor	Perfect Competition	MonopolisticCompetition	Oligopoly	Monopoly
Number of Factors	Many	Many	Few	One
Product Differentiation	No	Yes	Yes	Unknown
Entry or exit	Open	Open	Restricted	Blocked

As you might have observed in a perfectly competitive industry there is a large number of sellers marketing undifferentiable products. In a monopolistic competitive situation there are many sellers, many customers and a differentiated product. An oligopoly situation lies between monopolistic competition and monopoly situations. An emerging trend the world over is that of consolidation and merger of competiting firms leading to oligopolistic situations. In the U.S.A., Auto industry, Beer industry, Telecommunication industry and Airlines industries are a few such examples. Even in India the two-wheeler industry seems to be restructuring into an oligopolistic situation.

The Marketing View-Point

Here, competition is visualized through a buyer's viewpoint. In his drive to satisfy his or her need, a buyer may have many alternatives or choices. For example, if the need is 'entertainment', a buyer may consider choices like visit to park, a social call on friends, a visit to a restaurant, listening to music, going to a theatre, seeing a movie, playing cards, going for a picnic, watching T.V. and so on. In this sense, even though 'physical products' may belong to different industries or technologies, they become competitors to each other to satisfy a specific need or desire. This ubiquitous view can be perceived as belonging to four types of competitors. Kotler[3] has labelled them as 'the desire competitors', 'the generic competitors', 'the form competitors' and 'the brand competitors'. Exhibit 7.2 provides an illustration for a situation where the need is to 'break monotony' at the 'desire level' and terminates into a specific 'brand' situation for a south Indian Restaurant.

Exhibit 7.2: The Marketing View of Competition



In the backdrop of this framework, the South Indian Restaurant owners would be myopic if they focus only on their brand competitors. A challenge to any marketer is to expand the **primary demand** and hence enhance the area of opportunities. To do this, the South Indian Restaurant owners have to be concerned about the trends in the 'eating-out' environment. And this has been done very successfully by some of the South Indian Restaurants in large cities. Having gained a wide popularity amongst a large segment, they have also started offering Non-South Indian dishes and have thus expanded their market size and finally their opportunities.

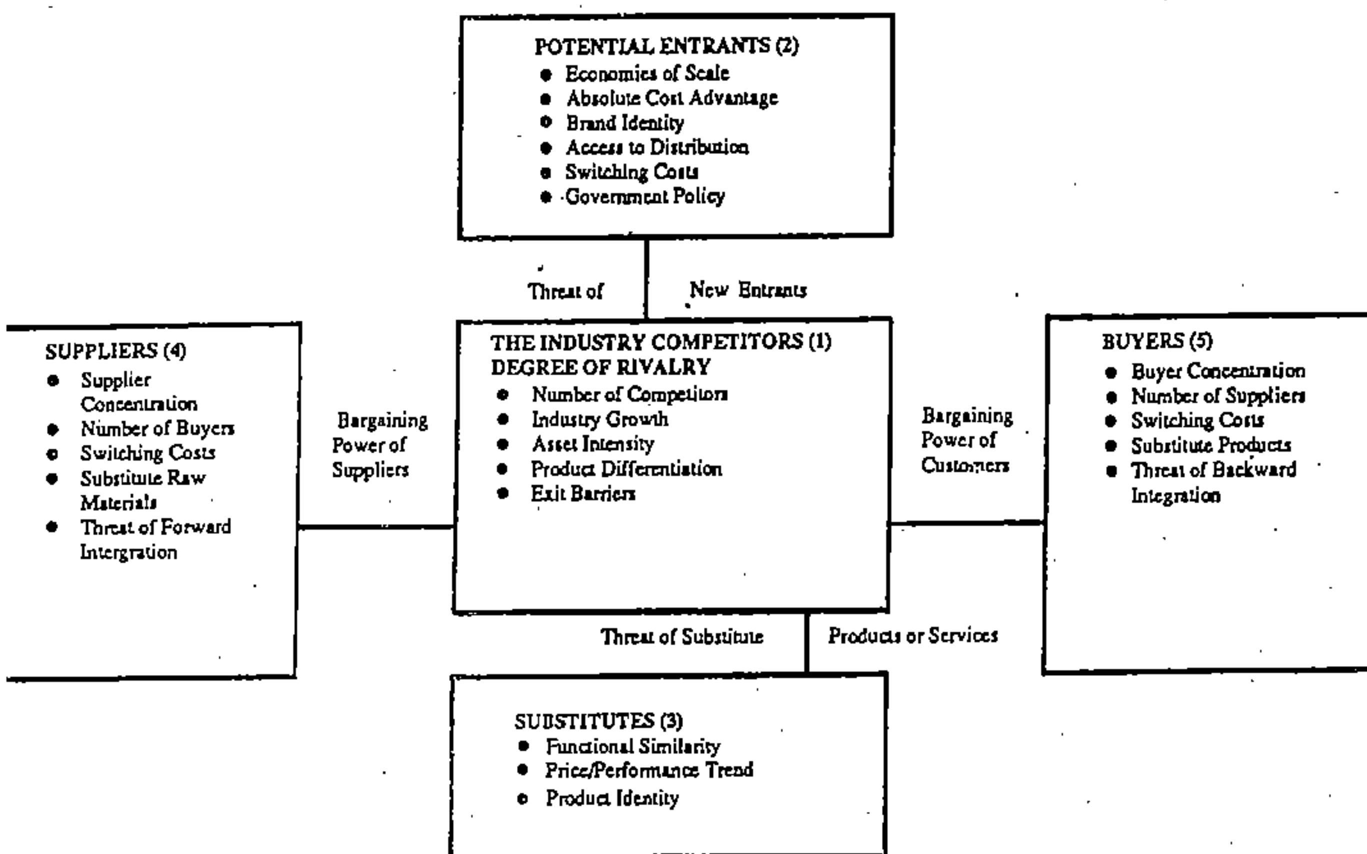
This kind of a view provides a wide terrain to radar the competitive environment. Levit's

classic article "The Marketing Myopia", is an excellent illustration of shifting the focus from product to need to ensure long term survival and growth of a firm.[4] However, this view of competition has certain operational problems.

Porter's Framework to Analyse Industry Structure

Michael E. Porter[5] has developed an excellent and comprehensive framework to analyze the industry structure to develop competitive strategies. According to Porter, the industry structure has a strong influence in determining the competitive rules of the games as well as strategies potentially available to the firm. To him, the competition in an industry is deep rooted in its underlying economic structure and goes well beyond the behaviour of current competitors. The intensity and the state of competition depends on five basic forces which collectively determine the ultimate profit potential in the industry. These five forces are: 1) rivalry amongst the current competitors 2) threat of new entrants 3) threat of substitutes, 4) bargaining power of suppliers and 5) bargaining power of buyers. Exhibit 7.3 provides the details and also identifies the factors within each constituent of this framework.

Exhibit 7.3: Porter's Model of Industry Competition



Industry Rivalry: You may observe that the degree of rivalry among different firms is a function of the number of competitors, industry growth, assets intensity, product differentiation and exit barriers. Amongst these, the number of competitors and the industry growth are the most influential. Industries with high fixed cost are likely to fact price wars in case of stagnant market or over capacity situations. Perceived or real product differentiation dampens rivalry. Similarly, difficulties in exit from an industry intensifies competition. Steel tubes, sulphuric acid, cement are a few products where fixed costs are high and price were are frequent during depressed market situations.

Threat of Entry into the industry by new firms may increase the competitive intensity, especially in matured market situations. During introduction and growth stage, a firm within an industry may welcome entry of new firms as this helps in expanding the market. On the other hand, in matured market situation, barriers to entry can be due to several factors like high capital requirement to seek scale advantage, proprietory technology,

inaccessibility of the distribution network etc. Idlers and rollers needed for conveyor belts for handling materials like coal and iron ore is a good example where low entry barriers led to the entry of large number of small manufacturers. This has intensified competition in the in. stry leading to price wars. Old and established manufacturers are experiencing profit cru ch as the exit barriers for them are high due to large expenses in specialised capital equipment. H T Fastener industry is also facing a similar situation in India.

Substitute Products satisfying similar needs of the same customer group can also intensify competition. Steel tubes are loosing markets to PVC tubes which are nearly one fourth the price of steel tubes but have almost the same life. Similarly,in the field of materials, copper has lost the market to aluminium and plastics have affected the market for steel. Railroads lost their market to automobiles and airlines.

Bargaining Power of Buyers refers to the ability of the industry's customers to force the industry to reduce prices or supply with extra features at the same price. This can usually happen when buyers have choice of substitutes or alternative source of supplies for the same product. Further, high buyer concentration, threat of backward integration and low switching costs add to the power of buyers. A large number of importers, especially in textile garments and leather goods are able to bargain a better deal from exporters from developing countries like India and China.

Bargaining Power of Suppliers is a situation where suppliers can force buyers to pay higher prices and thus affect their profitability. This would happen if a supplier enjoys monopoly like Indian Oil with regard to furnace oil, or where the switching cost of the buyer is very high. The collective strength of these five forces determines the attractiveness of an industry. The strongest forces which affect the profitability become the focal points in strategy formulation. In India, firms like TISCO and TELCO had rightly identified the threats due to shortages of raw materials and components. A series of timely backward integration decisions helped them maintain competitive advantages.

Activity 1

a) Consider a firm (like DCM, L&T, BHEL) you are very well familiar with.
b) Examine the industry and competitive structure for this firm along all the five forces of Porter's model. For each force as you must have noted, Exhibit 7.3 provides various components. You should first examine as to how the behaviour of each component within a force can affect the competitive intensity. With the help of this component analysis you may be able to visualise the aggregate impact of each force more clearly.

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7.4 COMPETITOR ANALYSES: A CLOSER LOOK

The frameworks and views discussed thus far provide a global perspective. For long term survival a firm has to scan the larger environment, and indentify newer opportunities and threats. In the process of strengthening long term profit potential, a firm, at any point of time (except may be in case of government monopoly), has to compete within industry i.e. with firms of similar type, supplying similar products to satisfy the needs of similar target segments. Thus, even though plastics may pose a serious threat to steel, TISCO still has to compete with SAIL. Likewise it has to monitor the developments and the impact of plastics on steel markets, but it may not monitor the performance of Polyolefins Ltd. (PIL) a leading manufacturer of basic plastic raw material as its close competitor. For a corporate strategy in a workable time frame, we need to have a closer look on the immediate competitors. This calls for a knowledge of competitive behaviour of each competitor. This can be done by raising some basic questions like:

- What is their current strategy?
- How are they performing?
- What are their strengths and weaknesses?
- What actions can be expected from them in the near future?

We will discuss each question separately.

Competitor Strategy

A useful way to know and analyse competitor's strategies is to follow the same framework of formulating the corporate strategy as for your own organisation. Thus, some of these could be:

- How is the competitor defining the business in terms of customer groups, customer functions, and technologies and how vertically integrated is he? How is he segmenting the markets and what are his target segments?
- What are his missions for the specific product lines, business units and firm as a whole?
- What are the specific contribution expectations from each product line, business unit and for the total organisation?
- What are the dominant policies for each functional area like production, design, marketing and so on?
- What are his financial resources and how are they being allocated over various business units and business functions?

With the help of the above and similar questions, and attempt can be made to know more competitors strategies.

Competitors Performance

The acutal performance of competitors, should be ascertained with the help of published information in terms of sales, profits, return on investment, market share, cash and cash flow situation. This should be a regular activity rather than a one time or ad hoc activity.

Competitors Strengths and Weaknesses

With the help of a framework, competitors major areas of strengths and weaknesses should be ascertained. Ansoff has suggested one such framework. This is shown in Exhibit 7.4

Exhibit 7.4: Areas of Strengths and Weaknesses

Functions	Facilities and Equipment	Personnel Skills	Organizational Capabilities	Management Capabilities
1. General Management				
2. Finance				
3. R&D				
4. Operations				
5. Marketing (examples)	• Warehousing • Retail Outlets • Sales Offices • Training Facilities for Sales Staff	• Door to Door Selling • Retail Selling • Advertising • After Sales Service	• Direct Sales • After Sales • Service Network • Customer Loyalty	• Industrial Marketing • Household Marketing • Large Customer Base

With the help of Exhibit 7.4, a fairly good idea about strengths and weaknesses of the competitors can be had. This should help in the identification of areas for gaining competitive advantage. The management and performance of organisation can also be analysed with the help of 7-S Framework, developed by McKinsey and Co., a leading consulting firm of USA. You will recall that this model was discussed at length in unit 2. According to this Framework, strategy is only one element that determines the performance.

The first three elements: strategy, structure and systems are considered the 'hard' elements and the next four shared values, skills, staff and style are considered as the 'soft' elements. With the help of this framework a comparative competitor analysis can provide deep insights on the strengths and weaknesses of the competitors.

Competitive Reaction

An analysis of competitors reaction helps in the kind of 'defense' or 'offense' one has to build up. Competitors reactions can be studied at two levels. One is its reaction to the

secular trends and developments in the external environment. This may indicate the kind of company the competitor is keen to become. The other level is to examine a competitor's reaction to the moves and initiatives of the other competitors. A common move is the reactions to the price reduction by one competitor initiates a price war. Immature and weak competitors could succumb to the pressures soon and this would lead to their bankruptcy. The mature and strong competitors may change the battle grounds and avoid competition on price. At the level of marketing strategy, a competitor has four variables: product,distribution, price and promotion. In an oligopoly situation, a small manufacturer can disturb the equilibrium by aggressively promoting almost similar quality product at low prices. In such situations, larger customers, if not careful, get trapped from both the sides: Nirma, Khaitan Fans are classic examples where they have completely changed the competitive structure and also the rules of competition. Large manufacturers which remained indifferent are now fighting the battle on a ground largely unfamiliar to them. Situations like these highlights the importance of developing strategic competition rather a tendency of natural competition which majority of leaders follow. Competitors reactions are likely to be different: a company having a wide product-mix will react differently in a single product for which the performance of the product is a matter of life and death for it. Some practitioners use the term 'competitive muscle' which may be a function of many factors. While analysing and evaluating competitors reaction, it is important to keep the 'muscle' in mind. A 'track record' of competitors' different moves over a period of time may provide good insights to anticipate the future.

Activity 2

Like Hindustan Lever (a multi-product company) and Nirma Chemical Works (a single product company), identify some more 'pairs' of similar companies in India. After identifying these 'pairs' speculate on their moves regarding changes in prices, promotion and products.

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7.5 THE ROUTES TO COMPETITIVE ADVANTAGE

The discussion in this section is mainly based on the book by Ohmae. So far we have discussed the various perspectives on competition and competitor analysis within an industry group. We will now discuss the most critical issue which is at the heart of any corporate strategy namely the issue of identifying and gaining competitive advantage. Ohmae suggested four ways of strengthening a company's position relative to that of its competitors. These are:

i) Intensify functional differentiation (key factors of success)
ii) Exploit competitor's weaknesses (relative superiority)
iii) Ask 'Why-Whys' (aggressive initiatives)
iv) Maximize user benefit (strategic degree of freedom)

Focusing on Key Factors of Success (KFS)

Ohmae suggests that in the event of limited resources, it may be wise to concentrate on key functional or operating areas that are the determinants of success for a particular business. This calls for identifying the key factors of success for a given industry. There are two approaches to identify the KFS. The first is to disect the market as imaginatively as possible to identify its key segments; the other is to discover what distinguishes successful companies from losers, and then the analyze the differences between them.

The key factors for success of different industries may live in different functions, areas, distribution, channels and so on. These can be identified along the various functional activities of business starting from raw material to customer servicing. Exhibit 7.6 provides the key factors for success to increase profit and gain market share for various industries.

Exhibit 7.5: How Success Factors Vary by Industry

Key factor or function....	....to increase profit	....to gain share
Raw materials sourcing	Uranium	Petroleum
Production facilities (economies of scale)	Shipbuilding. Steelmaking	Shipbuilding, Steelmaking
Design	Aircraft	Aircraft, Hi-Fi
Production technology	Soda, Semiconductors	Semiconductors
Product rage/variety	Departmental stores	Components
Application engineering/engineers	Minicomputers	LSI, Microprocessors
Sales Force (quality x quantity)	ECR	Automobiles
Distribution network	Beer	Films, Home appliances
Servicing	Elevators	Commercial vehicles e.g. taxis

Source: Kenichi Ohmae, The Mind of the Strategist: Business Planning for Competitive Advantage, 1983. Penguin books, p.47.

Business history indicates that the "most effective shortcut to major success appears to be to jump quickly to the top by concentrating major resources early on a single strategically significant function, become really good and competitive at it, and then move to consolidate a lead in the other functions by using the profit structure that the early top status has been made possible. All of to-day's industry leaders without exception, began by bold deployment of strategies based on KFS".[6] (Ohmae)

Building on Relative Superiority

A firm can compare its products with that of its competitors in order to identify the product superiority. Operation 'tear down' to compare each and every component in an assembled product like automobiles is commonly used to identify the areas of strengths and weaknesses. The case of Japanese colour film industry as mentioned by Ohmae[7] is an excellent example of building relative superiority:

> An interesting example of relative, superiority is found in the colour film industry. Japan's amateur colour film market is currently dominated by three companies, two of them Japanese: Fuji, which leads the market and Sakura. For the past fifteen years, Fuji had been gaining market share, while Sakura — the market leader in the early 1950s with over half the market — had been losing share to both its competitors. Blind test results showed that the problem was not product quality. Rather, Sakura was handicapped by an unfortunate word association: its name in Japanese means "cherry blossom," suggesting a soft, blurry, pinkish image. The name Fuji, on the other hand, was naturally associated with the brilliant blue skies and white snows of Japan's sacred mountain. Sakura was gravely handicapped by its unfortunate image but all its efforts to overcome the handicap through advertising were of no avail. At length, Sakura turned to analyzing the market from structural, economic, and customer points of view to see whether it could uncover any opportunity to develop a positive competitive advantage. Here is came upon a clue.
>
> What Sakura discovered was a growing cost-consciousness among film customers. Processors of exposed film reported that amateur photographers commonly left one or two frames unexposed in a 36-exposure roll but almost invariably tied to squeeze extra exposures from the 20-exposure rolls. Here was Sakura's opportunity. It decided to introduce a 24-exposure film at the same price as the competitors' 20-exposure film. Its marginal costs would be trivial but its big competitors would face significant penalties in following suit. If they moved instead to lower the price of their 20-frame rolls, Sakura was prepared to do battle. Its aim was two-fold. First, it would exploit the growing cost-mindedness of users. Second and more important, it would be drawing attention to the economic issue, where it had a relative advantage and away from the image issue where it could not win.

Pursuing Aggressive Initiatives

A third alternative route to gain competitive advantage to initiate an aggressive search for improvements is to relentlessly challenge the prevailing assumptions with a single question 'w... till major breakthroughs are achieved. In some business situations a stalemate appears when the older key factors of success no longer hold any competitive advantages. This approach has enabled excellent breakthroughs in products, processes and services. Thus, "a camera manufacturer wondered why a camera could not have a built-in flash that would spare users the trouble of finding and fixing attachment. To ask the question was to answer it. The company proceeded to design a 35-mm camera with built-in flash. It was an enormous success, sweeping the Japanese medium price lens shutter market."[8]

As Ohmae suggests. "the results of this kind of change in the direction of strategic thinking can be speculator. The basis of such an approach is always to confront what is taken for granted in an industry or business with the simple question, 'Why'?"

Exploiting the Strategic Degrees of Freedom

This is the last route, suggested by Ohmae to superior competitive performance. There can be situations where due to operational and resource constraints (time, energy and attention) there may be limited scope for improvements and manoeuvrability in a given key factor of success. The concept of Strategic Degree of Freedom (SDF) helps in tackling such situations to maintain the edge. Ohmae[9] mentions the following case:

> Consider the example of a coffee-making business. Suppose we have determined through market research that the objective function of our target customers is superior taste. What can we do to deliver that? What are the variables that fundamentally determine the taste of a cup of coffee?
>
> When we think about it, there are quite a number: kind and quality of the beans, type of roast, fineness of grind, elapsed time between grinding and brewing, water hardness, water temperature, mode of contact between water (or steam) and ground coffee, temperature at which the brewed coffee is maintained, elapsed time between brewing and drinking and so on.
>
> These are just a few of the variables that can change the taste of a cup of coffee. Some of them, being outside the manufacturer's control, don't qualify as degrees of freedom. Others,such as hardness of water, are conceivably within the manufacturer's power to affect (for example. by incorporating a regenerable filter in the machine) but are conventionally regarded as out of bounds. This means that we are not fully utilizing the degrees of freedom available to enhance the user's objective function, i.e. taste in this case. Instead of continuing to think in terms of the conventional alternatives — Should we make a percolator or a filter pot? Would the users go for glass or aluminium? We ought to look for unexploited degrees of freedom and ask what possibilities they may harbor. Whether A is better than B, or C is better than D, may be the obvious issues — but it is only by going outside of them and looking at K, Q and Z that we will ever hit on a source of real competitive differentiation.

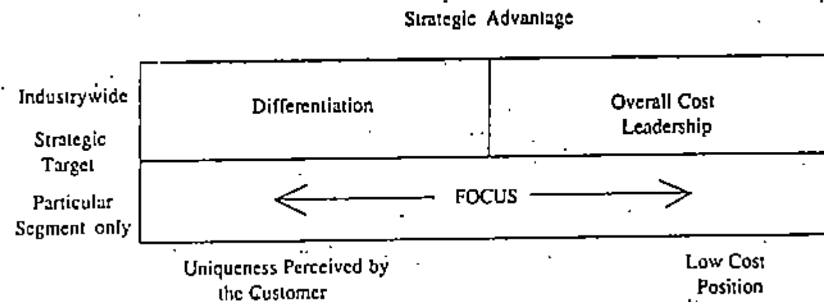
7.6 THE GENERIC COMPETITIVE STRATEGIES

We have earlier discussed Porter's framework to analyze the forces driving industry competition. In order to gain competitive advantage, Porter has also suggested a three generic strategies framework. You may like to compare Porter's suggestions with the four alternative routes suggested by Ohmae, which we have discussed in the previous section. According to Porter, there are three potentially successful generic strategic approaches to cope up with the five competitive forces as well as gain competitive advantage. These are:

- Overall cost leadership
- Differentiation
- Focus

The scheme is shown in Exhibit 7.7

Exhibit 7.6: Three Generic Strategies



Overall Cost Leadership

In this strategy company makes all possible attempts to achieve the lowest costs in production and marketing. The aim is to gain a large market share. Efficiency is the keyword guiding all decisions to keep the costs low. Bajaj Auto Limited and TELCO appear to be following this strategy in India.

Differentiation

Here the aim is to achieve class leadership by creating something which is perceived as unique. It can be achieved by creating highly differentiated products and marketing programmes — like design or brand image, customer service or dealer network, or any other feasible dimension. Companies pursuing this strategy have major strengths in R&D, design, quality control and marketing. Chiragh Din Shirts, Bata Shoes, OTIS Elevators, Cini Fans are some examples where this strategy seems to be the dominant guiding force.

Focus

The underlying assumption in 'Focus' is that a firm should be able to serve a narrow strategic target effectively and efficiently. As a result the firm achieves either differentiation from meeting the need of a particular target segment better, or lower costs in serving the target, on both. 'Genteel', a liquid detergent for expensive clothes by Swastik, and Ponds Talcum Powder are some handy examples for this strategy.

7.7 COMPETITION: A MARKETING WARFARE VIEW POINT

In their recent book, *Marketing Warfare*, Al Ries and Jack Trout have developed a war like analogy for marketing in competitive environment. The competition in the marketplace, especially in affluent and developed economies like U.S.A., Japan, and Western Europe has become very severe. "The true nature of marketing today is not serving the customer; it is outwitting, outflanking, outfighting your competitors. In short, marketing is war where the enemy is the competition and the customer is the ground to be won", say Ries and Trout. They suggest four ways to fight this war by following the principles of:

- Defensive warfare
- Offensive warfare
- Flanking warfare and
- Guerrilla warfare

The Defensive Warfare

This is essentially recommended for market leaders. It aims at protecting against regulatory provisions like M.R.T.P., industrial licensing restrictions,etc. According to authors, a leader has to spend more time in safeguarding its interests against government, social and public environment rather than the immediate next competitor. Thus, for companies like TELCO, Hindustan Lever, Bajaj Auto, the major worry may be the interference with the government. At the same time, a leader cannot afford to overlook the moves of the competitors. TELCO demonstrated its timely move by placing 407, a light commercial vehicle, to check the possibly successful entry of famous Japanese makes in this growing market segment. A leader should also be able to attack itself i.e. drop products which may appear to make the leadership position vulnerable. The three principles of defensive

warfare are: (i) only the market leader should consider playing the defense, (ii) the best defensive strategy is the courage to attack yourself, (iii) strong competitive moves should always be blocked.

The Offensive Warfare

'Offensive' warfare is almost like a mirror image of the defensive warfare. The number twos of the industry are suggested to follow the offensive strategy by identifying a weakness in leaders strength and attacking at that point. Thus, very high prices of steel tubes of Tata Steel gave an opportunity to other pipe manufacturers like Zenith Tubes, Gujarat Steel Tubes and the like to capture sizeable at lower prices. Similarly, a very offensive launch of 'Nirma detergent' has helped it to take away markets both from the market leader and other manufacturers. The principle of 'offensive warfare' are: (i) The main consideration is the strength of the leaders position, (ii) Find a weakness in the leader's strength and attack at that point, (iii) Launch the attack on as narrow a front as possible.

The Flanking Warfare

According to Ries and Trout, 'flanking' is the most innovative form of marketing warfare. Over the years, most of the biggest marketing success have been flanking moves. It is recommended to firms with limited resources. These firms cannot afford to fight the large firms holding number one or two position on the same battleground. The entry of 'Promise' toothpaste with 'clove oil' clout is an example of the flanking warfare in toothpaste market. 'Cini' fans is another excellent example of 'flanking warfare'. Flanking can be achieved in any manner such as flanking with low price, flanking with high price, flanking with small size, flanking with large size, flanking with distribution, flanking with product form.

You would see a parallel between a marketer cutting a 'niche' and flanking. Basically they mean the same thing i.e., creating a distinctive position for itself and avoiding any head on collision with the leaders. The principles of flanking warfare are: (i) A good flanking move must be made in an uncontested area (ii) Tactical surprise ought to be an important element of the plan (iii) The pursuit is just as critical as the attack itself.

The Guerrilla Warfare

The last form is the guerrilla warfare. Most of the players in a marketing war would be fighting in the market place like the guerrillas. According to Ries and Trout, "smaller companies can be highly successful as long as they do not try to emulate the giants in their field." Like flanking form there can be many guerrillas: geographic guerrillas, demographic guerrillas, industry guerrillas, product guerrillas and high end guerrillas.

In each state, for instance, you will find local make suitcases and other luggage items alongwith the well known national brands. Local brands of rubber and plastic chappals are other examples of a low price end guerrillas. Chiragh Din shirts, Metro shoes (both Bombay based organisations) are some examples of high price end form of guerrilla warfare. The principles of guerrilla warfare are: (i) Find a segment of the market small enough to defend, (ii) No matter how successful you become, never act like the leader (iii) Be prepared to bugout at a moment's notice.

Activity 3

You may like to grasp well the concepts of marketing warfare. For this let us take the following steps:

a) List some industries you are well familiar with.
b) Identify down the competitors. Make sure that you have number one, number two and some small organisations. (You may follow the size of the market i.e. the market share as a criterion for ranking positions).
c) Classify the strategy which they appear to be following or have followed in past. You may label it as 'offensive', 'defensive' and so on.
d) Try to ascertain the results of the study in terms of successes or failures.
e) Analyse the reasons for successes or failures and compare them with the 'principles' of various warfares.
f) You should now be in a position to comment as to whether a 'war like' view to analyse

the competition is helpful or not. In other words, critically appraise the suggestions of Al Ries and Jack Trout of using military strategies for the market place.

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7.8 SUMMARY

In this unit our aim was to study competition to seek competitive advantage. To do this we have to do a lot more in terms of theory, frameworks and analytical tools. No one tool can work in all the situations. The discussions in this unit should give you ideas to develop your views and frameworks. You were exposed to a number of concepts and approaches. You may benefit a great deal if you start using these approaches and concepts to communicate your views.

7.9 KEY CONCEPTS/TERMS

- Aggressive initiative
- Brand competitor
- 'Desire' competitors
- Differentiation, Focus and Overall Cost Leadership
- Generic competitors
- Key Factors of Success
- Monopolistic competition
- Monopoly
- Natural competition
- Oligopoly
- Perfect competition
- Product Form competitors
- Relative Superiority
- Strategic Degree of Freedom
- Strategic competition
- 7 'S' Framework of McKinsey and Co.
- The Marketing Warfare
- The Five Forces of Porter's Model
  The Industry, Potential Entrants
  Suppliers, Substitutes, Buyers.

7.10 SELF-ASSESSMENT QUESTIONS

1 Why is it necessary to study competition? Is "strategic competitive advantage" different from "operational competitive advantage?" Discuss.

2 In what way Economists' viewpoint regarding analysis of competition is different from the Marketing viewpoint.

3 Describe Porter's framework for analysis of industry structure. Critically evaluate the framewrok.

4 "If you want to have a closer look at your immediate competitors, you need to fully know their competitive behaviour". How can this be accomplished? Explain fully.

5 How can a business firm gain competitive advantage? When is the concept of 'strategic degree of freedom' helpful in this context?

6 What are the three generic strategic approaches to gain competitive advantage and to cope with the competitive forces as suggested by Porter? Under what conditions would the three approaches be particularly useful? Give examples.

7 Explain the Marketing Warfare viewpoint of competition. In what different ways the marketing war can be fought out? Under what conditions different Warfare strategies would be appropriate? Give examples.

7.11 FURTHER READINGS

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5 Porter, Michael E., 1980, *Competitive Strategy: Techniques for Analysing Industries and Competitors*, The Free Press, A Division of Macmillan Publishing Co., Inc., New York.

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7 Ibid.

8. Ibid, p.59.

9 Ibid.

UNIT 8 INTERNAL CORPORATE ANALYSIS

Objectives

After reading this unit you should become familiar with the:

- Meaning of corporate strengths and weaknesses
- Bases for classifying situations and characteristics into strengths and weaknesses
- Procedures for evaluating the impact of corporate strengths and weaknesses
- Meaning of Synergy.

Structure

8.1 Introduction
8.2 Meaning of Strengths and Weaknesses
8.3 Criteria for Determining Strengths and Weaknesses
8.4 Measuring Strengths and Weaknesses
8.5 Alternative Formats to Analyse Strengths and Weaknesses
8.6 Identifying the Strengths and Weaknesses
8.7 Matching Strengths and Weaknesses
8.8 The Concept of Synergy
8.9 Summary
8.10 Key Concepts/Terms
8.11 Self-assessment Questions
8.12 Further Readings
Appendix

8.1 INTRODUCTION

You will recall that in our discussions on environmental opportunities and threats (Unit 6), we had introduced the concept of 'relevant environment'. We had mentioned that a firm's relevant environment, to a large extent, is a function of corporate strengths and weaknesses. In other words the opportunities which can be successfully exploited largely depend upon corporate capabilities. In our discussions on competition (Unit 7) we had emphasized the importance of strategic competitive advantage which implies that a firm's capabilities, for a given product market situation, should out-perform its competitors. You should, therefore, begin to realise the pivotal role which corporate capabilities play in strategic success. Corporate capabilities, in this sense, become a lynchpin over which hinges the performance and survival of a firm. But identifying and exploiting the strengths and removing the weaknesses is not an arithmatic game of additions and subtractions. It is much beyond the quantifiable numbers like sales, profits, net worth and assets. It is an issue largely linked with one's state of mind and his outlook. Yes, it is a matter of entrepreneurial interpretation. For example, to a large majority of people huge population may be a major weakness of India, but to a few may be a major asset i.e. its strength. In this unit we will make attempts to approach the subject enabling a better perspective on and an entrepreneurial view of corporation strengths and weaknesses. Even at the cost of repetition, it may be a good idea to remember that corporate strategy is ultimately a 'matching game' between environmental opportunities and organisational strengths to gain competitive advantage. The process of assessing organisational strengths and weaknesses is also known as 'organisational audit'.

8.2 MEANING OF STRENGTHS AND WEAKNESSES

Corporate strengths and weaknesses, as stated earlier, are a matter of interpretation. Thus, a large cash reserve may appear to be a strength for a firm, but if it is not invested well it may cease to be a strength. Similarly, absence of own fleet of cars may be taken as a weakness, but if cars are freely available at economical rentals it may cease to be a

weakness. Though, no definition may ever be complete, we would define strengths and weaknesses as follows:

Corporate Strength: It refers to competitive advantages and other distinct competencies which a company can exert in the market place.

Corporate Weakness: It refers to constraints or obstacles which check movement in certain desired direction, and may also inhibit organisation in gaining a distinctive competitive advantage.

8.3 THE CRITERIA FOR DETERMINING STRENGTHS AND WEAKNESSES

A major problem which must be resolved prior to any analysis of corporate capabilities is the criteria that would determine whether an element under examination is a strength or a weakness. Earlier we had mentioned that to a large extent it is 'state of mind' which, determines whether a particular element or situation is a strength or a weakness. Judgment, in this sense, is an implicit ingredient in our analysis. However, this judgment, as you will appreciate, is also a function of the criteria which is used. Four types of criteria have been suggested to classify an element into strength or weakness. These are:i) historical; ii) normative; iii) competition parity; and iv) critical factors for success.

The Historical Criterion

Here, the analyst compares the characteristics under examination with past performances. Thus, sales, profits after tax, capacity utilisation etc. may be compared with those of the past. An improvement over the past performance may be seen as a strength, and a decline, a weakness. Before, arriving at such conclusions, it is always advisable to check the replicability of the 'past' in future. In a large number of situations 'past' may not be valid for future and this would certainly invalidate our assessment or judgment.

The Normative Criterion

Here, the basis of judgment is 'what ought to be' the level of performance to classify a particular element into a strength or a weakness. Thus, based on theory, expert opinion, industry practices or personal opinions, one can develop 'norms' for evaluation. For example 80% capacity utilisation for thermal power plants may be considered a strength and below that, a weakness.

The Competition Parity Criterion

As its basis for judgment, this criterion utilises the action of successful direct competitors or potential competitors. It is based on the premise that a firm must, at the minimum, meet the actions of the competitors. This, if the industry practice of providing 60 days credit to the trade is not followed, it may be considered a weakness. As a comparative yardstick, it is always desirable to know and compare with what other competitors are doing, but it may not be prudent to limit the assessment to only this criterion. At times, industry practices may not be optimum and as such not generalisable for all the firms as the product market scopes may vary amongst the members. Besides, the competition criterion, it is always advisable to identify the dimensions of uniquenesses and use other criteria to classify a particular situation either as a strength or a weakness.

The Critical Factors for Success Criterion

Each business, in some sense, is unique. It requires a set of minimum performance standards and hence capabilities. We would call these as 'critical factors' or 'key factors' of success (remember KFS to gain competitive advantage which we had discussed in unit 7). The three criteria discussed earlier in this section do not directly assess along the KFS. This criterion helps to examine the strengths and weakness in the context of meeting the minimum requirements for success. For example, if T.V. advertising is a must and a firm is not able to afford it, then it may be considered a weakness.

One criterion is seldom sufficient for a complete evaluation of a firm. Some elements like 'financial strengths' may be evaluated better on 'historical' and 'competition' criteria; and 'marketing' may be best evaluated on the basis of 'competition' and 'critical factors for

success criterion'. Likewise, 'managerial climate' may be better ascertained on a 'normative criterion'. To cover all the facets of corporate capabilities and weaknesses, it may be desirable to follow a 'multiple criteria method'. It is important to recall that to a large extent, your assessment of strength or weakness of a firm, depends on the criterion you have selected to evaluate and your frame of mind.

Activity 1

a) Identify a company you are familiar with.

b) List all elements you consider as its important strengths or weaknesses.

c) In terms of various criteria (historical, normative, competition parity, and critical factors for success), evaluate its strengths and weaknesses.

d) Suggest some corrective actions based on your assessment.

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8.4 MEASURING STRENGTHS AND WEAKNESSES

Strengths and weaknesses may exist in varying degrees. Some may view an organisation as very strong which others may consider it not that strong. The same may apply to its weaknesses. This would call for measurement of strengths and weaknesses. In earlier section we had discussed various criteria for assessment. In this section, we will discuss the techniques which an analyst can apply to judge the degree of a strength or a weakness. There are three 'measures': i) Attribute Measures, ii) Effectiveness Measures, and iii) Efficiency Measures.

Attribute Measures

This statement is developed to identify or list a characteristic or quality which an organisation possesses or is expected to possess in the near future. Some examples of attribute measurements are: 'our key strength is the high moral of the workers' or 'our bigger weakness is the lack of centralisation of the control systems'. Statements like these reflect the presence of a characteristic without attaching a unit of measurement, i.e. to what extent the strength is genuinely contributing to gain a competitive advantage. It might be a strength for strength sake with no substantial purpose behind it. Thus, leaving the analysis only at the 'attribute statement' level may be incomplete and inadequate. In many situations it may however, be the only alternative to express one's strengths or weaknesses.

Effectiveness Measures

In this approach, a characteristic is represented by a statement that identifies a capability of an organisation that will help in the accomplishment of a particular task or objective. Thus, a statement like "our company exercises for fitness plan have helped in maintaining the high energy levels of our managers who are now able to devote one more additional hour of work each day" is reflective of an effectiveness measure of a strength. Similarly, a statement of weakness could be. "the location of our plant entails more travel time to reach the market place, hence it dissuades our sales people to achieve their targets for field visits"

The Efficiency Measures

As the word 'efficiency' suggests, it measures the productivity of an organisation in converting inputs into desired outputs. Thus, "ten per cent rejection rates is a big loss to our production", is a statement of weakness hinting at poor quality control arrangements. Apparently efficiency measure is implementable only in quantifiable situations.

The use of three types of the measurements is a function of the degree of specificity possible for a given element or characteristic. Attribute measurement is simply a listing of the capabilities of an organisation; an effectiveness measure relates to the abilities of an organisation to achieve objectives; and an efficiency measure is concerned with the

optimum conversion of firm's resources into desired output. The type of measurement a firm would employ will be a function of (a) the characteristic (in terms of strengths or weaknesses) which is being measured and (b) the level within the organisation which is to utilize the measurement. In many situations, especially when dealing with softer variables like 'shared values', 'managerial climate and culture', 'depth of mangerial competence', 'human relationship skills' etc., it may be difficult to use effectiveness and efficiency measures. Only attribute measures are used in such situations. You would soon begin to realise that at lower levels i.e. at the functional levels like, marketing, finance, etc. efficiency and effectiveness measures can be usefully applied. However, at higher levels which is concerned with the total organisation, attribute measures and effectiveness measures are more feasible. To put it differently, attribute and effectiveness measures increase in importance as the scope of internal analysis is broadened to meet the demands of the higher management.

8.5 ALTERNATIVE FORMATS TO ANALYSE STRENGTHS AND WEAKNESSES

A comprehensive and objective analysis of strengths and weaknesses may be facilitated by the use of a format or a framework. In this section we will study a few of such formats or frameworks.

The Check List

Some writers have suggested the use of organisational checklists to evaluate organisational capabilities and weaknesses. One such checklist contains 446 checkpoints. Obviously, all 446 checkpoints may not be relevant for a particular organisation. Pearce and Robinson[1] suggest the following checklist.

Marketing

- Firm's products/services; breadth of product line.
- Ability to gather needed information about markets.
- Market share or submarket shares.
- Product/service mix and expansion potential; life cycle of key products; profit/sales balance in produce/service.
- Channels of distribution.
- Effective sales organisation; knowledge of customer needs.
- Concentration of sales in a few products or to a few customers.
- Product/service image reputation, and quality.
- Imaginative, efficient, and effective sales promotion and advertising..
- Pricing strategy.
- Producers for digesting market feedback and developing new products/service or markets.
- After sale service and follow-up.
- Goodwill/ brand loyalty.

Finance and Accounting

- Ability to raise short-term capital.
- Ability to raise long-term capital; debt, equity.
- Corporate-level resources (multibusiness firm).
- Cost of Capital relative to industry and competitors.
- Tax considerations. .
- Relations with owners, investors, and stockholders.
- Leverage position: Capacity to utilise alternative financial strategies such as lease or sale and leaseback.
- Cost of entry and barriers to entry.
- Presence of financial planning and budgeting practices.
- Working capital.
- Effective cost control; ability to reduce cost.
- Financial size.
- Efficient and effective accounting system for cost, budget and profit planning.

Production/Operations/Technical

- Raw materials cost and availability.
- Inventory control systems.
- Location of facilities.
- Layout and utilisation of facilities.
- Technical efficiency of facilities and utilisation of capacity.
- Effective use of subcontracting.
- Degree of vertical integration: value added and profit margin.
- Efficiency and cost/benefits of equipment.
- Effective operation control procedures: design, scheduling, purchasing, quality control and efficiency.
- Costs and technological competencies relative to industry and competitors.
- Research and development/technology/innovation.
- Patent, trademarks, and similar legal protection.

Personnel

- Management personnel.
- Employees' skill and morale.
- Labour relations/costs compared to industry and competition.
- Efficient and effective personnel policies.
- Effective use of incentives to motivate performance.
- Ability to level peaks and valleys of employment.
- Employee turnover and absenteeism.
- Specialised skills.
- Experience.

Organisation/General Management

- Organisational structure.
- Firm's image and prestige.
- Firm's record for achieving objectives.
- Organisation communication system.
- Overall organisational control system effectiveness and utilisation.
- Organisational climate.
- Use of systematic procedures and techniques in decision making.
- Top management skill, capabilities and interest.

The Conceptual Approach

Bates and Eldredge[2] have suggested what has been described as conceptual approach to analyse strengths and weaknesses. According to them, the format for analysis can be divided into three dimensions: management, operations, and finance. These three dimensions would be common for a majority of the organisations. 'Management' dimension covers top management functions and broader issues encompassing the total organisation. Some of these could be strategic planning processes and systems, organisation climate and culture managerial succession, top management values, etc. 'Operations' dimension includes resource conversion and distribution functions like production, material management design, marketing, etc. 'Finances' include issues like capital structure, working capital, credit policies, etc:

Analysis of Management Dimension

At the corporate level, i.e. at the level of corporate strategy, the strategist must begin the assessment of organisational strengths and weaknesses with an analysis of firm's management. To a large extent, the quality of top management determines and affects corporate strengths and weakness, not only the current but the 'potential' strengths as well. As an illustration, Bates and Eldredge have suggested the following dimensions to evaluate the strategic planning system of a firm.

Critical Factors: Identification of the present and future conditions having a bearing on the achievement of objectives.

Resources: Identification and provision for resources required to meet present and future conditions for achieving objectives.

Objectives: Clearly spelt out results and details of the means to be used to measures accomplishment.

Appraisal: Compairing actual with expected performance that results in timely corrective action.

Deployment of Resources: Establishing and delegating areas of responsibility and authority fo[illegible] [illegible]tical facto[illegible]. For its strategic planning system, a firm's strengths and weaknesses can be evaluated on the above dimensions.

Analysis of 'Financial' Dimension

A firm's performance is largely determined through its financial performance like sales revenue, profits net worth, divided pay out, etc. A number of dimensions within finance capital structure, capital budgeting, dividend policy, debt policy, interest cost, credit policies, management of working capital etc., need to be examined to assess a firm's strengths and weaknesses. A caution, however, needs to be observed while drawing inferences 'financial analysis' may reflect only the 'symptoms' and not the causes. For strategic decisions, we need to unfold the underlying causes and their relationship with other business function. Thus, an outstanding receivable account with 90 days may reflect poorly on the working capital management, but if it is a marketing necessity, then it may not be interpreted as a weakness.

Analysis of the 'Operations' Dimensions

The resource conversion process requires operational arrangements. The efficiency of the 'conversion' process reflects strengths or weaknesses. Besides conversion, the organisation also needs to transform the products and services through the process of marketing and distribution into liquid or cash resources which are then recycled. Organisational audit, therefore, must include the assessment of corporate strengths and weaknesses in each functional area. In the area of marketing, this may mean assessment of factors like familiarity with the industry breadth of the products/services offered, quality of the marketing research, customer pre and after sales service, consumer loyalty, etc. A similar type of 'audit' can be done for human resources, materials management production and so on.

Strengths and Weaknesses Profile

After the corporate audit on three dimensions: management, finance, and operation has been done. Bates and Eldredge[3] suggest consolidation of all these dimensions to develop a profile. This is shown in Exhibit 8.1

Exhibit 8.1 : Strengths and Weaknesses Profile

Dimension	Basis of Comparison[1]	Ranking[2]	Existing[3]	Strengths or weaknesses[4]
Management				
Financial				
Operations				

1 The purpose is to ensure that the strategist is aware of a basis of comparison and its appropriateness to the factor under assessment.

2 Ranking indicates degree of importance of the factor under assessment to the organisation's success. All critical factors should have a ranking of 1 in their respective dimensions.

3 A brief description of what exists.

4 Strengths or weaknesses are coded as follows: 0 = neutral; + = strength, and the more pluses, the greater the strength; – = weakness and the more minuses, the greater the weakness. The profile gives a quick view of the total situation as well as the criteria which an analyst has used to arrive at conclusions. By ranking, it also helps in focusing attention on more important rather than less important factors.

The Grid Approach

The earlier framework of Bates and Eldredge suggested a diagnosis around three dimensions: management, finance, operations. Almost a similar approach has been suggested by Ansoff[5]. This is shown in Exhibit 8.2.

Exhibit 8.2 : 'GRID' for Corporate Audit

	FACILITIES EQUIPMENT	PERSONNEL SKILLS	ORGANISATIONAL CAPABILITIES	MANAGEMENT CAPABILITIES
General Management & Finance				
R & D				
Operations				
Marketing	Warehousing Retail outlets Sales offices Service offices Transportation equipment Training facilities for sales staff Data processing equipment	Door-to-door selling Retail selling Wholesale selling Direct industry selling Dept. of Defense selling Cross-industry selling Applications engineering Advertising Sales promotion Servicing Contract administration Sales analysis Data analysis Forecasting Computer modelling Product Planning Background of People Corporate culture	Direct sales Distributor chain Retail chain Consumer service organisation Industrial service organisation Dept. of Defense product support Inventory distribution & Control Ability to make quick response to customer requirements Ability to adapt to socio-political upheavals in the market place Loyal set of customers Cordial relations with media and channels Flexibility in all phases of corporate life Consumer financing Discount policy Teamwork Product quality	Industrial marketing Consumer merchandising Dept. of Defense marketing State and municipality marketing Well-informed and respective management Large customer base Decentralized control Favourable public image Future orientation Ethical standards

The 'rows' contain various functions and take 'columns' capabilities'. The above Exhibit, as an illustration, provides the audit points for marketing. With the help of a comprehensive checklist (one such list was mentioned earlier), you can identify the relevant characteristics for a firm vis-a vis various functions.

You will observe that 'attributes' have been used to indicate the strengths or weaknesses. It may be necessary to complete the exercise by using both 'effectiveness' and 'efficiency' measures, wherever possible.

Another 'grid analysis' which takes into account the 'measures' mentioned earlier is shown in Exhibit 8.3. This was developed for a hypothetical company. You will observe that the grid highlights a number of weaknesses and a limited number of strengths for the organisation as a whole.

MAJOR FUNCTIONS

Exhibit 8.3: The Grid

ATTRIBUTES	MAJOR FUNCTIONS						
	Marketing	Human Resources	Finance	Mfg.	Systems	Corp. Strategy.	Orgnal. Structure
Efficiency and Effectiveness	Avg.	Good for the present	Poor	Poor	Good for the present	Avg.	Poor to Avg.
Stability and Flexibility	Avg. to good	Average	Poor	Yet to be established	No comments	Average	No comments
Future Development and Directions	Avg. to Good Needs re-examination	Needs improvement	Needs top most Priority	Needs consolidation at this stage	Needs to be formalised	This concept needs to be introduced	Needs reorganisation

Activity 2

What would be your recommendation to the management of the company with the help of the grid as shown in Exhibit 3.

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The 7 'S' Framework

You will recall that in our discussions on competition in Unit 7 we had indicated about the usefulness of 7-S Framework. We had indicated that the three Ss i.e. strategy, structure and systems were the 'hard variables' for an organisation and the remaining four Ss i.e. shared values, skills, staff, and style the four soft variables. This framework can also be used to perform corporate audit for an organisation. The 7'S' framework can be used both at the corporate level as well as at the functional level. One such matrix for the corporate level is shown in Exhibit 8.4.

Exhibit 8.4: The 7 'S' Framework

Functions

DIMENSION	MARKETING	FINANCE	HUMAN RESOURCES	PRODCUTION
1 Strategy				
2 Structure				
3 Systems				
4 Shared Values				
6 Skills				
6 Style				
7 Staff				

You should begin to appreciate that there are many approaches to performing the corporate audit and identifying the corporate capabilities and weaknesses. The selection of any approach of framework would ultimately, however, depend upon some of the following conditions/situations.

a) The level at which the exercise of corporate audit (strengths and weaknesses) is being performed.

b) The 'characteristics' which are being examined i.e. approach to planning, management culture, marketing management, distribution system etc.

c) The 'use' which management wants to make of the strengths and weaknesses analysis. If the idea is to reformulate a corporate strategy, management may employ two or three frameworks to have different viewpoints for the total organisation. If the use is 'gap analysis' in some specific functional area, it may confine to only one framework, using the various 'measures' to come to sound decisions.

8.6 IDENTIFYING STRENGTHS AND WEAKNESSES

So far our major preoccupation has been with 'what' are strengths and weaknesses and 'how' they have to be measured. An equally important step in the whole exercise of corporate audit is the process which an analyst can follow to identify, diagnose, and assess the situation in the form of strengths and weaknesses. Basically, there are three approaches to performing the 'coporate audit':

i) **Ask questions:** That is some form of executive survey. It can involve the respondents from both within the organisation and from outside; those who are well familiar with the organisation e.g. customers, and suppliers are two such examples of outside respondents. There can be many forms to this survey like structured questionnaire, informal depth interviews and so on.

ii) **Observation:** Here the analyst observe the behaviour and reactions of the corporate

executives to draw his own inferences on some specific situations. Issues like leadership styles, work culture, participation are best studied by observation.

iii) **Examine Records:** Records are an excellent source of past performance and a number of other issues which are seldom articulated in a 'questionnaire survey' or observations. Usually, examination of records becomes essential for all the 'characteristics' where 'efficiency measures' are being used.

A good and comprehensive audit would require the use of all the three approaches. This requires enormous amount of information and efforts. At the corporate level especially for large organisations, this may require a 'team effort' and may take 6 to 8 months before a review of organisation's strengths and weaknesses can be complete. A major pre-requisite for the analysis would be the 'breadth' and the 'depth' of their experience and an ability to 'muddle' through a vast pool of information, opinions and reactions.

8.7 MATCHING STRENGTHS AND WEAKNESSES

We have been discussing corporate strengths and weaknesses. The purpose is to arrive at a 'match' between corporate strengths and environmental opportunities for competitive advantage. The purpose is to improve corporate performance. A simple but powerful question to keep us on the right track, lest the exercise become unwieldy and an end in itself is to ask: 'so what'? This 'so what'? question should lead us to recognise the pay off from a strength. It should also enable us to identify the degree of damage or hinderance which a weakness can cause to corporate performance. If the response to a 'so what'? question is neutral or inconclusive, then the characteristics have to be dropped from our analysis. The corporate audit of a company revealed a supplier's excellent reputation for consistency in the supply of high quality products. However, its limited production capacity prevented it from becoming a market leader in terms of market share. It will, therefore, be a strategic error to assume that expansion may lead to a larger market share as large markets may essentially be for low price, low quality products. Thus, an excellent strength may have limited to no pay off unless the entire corporate strategy is changed. Similarly, presence of highly qualified scientists and engineers for R & D may become meaningless if there is no opportunity for R & D to flourish and make worthwhile contribution. In short, a strength is meaningless if it cannot abet in the corporate performance present and future. In the same way presence of a weakness may not always be damaging.

8.8 THE CONCEPT OF SYNERGY

Upto this point we have been discussing the issues related to coporate audit. Before we conclude it may be a good idea to briefly introduce the concept of synergy. In its simple form, the concept of synergy recognises that in the organisational context, the combined effect of certain parts is greater than the sum of their individual effects. For instance, if produced separately, the contribution of product A may be x and product B's contribution may be y. The concept of synergy, implies that if produced jointly, their contribution may be $x + y + z$ instead of $x + y$ alone. This extra contribution i.e. 'z' is called the synergistic effect of A and B together. Thus 'z' represents positive synergy. There can be negative synergy also. Some writers describe synergy as a $2 + 2 = 5$ effect. This concept, which is difficult to quantify, is a very helpful concept in identifying what we would like to call 'potential strengths'. Thus, the 'reputation' of a firm can provide positive synergestic pay off to launch high quality products. Corporate image, R & D facilities, availability of competent professionals are some more examples where an organisation can reap synergestic benefits for competitive advantage.

Activity 3

Step 1: Consider a company of your interest and collect, at least for two years, copies of its annual reports and chairman's statement to the shareholders.

Step 2: Analyse company's performance for the last two years and compare it with its competitors.

Step 3: Try to identify its key strengths and weaknesses with the help of the analysis of the annual reports and the chairman's statement.

Step 4: Speculate as to what best use the company can make of its strengths. Also, which weaknesses need to be removed on.

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8.9 SUMMARY

The analysis of corporate capabilities and weaknesses becomes a pre-requisite for successful formulation and reformulation of corporate strategies. This analysis can be done at various levels: functional, divisional, and corporate. The classification of an item or characteristic in terms of strength and weakness can be done on the basis of some criteria like historical criterion, normative criterion, competitive parity criterion and the critical factor of success criterion. In order to measure the degree of strength or weakness, we can use three measures: attribute measures, effectiveness measures and efficiency measures. A format like a 'checklist', a grid or a matrix helps in making a comprehensive analysis. It also helps in consolidating the analysis on corporate audit. While performing the audit, it is important to remember that in the ultimate analysis, it is the entrepreneurial viewpoint of strengths and weaknesses which can make or break a company. In this view, the concept of synergy holds the key to enhance the pay offs from the existing corporate capabilities. A strong mind, even with limited capabilities, may build a giant organisation and a weak mind may cripple a sound organisation by magnifying the minor weaknesses. The frame of mind, thus, may appear to be a more important intangible strength than all the tangible assets.

8.10 KEY CONCEPTS/TERMS

- Attribute measures
- Corporate strengths
- Corporate weaknesses
- Competition criterion for strengths and weaknesses
- Critical factors for success
- Effectiveness measures
- Efficiency measure
- Grid for corporate audit
- Historical criterion for strengths and weaknesses
- Normative criterion for strengths and weaknesses
- Strength and weakness profile

8.11 SELF-ASSESSMENT QUESTIONS

1 How would you determine whether a particular element is a strength or a weakness?

2 What are the different criteria for classifying elements into strengths and weaknesses? Explain briefly by giving suitable examples. Are different criteria exclusive?

3 What measures can be used for judging the degree of a particular strength or a weakness? Are they equally applicable in all situations?

4 In section 8.5, among others, checklists for analysing strengths and weaknesses in the area of marketing and personnel are provided. Think of some more items which could be added to these checklists.

5 Critically evaluate the following for analysing strengths and weaknesses and give your views as to which is a better one:
   a) The Conceptual approach
   b) The Grid approach
   c) The 7-s Framework

6 If you were to conduct a corporate audit of a business firm, what approaches would you use? Discuss briefly.

7 "The purpose of analysing corporate strengths and weaknesses is to ultimately match them." Explain.

8 Explain the concept of synergy. Drawing upon your organisational experience, recall situations/decisions in which the concept of synergy came into play or it played a major part.

8.12 FURTHER READINGS

Abell, Derek F. and John S. Hammond, 1979, *Strategic Market Planning: Problems and Analytical Approaches.* Prentice-Hall, Inc., Englewood Cliffs, New Jersey 07632.

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Argenti, John, 1947, *Systematic Corporate Planning,* Willmer Brothers Limited, Birkenhead.

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APPENDIX

Some Useful Sources of Information on Indian Business Environment

(Common for 6, 7 and 8)

a) Related to a company

- Annual reports
- Chairman's speeches
- Company's advertisement
- Company's house journals
- Company's executives
- Bombay Stock Exchange — the relevant volumes.

b) Related to the environment

- Kothari's encyclopaedia
- Annual issues of leading commercial periodicals
- Report of the Industrial Licensing Policy Inquiry Committee.
- M.R.T.P. Publications.
- Articles published in leading newspapers, journals related to the industry of the company under study
- Hindu Annual Review.
- Times of India Directory.
- Reserve Bank's Annual Reports.
- Publications of Chamber of Commerce, trade associations and export councils.
- Commerce Annual on public sector undertakings.
- The Economic Scene published by TECES.
- Data India.
- Business India, India Today, Business World.
- Journals like Commerce, Economic & Political Weekly, Journal of Industry and Trade, Industrial Times, etc.
- Guidelines to industries.
- Newspapers like Economic Times, Financial Express, etc.

REFERENCES

1. Pearce II, John A and Richard B. Robinson, Jr., 1982. *Strategic Management: Strategy, Formulation and Implementation*, Richard D. Irwin, Inc.
2. Bates, Donald L. and Dallid L., Eldredge, 1980, *Strategy and Policy: Analysis, Formulation, and Implementation*, Wm., C. Brown Company Publishers, Dubuque, Iowa.
3. Ibid.
4. Ansoff, H. Igor, 1965, pp. 98-99, *Corporate Strategy*, McGraw-Hill Book Co., New York.

NOTES

Uttar Pradesh
Rajarshi Tandon Open University

MBA-3.1

Corporate Policies and Practices

Block

4

STRATEGIC ANALYSIS

UNIT 9
Cost Dynamics 5

UNIT 10
Portfolio Analysis and Display Matrices 30

UNIT 11
Operating and Financial Analysis 47

BLOCK 4 STRATEGIC ANALYSIS

In this block we focus our attention on a number of techniques and approaches for strategic analysis of a business. These techniques, developed in the last two decades, can help in understanding the cost structure, the product mix, the related cash effects and other strategic elements of a business. Such analysis can be helpful in developing effective business strategies. This block has three units.

Unit 9 gives you some idea about the cost levels in some selected industries in India in the international prospective. You will note that the cost levels in India are comparatively higher. The causes and effects of higher cost levels and the role of cost in different market conditions are examined. The unit then discusses the concept of experience curve and its effects. The uses, applicability and limitations of experience curve effect are considered. In the last part of the unit, break-even technique, alongwith related issues, is explained.

Unit 10 introduces to you the subject of portfolio analysis and display matrices, the latter facilitate the former. Some well-known display techniques and their relative merits and demerits are discussed. The utility of display matrices in general and their applicability in the Indian situation are explored.

Unit 11 describes certain techniques for operating and financial analysis from the strategic point of view. The unit begins with a discussion of a technique for exercising control over movement of raw material, semi-finished goods and finished goods. The Pareto or ABC analysis for maintaining effective control on stores is explained. The usefulness of ratios for strategic financial analysis is indicated. Some other techniques which can be useful for assessing and managing portfolio of businesses are discussed.

UNIT 9 COST DYNAMICS

Objectives

The objectives of this unit are to acquaint you with:

- cost levels in Indian industry
- experience curve, its effects, factors causing such effects, its uses and limitations
- break-even analysis (linear and non-linear) and its assumptions.

Structure

9.1 Introduction
9.2 Cost Levels in India
9.3 Causes and Effects of High Costs in India
9.4 Relationship between Cost and Size of Production
9.5 Changing Role of Cost in Different Market Conditions
9.6 The Experience Curve
9.7 What Causes Experience Curve Effect?
9.8 Some Additional Considerations for Using Experience Curve Effect
9.9 Uses of Experience Curve in Competitive Strategy
9.10 Applicability of Experience Effect
9.11 Limitations of Experience Curve Effect
9.12 Break-even Analysis
9.13 Sensitivity Analysis
9.14 Non-Linear Break-even Analysis
9.15 Generalised Break-even Analysis
9.16 Relative Cost Advantage and Competitive Strategy
9.17 Summary
9.18 Key Concepts/Terms
9.19 Self-assessment Questions
9.20 Further Readings

9.1 INTRODUCTION

Cost analysis occupies an important place in business strategy. In order to gain and sustain competitive advantage, a firm should not only monitor its cost performance but also should endeavour to control it. Several strategic decisions like fixation of competitive prices, provision of after-sale services, quality of the products etc. depend upon relative cost level of the business firm. This unit highlights the elements and role of cost in overall business strategy. The unit begins by acquainting you first with the cost levels for some industries in India. The role of cost in different market conditions is also examined. The unit then shifts its focus to two techniques which can be helpful in strategy formulation and implementation in so far as the role of cost is concerned. These are Experience Curve and Break-even Analysis.

9.2 COST LEVELS IN INDIA

It is widely accepted by the industrialists as well as the planners that Indian economy and industry are becoming increasingly high cost-oriented. This has narrowed down our domestic market particularly for consumer durables and has also impeded Indian Products from competing in the international markets. To understand this observation, let us consider some specific examples of different industrial sectors in India.

Textile Industry

Clothing is one of the three basic human needs alongwith food and shelter. Further, India was once known all over the world for its fine clothes made from silk and cotton,

and was a major supplier of textiles to the rest of the world. But today our own people can't afford to have cloth at reasonable prices because of our high cost of production.

A comparison between Indian and International Costs and prices for polyester fibre (produced from DMT route) is given in Table 9.1.

Table 9.1
Synthetic Fibre Costs Comparison

		International	Indian		
		(USA)	Large	Medium	Small
Capacity	Tons/Yr	30,000	30,000	15,000	6,000
Total Investment	US $	73 million	106 m	70 m	40 m
Raw Material Cost	US$/Ton	1,170	1,360	1,360	1,360
Operating Cost	US$/Ton	350	350	430	560
Manufacturing Cost[1]	US$/Ton	1,760	2,030	2,240	2,590
Selling Price[2]	US$/Ton	2,490	3,090	3,640	4,590
Differential in Price %		—	24.1%	46.2%	84.3%

[1] Including depreciation, taxes and insurance.
[2] With 30% pre-tax return on investment included.
Source: Economic Trends (FICCI)

Thus, for comparable pre-tax return on investment, a typical Indian plant with a capacity of 6,000 tons/year polyester production has more than 84% higher selling price than a typical U.S. polyester plant with a capacity of 30,000 tons/year. Even when a comparable capacity plant of 30,000 tons/year is set up in India, the differential in selling price is 24% higher because the raw material cost in India is 15% higher than in the U.S. The capital requirement is about 40% more in India than in the U.S.

Textile Fabric Production

First yarn is spun out of synthetic staple fibre and then the fabric is woven out of it. A comparison of the relevant costs for these two stages of textile production, between Indian and the international prices (in this case for U.K.) are given in Tables 9.2 and 9.3.

Table 9.2
Spinning Costs for Polyester/Cotton Yarn

	Units	International	Indian	Difference In India
Total Investment	US$	6.8 million	8.7 million	+ 28%
Raw Material Cost	$/Ton	2,170	4,940	+128%
Operating Cost	$/Ton	2,830	2,160	- 31%
Manufacturing Cost[1]	$/Ton	5,000	7,100	+ 42%
Selling Prices[2]	$/Ton	7,300	10,000	+ 37%

[1] Manufacturing cost is exclusive of profit on investment.
[2] Selling price is inclusive of profit on investment.
Source: Economic Trends (FICCI)

Table 9.3
Cost of Textiles Fabric Production

	Units	International	Indian	Difference in India
Total Investment	US$	11.6 million	13.8 million	+ 19%
Raw Material Cost	$/Ton	6,300	9,290	+ 47%
Operating Cost	$/Ton	4,510	3,360	- 30%
Manufacturing Cost[1]	$/Ton	10,810	12,650	+ 17%
Dyeing & Fini Cost	$/Ton	4,600	4,600	—
Selling Prices[2]	$/Ton	15,410	17,250	+ 12%

[1] Manufacturing cost is exclusive of profit on investment.
[2] Selling price is inclusive of profit on investment.
Source: Economic Trends (FICCI)

From these comparisons it can be seen that at the spinning stage the raw material costs in India are 128% and at the fabric production stage 47% more than in the international markets. Consequently, the manufacturing costs in India are 42% higher at the fabric production stage. Thus, the selling prices in India are dearer by 37% at spinning stage

and 12% at fabric stage under comparable assumptions for return on investment. This is so despite the fact that the operating costs in India are about 30% lower at spinning as well as fabric production stages (because of cheaper wage rates in India).

Tyre and Tube Industry

Road transportation represents an important component in the life-line of economic activity of any country, and tyres and tubes form a significant input of the operating costs in this section. A comparison between the costs for the raw materials which go into the production of tyres and tubes is given in Table 9.4. Again we see that these inputs cost the Indian tyre and tube manufacturers much more, and in turn this is reflected in the tyres and tubes as paid by the prices of transporters. This cost is then passed on to the industrial customers using the services of the transporters. Thus there is a cascading effect whereby costs get accumulated over different stages and the final consumers have to bear the cumulative costs.

Table 9.4
Costs in Tyre and Tube Industry

(Rs./Ton)

Raw Material	International	Indian	Difference in India
Natural Rubber	10,000	17,000	+ 70%
Synthetic Rubber	10,500	25,500	+143%
Polybutadiene	14,280	20,720	+ 45%
Carbon Black	8,700	19,010	+118%
Nylon Fabric	36,000	91,000	+152%

Source: Economic Trends (FICCI)

Of course, as regards tyre industry, it is often observed that the leading tyre manufacturers have operated like a cartel in supplying and pricing their products. To make up for shortages and to provide price competition the Government allowed substantial imports of tyres recently.

Aluminium Industry

In aluminium industry also, considered today the parameter for determining the industrial development of a nation, the Indian costs are much higher than the international prices. This is despite the fact that India has an advantage in this sector because of the natural resources. But, even without the excise duty and taxes, the prices of aluminium in India are 140% higher than the U.K. prices (indicating international levels).

Steel Industry

In the case of steel products also the prices are high in India. This is so even after excluding excise duty, freight equalisation levy, Steel Development Fund levy, Engineering Export levy and a small cess, together amounting to about 30% of the price of various steel items.

The comparative figures for India and in the international markets (for 1985-86) are given in Table 9.5. The Indian prices of steel products are more by 85% to 150% over the international prices.

Table 9.5
Prices of Steel Products

(In Rs./Ton)

Steel Item	International	Indian	Difference in India
Steel Bars	2,745	5,080	+ 85%
Sections	2,730	6,900	+153%
Hot Rolled Coils	2,790	6,150	+125%
Plates (5-10 mm & above)	3,270	6,570	+101%
Chequered Plates	3,420	6,670	+ 95%
Cold Rolled Coils	3,600	8,040	+123%

Source: Economic Trends (FICCI)

Here, it would be interesting to note that till a few years ago the ex-works prices of some of the steel products were lower in India compared to prices in U.S.A., Japan etc.

Activity 1

Arrange a meeting with the Cost Accountant of the organisation in which you are working and try to ascertain the cost level (average cost per unit) of the major product (or service) of your organisation for the latest completed year. Is it different from the cost level in previous years? Account for the reasons. How does the cost level so obtained compare with the cost level for that particular industry (or service)?

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9.3 CAUSES AND EFFECTS OF HIGH COSTS IN INDIA

The cost differences mentioned above for some sectors of the Indian industry are illustrative of a somewhat general situation prevailing in India. A large number of factors go into the high costs of Indian products, such as the growing excise, customs and sales tax levies etc. But a significant component of these high costs may be due to uneconomic production levels, use of obsolete technology, high fixed or variable costs, high break-even points or excessive dependence on imports of semi-finished goods, etc.

It is pertinent for us to consider the effects of such high costs in India. As the component of government imposed levies in the prices increases, the rising prices cause a shrinkage in consumption and demand. For instance, in terms of 1970-71 prices, the average household expenditure on essential consumer goods like sugar, clothing and footwear etc. has actually declined from Rs. 2,802 in 1977-78 to Rs. 2,778. Similarly, for the industrial goods, the household expenditure correspondingly declined from Rs. 1,106 to Rs. 1,092. A recent manifestation of such high cost of production and the corresponding shrinkage in demand created havoc in the Light Commercial Vehicle (LCV) industry where there was an added burden of high exchange rate between Yen and Rupee on the imported components from Japan. The present situation is that some of the recently set up units manufacturing LCV are operating much below their rated capacity, and are accumulating losses with time.

In the international markets also there are serious consequences of higher costs for India. India's share in the global markets has reduced from 1.88% in 1950-51 to 0.8% in 1965-66 (when devaluation took place), and further fell to only 0.48% in 1984-85. This shrinkage in India's share is taking place despite the fact that international trade has been expanding at a fast rate, and the share of smaller nations like South Korea, Taiwan and Hong Kong is growing at a faster rate. This is again perhaps attributable to our high cost levels at all stages from raw materials to the finished products.

9.4 RELATIONSHIP BETWEEN COST AND SIZE OF PRODUCTION

Here it is important to consider the relative size factor between the Indian industry and the international industry.

- The 1981 production of the largest integrated steel plant of India was only 1/12th or 8% of that of Nippon Steel of Japan. Even if the production of all the units of Steel Authority of India Ltd. (SAIL) is taken together, it would be equal to only 22% (or

1/5th) of the production of Nippon Steel, the largest steel producer, and 31% (or 1/3rd) of U.S. Steel, the second largest steel producer in the world. Later in this section we will consider the effect of different production levels and the accumulated experience on the cost of production.

- Similarly, in the synthetic fibre industry, the plant capacities in India are much lower than those in the developed countries, as shown in Table 9.6.

Table 9.6
Plant Capacities In Synthetic Fibre Industry

Product	International	Indian	Capacity Factor
Polyester Staple	1,00,000	7,000	7%
Polyester Filament	70,000	2,000	3%
Nylon Filament	30,000	3,000	10%
DMT	2,00,000	24,000	12%
Caprolactam	75,000	20,000	30%

Source: Economic Trends (FICCI)

It will be seen that plants in India have much smaller capacity compared to the plants operating in the developed countries.

- In the cement industry in India, the Indian plants produced between 600 and 1,200 tons a day, compared to 8,900 tons per day of Kawasaki, and several other plants making 3,000 to 5,000 tons per day in Japan and other countries. Cost advantages arising from bigger sized cement plants have been calculated by the industry.
- A 1,200 tons/day plant with pre-calcinator technology requires Rs. 787 in fixed and working capital per ton, compared to only Rs. 655 for plant of 2,500 tons/day capacity. Similarly, it has been established that by raising the capacity from 200 tons/day to 800 tons/day of cement, 18% saving in cost of production of cement can be achieved. If there is a further quadruplicating of capacity to 3,200 tons/day, another 18-19% can be saved. Empirically, the cost is following an Experience Curve kind of effect which will be described subsequently.
- Similar economies have been established for higher capacities in other industries. For integrated steel mills producing flat-rolled products, there is a 20% cost saving for each doubling of mill capacity 8,00,000 tons/year, and a further 10% saving on redoubling to 1.5 million tons/year.
- Regarding production levels in India for scooters, in 1984-85, all the Indian units put together produced 3,47,000 scooters, whereas Kawasaki alone produced 5,00,000 and Honda 3,00,000 scooters per annum. As a result of this, scooters in India still cost very high, even after long years of producing them, whereas Japan which entered in this sector in a big way was only recently can afford to sell them at a cheaper price.
- In the petrochemical plants, the doubling of capacity generates 25-30% savings in investment costs. While in paper and pulp mills, as the capacity is doubled upto 1,000 tons/day, investment costs are reduced by 25%.

The above empirical data, accumulated over many years, has been mentioned here to show how costs are related to the plant capacities and production levels. Larger sized plants not only save on the initial investment cost but also on the operational costs. The manager has to be conscious about these factors, some of which would be given to him, whereas others could be planned carefully in order to be competitive in the market.

In the next section we will consider how the role of costs changes as the competitive conditions with respect to supply and demand change in the markets.

9.5 CHANGING ROLE OF COST IN DIFFERENT MARKET CONDITIONS

Cost is an important aspect of running any business operation. It is a major lever for running the business activities, and has its influence on the progress of an organisation. Acceleration, stagnation or deceleration in progress are affected by it.

Cost in Sellers' Market

While the markets are operating as sellers' markets, the cost may not be considered so critical in determining the profits of a running organisation. Under sellers' market conditions, price is fixed on cost plus basis. So whatever is the internal cost, the desired profit margin is added to it by the business firm, and the price is derived accordingly.

Thus, Price of Product = Internal Cost + Desired Profit Margin.

Here, the price of the product is the derived variable, and the cost is an independent variable. The customer in the market is forced to pay the price so derived by the sellers. If the cost moves up, due to certain unavoidable factors like scarcity of raw material, labour problems or additional taxation, the manufacturer/seller merely takes the boosted cost figures, adds his desirable profit margin and sells the goods at the enhanced price. In the sellers' market conditions (say due to shortage in emergency conditions or man-made), the customer has no choice but to buy goods at the new prices. Under these conditions, the seller is not much worried about the costs or their upward movements, as he can pass on these additional burdens to the customers.

Cost in Buyers' Markets

On the other hand, as the number of suppliers grows due to conspicuous profits in sellers' markets, the competition from the internal (or external) sources may increase. A surplus supply of goods in the market may be created, if the demand does not move at the corresponding rate. In such conditions the buyers get a choice to pick and choose from. The markets are thus governed by the buyers and the way their preferences change. Under these competitive conditions, the manufacturer or supplier is no more free to choose whatever price he wishes. The equilibrium equation changes to:

Profit Margin = Permissible Price – Internal Cost

Or

Tolerable Cost = Permissible Price – Acceptable Profit.

Under the new conditions, the price of a product is decided outside the organisation in the market place and, not according to the wishes of the manufacturer or supplier.

The price becomes an independent variable decided by the competition in the market place. Each competitor, in general, may choose a different level of acceptable profit for himself or fix the price matching with the market requirements. As the competitors become more and more active there will be a downward push on these permissible profits, unless the firm activates itself for effective cost reduction. Thus, unlike in the sellers' market conditions, now the cost or profit margin becomes the derived variable. If the firm can't do much about the cost of manufacture or supply, then the profit margin also gets fixed by the market forces, and the firm has to decide whether it can survive at the prescribed level.

The other alternative for the organisation is to fix a minimum acceptable profit (or contribution), and then determine its tolerable level of cost. The next step is to do a careful introspection and see what are the different variables getting into the cost of goods, and find ways and means to reduce the cost so as to improve its profitability.

One way of doing this is to make use of the Experience Curve, and the other way is to carefully consider its break-even point and operate well above this level.

9.6 THE EXPERIENCE CURVE

Cost has been correlated with the accumulated experience (of say production) by the Experience Curve Effect. The underlying principle behind the experience curve is that as total quantity of production of a standardised item is increased, its unit manufacturing cost decreases in a systematic manner.

Initially, this inverse relationship was discovered for the learning costs which are the costs for direct labour input in the manufacturing cost. Thus, as the production of a particular item (such as aircraft components) increased, the quantum of time of direct labour component to make each of these successive items declined. This helped the aircraft manufacturers to predict the cost of man-hours required to manufacture in future, say the number of aircraft, and helped them to fix the price accordingly. The

Experiences Curve Effect phenomenon, where costs fall with accumulated volume of experience, was known to industrial managers for many years.

But, the experience curve became widely known and was utilised as a tool in business strategy with the work of Boston Consulting Group in the 1960s and the 1970s. They provided the evidence that, for certain standardised products, the total unit cost of the product reduced by a consistent percentage everytime the volume of production was doubled.

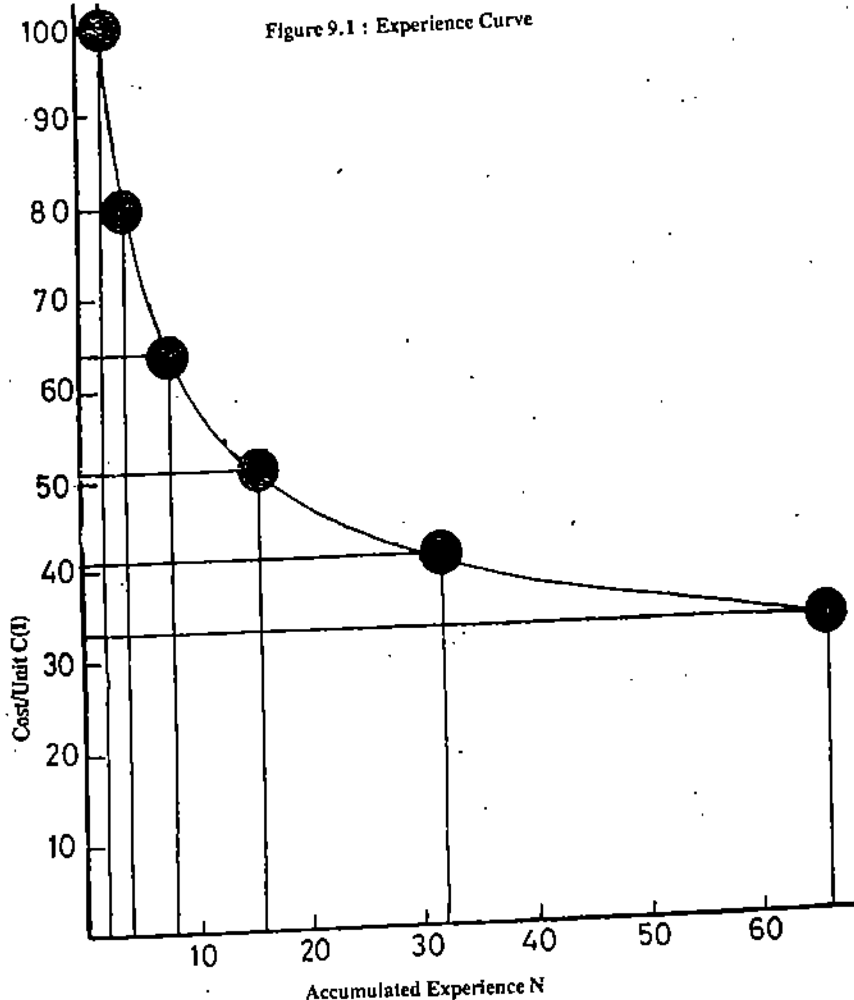
Thus, when one starts the production of a new product (2 units), the unit cost is, say Rs. 100. Then, as the accumulated production volume reaches 4 units, the unit cost is reduced by say 20%, to Rs. 80. Furthermore, as the accumulated production reaches 8 units, the cost gets reduced by another 20%, to only Rs. 64, and so on. This trend has been tabulated in Table 9.7.

Table 9.7
80% Experience Curve

Accumulated production		Cost/Unit (Rs.)
2		100
4	100 × .80 =	80
8	80 × .80 =	64
16	64 × .80 =	51
32	51 × .80 =	41
64	41 × .80 =	33
128	33 × .80 =	26
256	26 × .80 =	21
512	21 × .80 =	17
1000	17 × .80 =	13
	....	..
	....	..

The data of this Table when plotted on a plain graph paper gives an 80% Experience Curve, as shown in figure 9.1. The Experience Curve has a hyperbolic shape.

Figure 9.1 : Experience Curve



Activity 2

Recount your own personal experience as a manager regarding manifestations of the Experience Curve Effect in your day-to-day life. (**Hint:** Try to record the learning that takes place in repeating any managerial action; does it reduce the implementation time each time.)

....

....

....

....

....

The above hyperbolic function would look linear by taking log functions on both the sides.

$$\text{Log } C_N = \text{Log } C_1 - E \text{ Log } N$$

This implies that if Log C_N is plotted against log of accumulated experience, then the relationship would be a straight line with the slope of $-E$.

Thus, 80%, 70% or 90% Experience Curve would be straight lines on log – log graphs, with common initial costs and having correspondingly different slopes.

Here, the Slope Factor K, and the Elasticity Coefficient of the Experience Curve E, are related to each other by a constant factor, as illustrated below :

Say, $\text{Log } C_N = \text{Log } C_1 - E \text{ Log } N$

and, $\text{Log } C_{2N} = \text{Log } {}^{C}C_1 - E \text{ Log } (2N)$

Subtracting first equation from the second one, we get

$$\text{Log } C_{2N} - \text{Log } C_N = -E (\text{Log } 2N - \text{Log } N)$$

$$\text{Log } \frac{C_{2N}}{C_N} = -E \text{ Log} \frac{2N}{N}$$

$$\text{Or Log } K = -E \text{ Log } 2$$

$$\text{Or } E = \frac{-\text{Log } K}{\text{Log } 2}$$

Here, on the right hand side we have a ratio of two constant numbers, and E and K are related by a constant factor. Thus, Experience Curve Effect can be analysed mathematically also.

Experience Function

Mathematically also the Experience Curve relationship can be developed as follows.

Let C_1 = Cost of the 1st unit,

C_2 = Cost of the 2nd unit,

C_N = Cost of the N_{th} unit

N = The accumulated experience,

Then,

$$\frac{C_2}{C_1} = 0.80$$

$$\frac{C_4}{C_2} = 0.80$$

Or $C_4 = 0.80 \times C_2 = 0.80 \times C_1 \times 0.80 = (0.80)^2 C_1$

Similarly,

$$C_8 = 0.80 \times C_4 = (0.80)^3 C_1$$

$$C_{16} = (0.80)^4 C_1$$

Thus, if we generalise, we get the expression :

$$\frac{C_{2N}}{C_N} = K,$$

where K is less than or equal to 1. It is called the Shape Factor and is the factor for reduction in cost as a result of accumulation of experience.

Further more,

$C_N = C_1 \times N^{-E}$

where, E is the Elasticity Coefficient of the Experience Curve Relationship.

).7 WHAT CAUSES EXPERIENCE CURVE EFFECT?

In order to fully utilise the experience curve effect, it is important to fully grasp what causes this effect. With increase in accumulated production of a standardised product, the experience curve effect of systematic reduction in cost is caused due to management synergy, as outlined below.

Improved Productivity of Labour

As the accumulated production of standardised product increases, the labour force acquires the skills to do their task more efficiently. This may be in the form of memorising the steps involved, or developing reflex actions for doing the needed operations.

However, as the experience accumulates, not only the direct labour, but also the supervisory staff as well as managers must successively streamline the needed operations to improve the efficiency.

It is important to note that to consolidate the above gains for a sustained improvement, adequate training facilities have to be provided to the new entrants.

Increased Specialisation

Increased volume of standardised production may also merit specialisation of individual or a group of skills among different employees.

Thus as the production volume increases, individual components may also become viable to be produced in different profit centres. Alternatively, suitable vendors for ancillaries may be developed to shift the overheads and other non-productive expenses away from the organisation. For example, a large vehicle plant can procure engines, transmission train, drive, wheels, gear boxes etc. from outside, and do their assembly only within their plants.

Innovation in Production Methods

With accumulated experience and higher specialisation, the concerned workers are likely to come across innovative ways of improving the production processes.

For instance, Japanese engineering workers evolve unique jigs and fixtures which facilitate their working and smooth flow of operations. However, fixed investments in such jigs and fixtures are viable only at high volumes of production, and they can't be utilised at low production volumes. On enlarged volumes, the unit fixed cost per item reduces substantially, and benefits far exceed the cost.

Value Engineering and Fine Tuning

As the experience with the production as well as usage of a product accumulates, newer ideas based on value engineering may be adopted to cut down the unnecessary material consumption and other under-utilised inputs.

For instance, for conduction of electricity, copper wires are often the preferred choice. However, by now it has been also scientifically demonstrated that in copper conductors, the current flows only on the surface of the conductors. Thus, to save cost without compromising performance, the lead conductors coated on the surface by copper have been successfully substituted with substantial economies in initial costs and replacement costs. But such coating operations would necessarily require high volume of production.

Balancing of Production Line

Sometimes, by mere addition of balancing equipments, substantial increases in capacities can be increased without incurring the proportionate new investments.

Thus, all these factors have an accumulated integrated influence of reducing the cost with accumulated experience, and the manager must facilitate and promote these factors to get the desired reduction in cost.

In the absence of the above, cost economies would not come about.

Methods and System Rationalisation

The standardisation in production, marketing and administrative procedures results in efficiencies over time. Also, more up-to-date technology with better economies of scale can be inducted as the volumes increases.

9.8 SOME ADDITIONAL CONSIDERATIONS FOR USING EXPERIENCE CURVE EFFECT

The experience curves, in general, are simple approximations of extremely complex real-time interactions of a variety of associated parameters. Therefore while utilising the experience curve effect for actual day-to-day decision-making, extreme care is necessary to get reliable results.

Distinguish Experience from Time

Many a time, there is a tendency to substitute passage of time for the experience, and to expect fall in costs related to time, say on an annual basis. For example, a machinery manufacturer makes 1,000 units per year, and the production increases 10% per annum. Now let us also suppose that the production of machines follows the 80% experience curve. Then, the production and the experience or cumulative production would vary as shown in Table 9.8.

Table 9.8

Production and Experience with Time

Year	Annual production	Experience (cumulative)
1st	1000	1000
2nd	1100	2100
3rd	1210	3310
4th	1331	4641
5th	1464	6105
6th	1610	7715
7th	1771	9486
8th	1948	11434
9th	2143	13577
10th	2357	15934

Thus, it takes 10 years to achieve four doublings of the experience, and the annual production level has reached nearly two and a half times mark. The unit cost at the end of this period, should be about 41% of the initial cost. Due to the Experience Effect, it reduces to 80% in 2nd year, 64% in the middle of 4th year and 51% in the early part of the 7th year and so on.

What is a Unit Experience?

Another important consideration is to carefully define the basic unit of experience. This is particularly so in the recent years when the market segmentation is proceeding at a fast rate. (Thus, one has to make sure that apples are not being compared with potatoes.)

For example, should a vehicle manufacturer consider that all vehicles—trucks, light commercial vehicles (LCV) and passenger cars—follow a common experience curve effect, or should these be considered separately on their respective individual experience curves? To focus attention on the segmental specialisation, may be one should take the individual truck or LCV or the passenger car as the unit of analysis rather than collectively as vehicles.

How to Consider Influence of Time?

As the experience curve effect is to consider cost effects for production of a standardised product, it is important to consider the likely effects of varying short-term fluctuations and inflation. The experience curve effect is a long-run trend, and it will not be able to account for year-to-year variations in costs due to manufacturing bottlenecks, industrial relations problems or other supply-demand mismatches. Similarly, the cost data for experience curve, must be in terms of 'real money' or net of inflation.

The managers planning to use the experience curve effect for building the cost related strategies must keep these additional considerations in mind to derive the desired benefits with accumulated experience. A unit experience must be clearly defined for the concerned business. The experience should be distinguished from certain time-related changes. Further, concerned cost figures must be net of inflation.

9.9 USES OF EXPERIENCE CURVE IN COMPETITIVE STRATEGY

The experience curve relationship provides a good framework for managerial considerations for predicting industrial scenario with respect to future costs, profit margins and corresponding cash flows for the manager's own as well as his competitors' operations. Here the only underlying assumption is that the costs and therefore the prices will follow the experience curve effect, which can also be verified and correlated with the trend of the past few years.

For example, the market price of a product P at present is Rs. 100, and it is being manufactured by three companies in the industry, X Co., Y Co., and Z Co., which compete with each other by direct selling. Their annual sales and market shares are shown below.

	X Co.	Y Co.	Z Co.	Total
Sales Volume	10,000	5,000	2,500	17,500
Market Share	57%	29%	14%	100%

Let us assume that the slope of the Experience Curve = 80% and the annual growth rate in demand = 20%.

Now, the corporate manager in X Co. also knows his cost as Rs. 80.

On the basis of such information, he has to determine the costs of making these products in Y Co. and Z Co. To do so, he knows that his market share is twice that of Y Co., so the cost of Y Co. on the 80% experience curve would be 80 × (100/80) = Rs. 100. Similarly, the cost of Z Co., with half the market share of Y Co., would be 100 × (100/80) = Rs. 125. Thus, the costs and the profit margin, at a common price, would look like :

	X Co.	Y Co.	Z Co.
Cost/unit	80	100	125
Profit/Loss	20	0	(25)

In other words, the manager in X Co. can determine that while they are selling the product at 20% profit margin, while their competitors have little chance of breaking even. Armed with this information he can then develop suitable competitive strategies. These strategies may be :

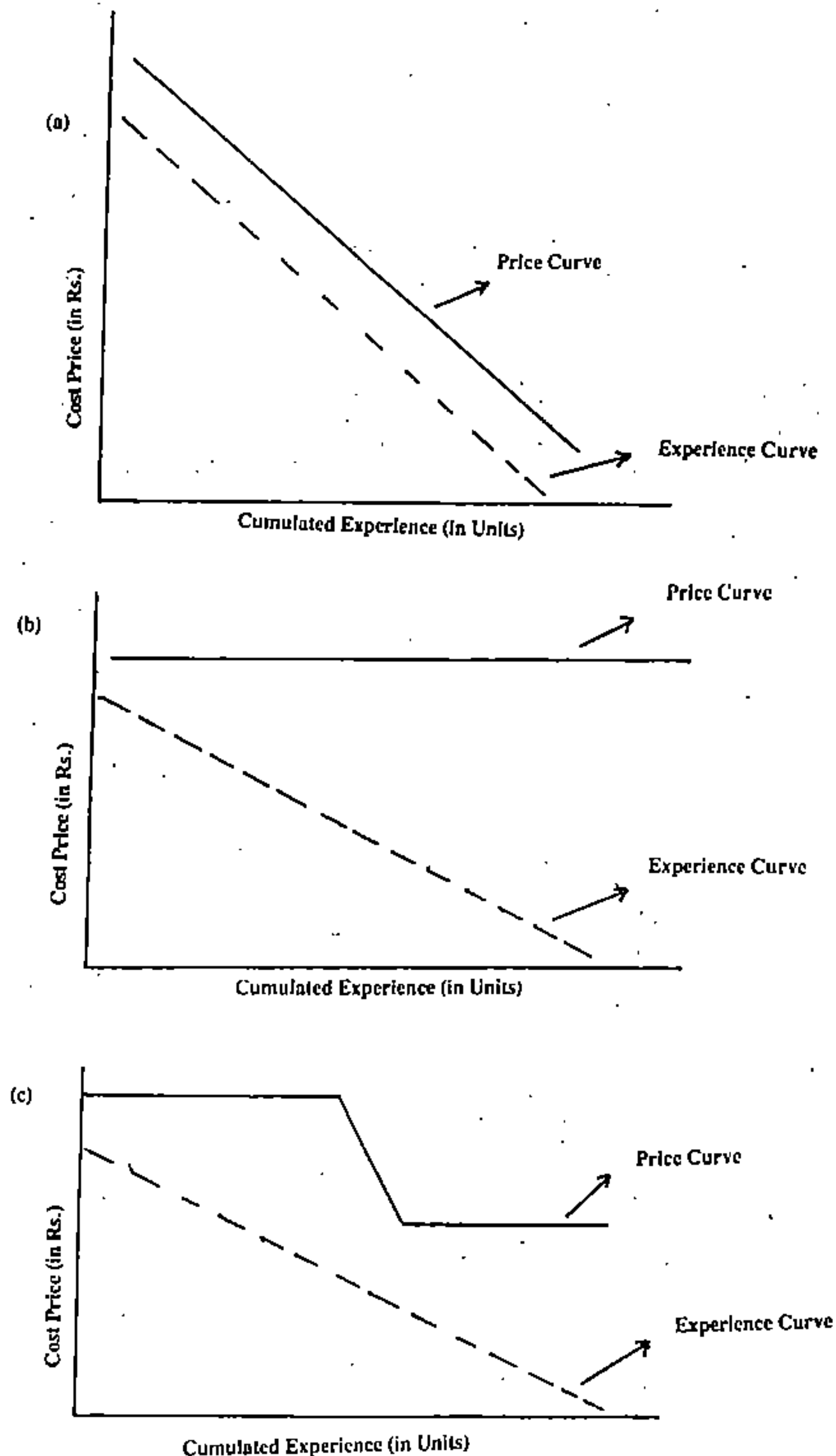
a) Selling product at most competitive price,

b) Maximising profits by selling at the highest price the market can afford,

c) Selling at a higher price initially but crashing the prices later to keep the competition out.

These major strategy options are graphically presented in Figure 9.2.

Figure 9.2 : Major Strategy Options



Experience Curve Effect for Manufacturing Strategy

In general, the conventional incremental approach leads to successive increments to boost output. This is also supported by their relatively higher rates of returns, based on discounted cash flow method. Such a tendency is also favoured because the management is on a familiar ground and need not worry about the uncertainties of a new avenue, and thus requires less commitment of capital.

However, if this practice is blindly followed, it may result in old and obsolete manufacturing capacity being enlarged successively in the hope of small decreases in

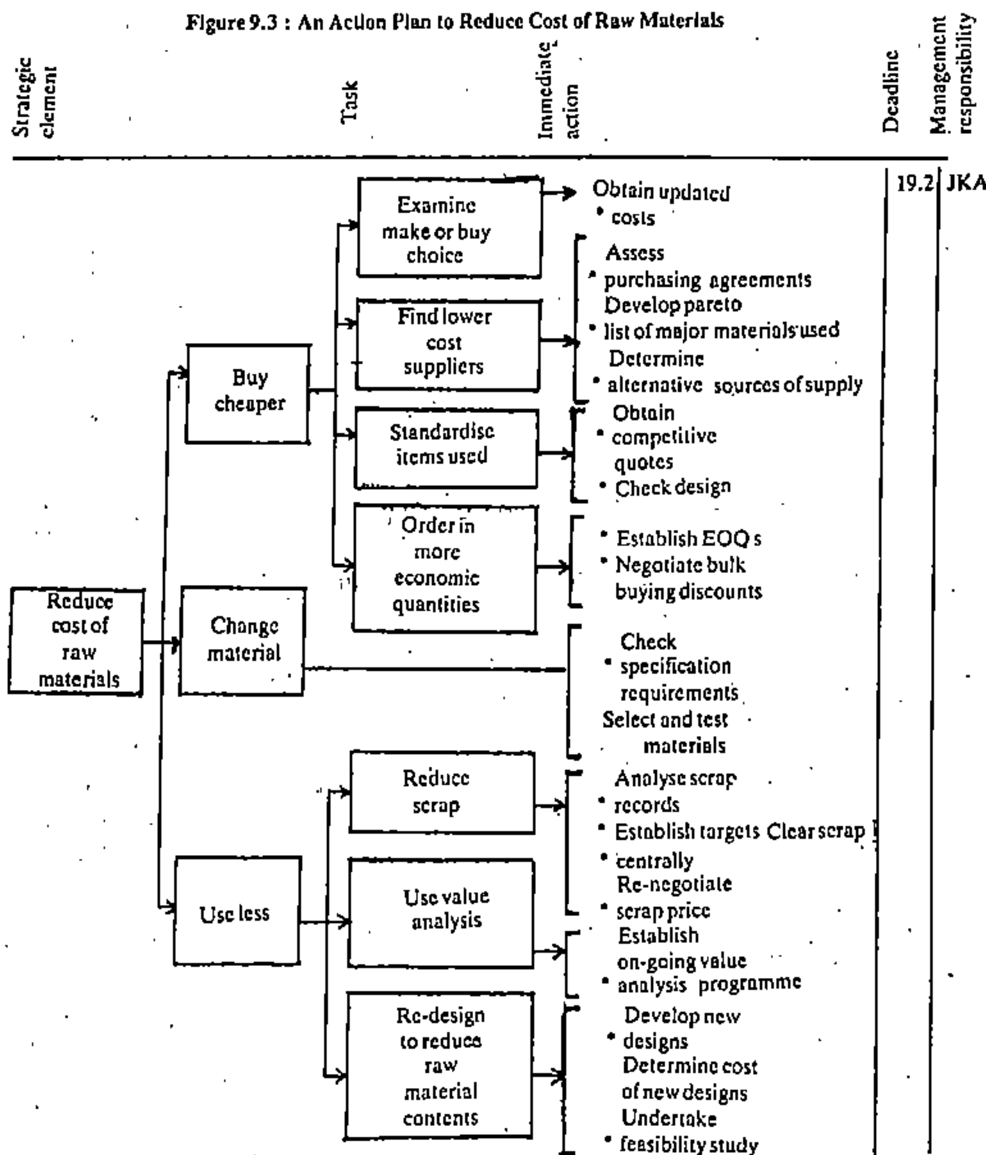
costs. The new opportunities providing the possibilities of drastic reduction in unit costs (introduction of new technologies and processes) may be overlooked. The conventional approach also tends to overlook what the competitors might be doing or thinking.

In general there is a reluctance to have a periodic rethinking of fundamental nature. In the search for efficiency the effectiveness (by doing right thing by different ways) is compromised. It is important to note that improvements in efficiency can be delegated to the operational managers, whereas improvements in effectiveness demand the attention of the top management.

Unfortunately, if the management is not conscious about the 'right thing' for a considerable period, it may lose its market presence one day, and it may be too late for it to do anything about it.

Thus, there is a dynamic interdependence between the manufacturing plans and alternative market-related strategies. The price of the product and the manufactured output are related via the market place, which determines the demand levels corresponding to different price levels (considering the inherent characteristics of the market conditions). The Company in return, has to determine how much it can supply to the market and, what will be its corresponding costs. These may then be linked with the alternate manufacturing strategies. However, since cost reduction is not inherent in any production expansion strategy, it is desirable to put in conscious effort to reduce the costs in specific areas. In the Indian context the raw material cost is a major area for overloading of cost structure. Therefore it is imperative that individual firms wanting to follow the benefits of cumulative experience of production must consciously reduce the costs. Figure 9.3 presents an action plan for reducing costs of raw material in a firm.

Figure 9.3 : An Action Plan to Reduce Cost of Raw Materials



Source : Stuart St. P. Slatter, 'Executive Diagnosis Through Component Analysis', *Management Decision*, Vol. 11, Winter 1973.

9.10 APPLICABILITY OF EXPERIENCE EFFECT

The experience curve effect has been demonstrated very well in some segments of the electronics industry where, as the volumes grew, a real decline in cost as well as prices has been observed.

One consequence of this effect has been that in the early stages of the market war in the personal computer business, the manufacturers with high volumes became more aggressive and led the markets with lower costs and prices, whereas the manufacturers with smaller production volumes had uncompetitively higher costs and prices. The latter could not survive in the competitive market arena.

The experience curve effect has some clear implications for manufacturing strategy, so that only a few large plants with standardised products would be able to supply the global market. Further, their marketing efforts should be fully coordinated with their manufacturing plans. On the other hand, with competition, the marketing department is forced to reduce the prices, and the manufacturing department should be ready to supply the higher volume. This demands a careful and close linkage with the purchasing department and relationship with vendors for prompt sub-contracting.

Further, while prices are lowered the products should not get associated with inferior quality. The quality levels must be carefully guarded. This is how the Japanese have managed to conquer the world markets for their cars, electronic appliances and other sectors.

In 1974 the Japanese factories were producing 350 motor cycles per man-year, whereas the best British motor cycle factory produced only 18 motor cycles per man-year or about 1/20th of the Japanese level. The British motor cycle industry tried to compete conventionally against the experience curve strategy of the Japanese, and their crash was inevitable.

It may however be observed that the relationship implied in the simplistic model of experience curve cannot be applied universally.

To begin with, experience curve effect is applicable only if the demand is sufficiently elastic so that by lowering the prices, it is possible to generate the needed higher demand. Thus larger volumes of goods will be produced and correspondingly the costs will be lowered. The overall contribution and profitability levels are maintained or improved further. Under such a setting, a market leader can push the volumes to such an extreme that he markets the products at such low prices that it would become impossible for any new competitor to enter the market and gain volume high enough for him to operate viably.

Looked at from another perspective, in a dynamic competitive market the laggards among the lot, complacent about their comfortable position, will become successively less competitive and more uneconomic and will eventually be driven out.

On the other hand, the experience curve effect cannot be utilised if the demand is inelastic so that by lowering the prices, additional demand volumes cannot be generated. As such the costs will not come down but will stay at higher levels. Under such circumstances, the contributions and profit margins will shrink. The company can stay and survive in the market only with low margins.

A similar situation will exist when the competition is so severe that it is difficult to increase market volumes dramatically, or increase output significantly to gain major reductions in cost.

Thus, the experience curve effect can damage the company if it is not cautious and careful in its aggressive activities for increasing production of standardised product. And this situation of crisis may arise if the demand falls suddenly in the market. With this the company is forced to reduce its volume of production, and correspondingly its costs will rise. Under such a scenario, if the company is forced to increase its prices, then the demand may fall further. Thus, a recessionary trend may set in. For instance, the above referred Japanese motor cycle industry is today in a critical state because of the high yen rate and the world-wide recession which has dried up their export demand. Thus, the Japanese are stuck up with huge manufacturing capacity and unsold inventories.

9.11 LIMITATIONS OF EXPERIENCE CURVE EFFECT

The experience curve effect, a simple conceptual model, has its own difficulties in application, though it might look otherwise.

For example, while compiling costs the managers may come to know that the costs of the products manufactured in their plants are not being separately accounted for, and are instead being lumped together department-wise, or division-wise. Over the experience scale also, the systematic cost data may not be available, but may instead be accounted batch-wise or lot-wise. Sometimes, the accounting practices may be changed over the years or the cost allocations may be modified.

For determining the data regarding competitors, the problems are further compounded. Generally, in highly competitive markets, installed production capacities are not disclosed by the manufacturers openly. Besides, each competitor has a different starting point, so the respective cost data may have to be adjusted accordingly. The cost differences between different manufacturers are of critical importance for developing an effective strategic plan, but these are very difficult to obtain in reality.

In terms of the experience curve effect a late entrant, in order to survive in the competitive world, must necessarily operate at lower initial cost than the competitors who entered earlier. To be profitable, the late entrants have to learn about the business and develop technological advantage regarding their equipment etc. over their predecessors. They may also acquire the experience of others by offering higher incentives to the experienced employees, thus snatching them from the earlier entrants.

A manager must utilise the experience curve effect most effectively, keeping in mind the inherent limitations of the phenomenon as well as the organisation under consideration.

9.12 BREAK-EVEN ANALYSIS

Role of Cost in Business Growth

You have noted that costs play an important role in the survival and growth of a business firm. For survival, a business firm must make some profit so that it can sustain its operations on a long-term basis and fulfil its other obligations.

Before a business starts operating, it has to incur certain initial costs for acquiring assets, such as land, building, plant and equipment. These assets have to be installed and commissioned. Then the raw materials are paid for fed into the machines so that the finished goods can be produced. These are then sold in the market to generate revenue. A part of this revenue is used for repaying instalments towards loans and other borrowings. The shareholders also expect certain returns in the form of dividends on the equity held by them.

Hopefully, after meeting such expenses, the firm is left with some revenue to buy the raw materials and other needed utilities so that it can run the next operating cycle of the business process. The survival and growth of the business firm, to a large extent, depends on what the firm pays for its fixed costs and what contribution it generates after meeting all the expenses.

Apportioning of the fixed costs incurred by the firm in starting a business depends on the volume of its operations. A lower volume of products puts a heavy burden on each unit produced. A larger volume of operations reduces the cost per unit. The total variable cost, which varies with the volume produced, may also reduce, as a consequence of the Experience Curve Effect.

A systematic analysis of the various factors enumerated above is done by Break-even Analysis, which provides a guiding framework for operating a business successfully. It identifies the critical cut-off volume below which it is difficult to sustain the business activity on an on-going basis. While actual costs incurred are influenced by the Experience Curve Effect, the Break-even Analysis can help a business firm in its efforts to survive and grow.

A critical component of a business firm's strategy is the decision with respect to its policy, and its relationship with the fixed costs, variable costs, overall volume and the total revenues.

Break-even Analysis helps to determine the volume of operations where the total revenue from selling a certain quantity of product exactly matches with the total costs incurred by the firm in producing that volume of goods. This is the **break-even point** for the operations.

Furthermore, Break-even Analysis can also be utilised to determine the sensitivity of different changes in prices, fixed costs or the variable costs.

Model Assumptions and Definitions

The Break-even model demands that certain assumptions be made to simplify the mathematical analysis. These are :

Total Costs (TC) are split into Fixed Costs (FC) and Variable Costs (VC). Fixed Costs (FC) are treated as constant which do not vary with the volume of production (Q). Variable Costs (VC) are treated as Costs which vary in linear proportion to the volume of production. Total Variable Cost is a product of unit variable costs and the quantity of production, Q.

The Fixed Cost (FC) includes finance charges, interest payments, building rent etc. The Variable Cost (VC) includes the raw material cost, electricity and fuel expenditure, packing cost etc.

Furthermore, the selling price (SP) for the business firm would be the one determined by the market, so it cannot be increased or reduced unilaterally by the manufacturer.

Then, Total Revenue can be determined as a product of price P and the Quantity Q.

Thus, during a one-year period :

Total Cost (TC) = FC + VC × Q
Total Revenue (TR) = P × Q

Thus, at the break-even production Q_B,

Total Revenue = Total Cost

$$P \times Q_B = FC + VC \times Q_B$$

$$Q_B = \frac{FC}{P - VC}$$

Here, the difference between the unit price P and the unit variable cost VC is called the Contribution per unit of product.

Thus, break-even point is the volume of production required to recover the fixed cost from the corresponding contribution.

Example

X Co. incurs fixed costs of Rs. 1,00,000;
Its unit variable cost is Rs. 60.
X Co. decides to fix a price of Rs. 100.
Then, X Co. is getting a contribution of Rs. 100–Rs. 60
= Rs. 40/ unit and the break-even point for X Co. is :

$$Q_B = \frac{\text{Rs. } 1,00,000}{\text{Rs. } 100 - \text{Rs. } 60}$$

$$= 2,500.$$

Let us say that X Co. cannot keep its costs down to Rs. 60, and instead subsequently incurs a variable cost of Rs. 80.

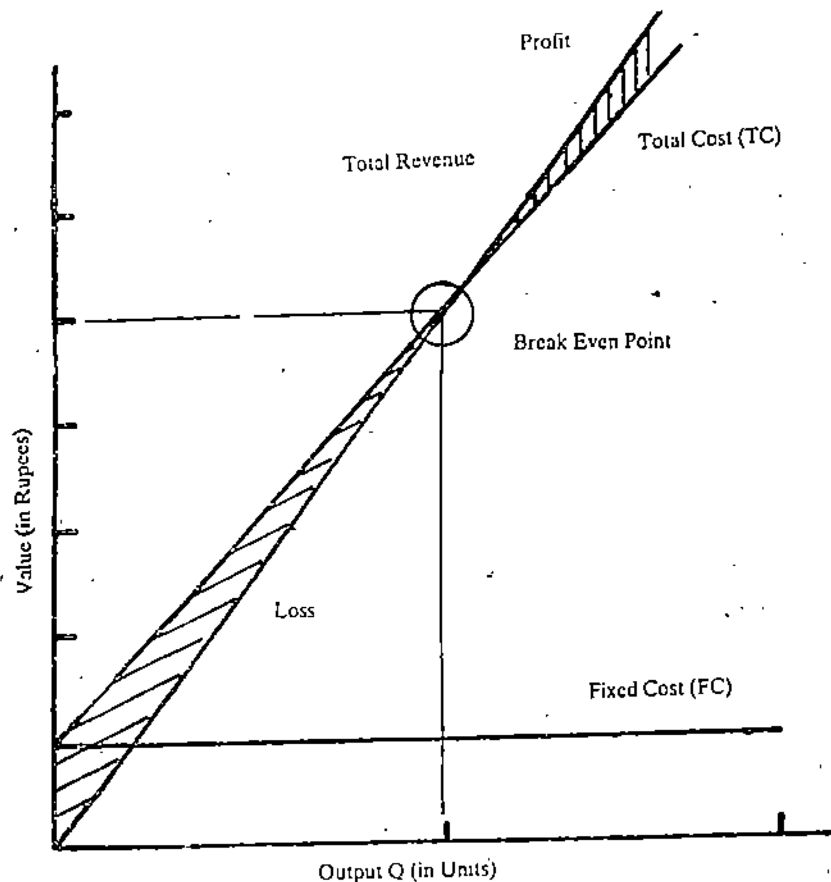
Now, the contribution per unit is reduced to Rs. 100 – Rs. 80 = Rs. 20.

The new Break-even point is

$$Q_B = \frac{\text{Rs. } 1,00,000}{\text{Rs. } 100 - \text{Rs. } 80} = 5,000.$$

This implies that at a lower contribution, X Co. has to produce more goods, that is at least 5,000 units to recover its fixed costs, and achieve a break-even point. The total revenue at the two break-even points is 2,500 × 100 = 2,50,000 for the former and 5,000 × 100 = 5,00,000 for the latter case. The total costs match total revenues at these break-even points. The break-even chart is presented in Figure 9.4.

Figure 9.4: Break-even Chart



9.13 SENSITIVITY ANALYSIS

Now let us develop Sensitivity Analysis to see what happens to the operations of an organisation when changes are simulated in price (upward and downward), as well as the changes in fixed costs and variable costs.

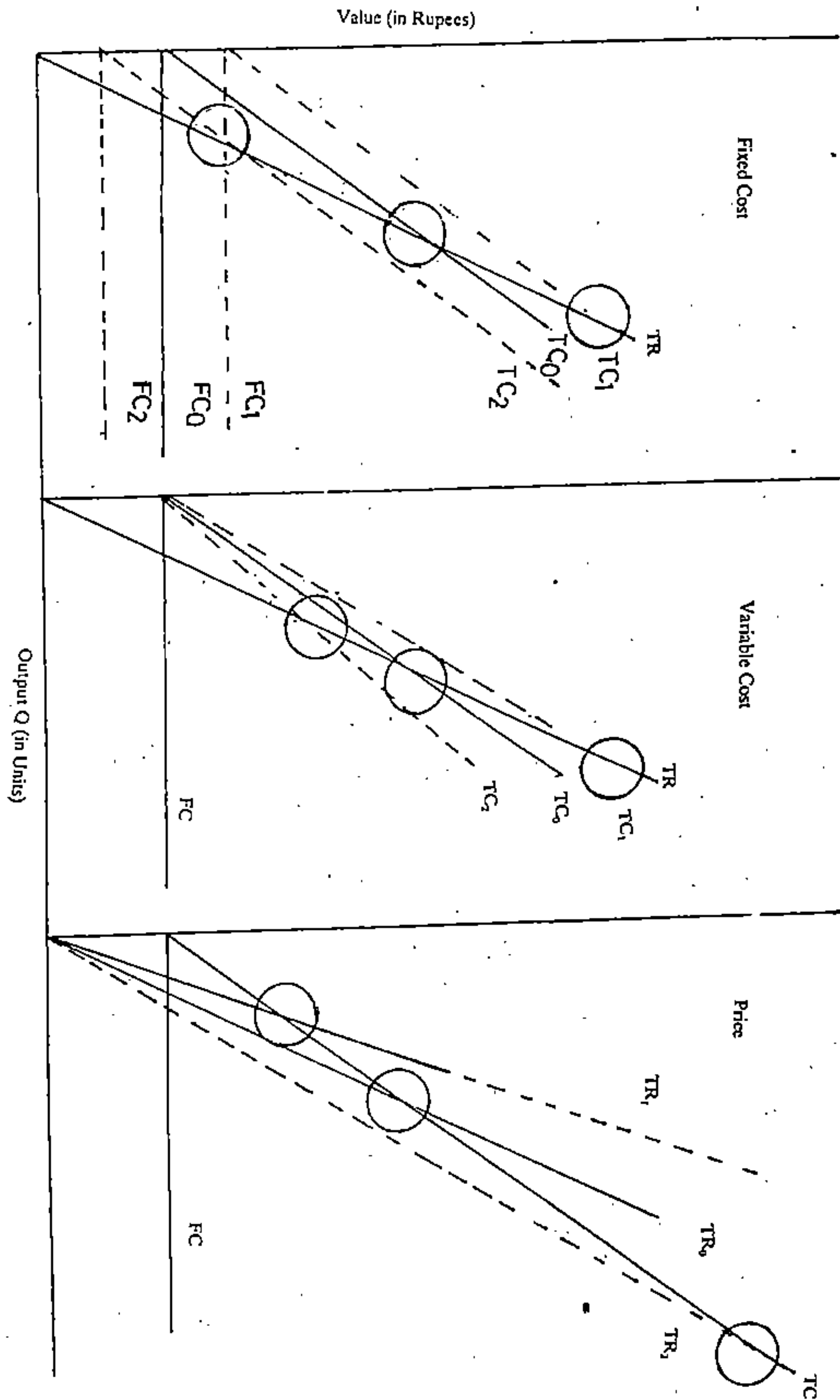
Changes in Fixed Cost

Let us develop scenario with respect to say 10% upward and downward changes in Fixed Cost, to see how the profitability of the firm changes.

	Scene A Original	Scene B 10% Increase	Scene C 10% Decrease
Fixed Cost	1,00,000	1,10,000	90,000
Price	100	100	100
Variable Cost	80	80	80
Break-even Point	5,000	5,500	4,500
Profit At			
Volume = 0	-1,00,000	-1,10,000	-90,000
= 5,000	0	-10,000	+ 10,000
= 10,000	+ 1,00,000	+ 90,000	+ 1,10,000

Here we see that with decrease in fixed cost, the break-even point decreases. The profitability at a particular volume of production improves with lower fixed cost.

Figure 9.5: Sensitivity Analysis



If we look at the situation graphically, by lowering the fixed cost the firm manages to increase its region of profit, or reduce the operations under **loss-making conditions.**

Changes in Variable Costs

Next we develop a scenario with respect to changes (upward as well as downward) in variable costs. You may recall that variable costs include costs of those inputs which directly vary with the change in output level. These may relate to consumption of raw materials, energy or labour per unit of production.

	Scene A Original VC	Scene B 10% Higher VC	Scene C 10% Lower VC
Variable Cost	80	88	72
Price	100	100	100
Fixed Cost	,00,000	1,00,000	1,00,000
Break-even Point	5,000	8,333	3,570
Profit At			
Volume = 0	- 1,00,000	-1,00,000	-1,00,000
= 5,000	0	-54,000	+ 60,000
= 10,000	+ 1,00,000	+ 20,000	+ 1,80,000

Thus, increase in variable cost has a marked effect on the break-even point, and eats up the profits. By reducing variable cost the profitability improves substantially

Changes in Price

Finally upward and downward changes in price are simulated.

	Scene A Original Price	Scene B 10% Higher Price	Scene C 10% Lower Price
Price	Rs. 100	110	90
Variable Cost	Rs. 80	80	80
Fixed Cost	Rs. 1,00,000	1,00,000	1,00,000
Break-even Point	5,000	3,300	10,000
Profit At			
Volume = 0	- 1,00,000	- 1,00,000	-1,00,000
= 5000	0	+ 50,000	-50,000
= 10,000	+ 1,00,000	+2,00,000	0

Here, we see that as the permissible price increases, the break-even point reduces, and vice versa. At a particular volume of production the profitability improves.

From the above sensitivity analysis, price seems to be the most sensitivity instrument to influence changes in the profitability, but it is linked to the market forces in operation. The variable cost is the next sensitive instrument; the changes in the fixed cost however are the least sensitive.

Thus, a very simple mathematical calculation can give the manager a simplified methodology to select the appropriate strategy for action with some estimation of the likely outcomes. Figure 9.5 presents sensitivity analysis showing the result of changes in the underlying variables.

Activity 3

Make inquiries and ascertain the break-even point for the major product/service produced/rendered by the organisation in which you are working for the latest completed year. Has it changed over the years? Examine the reasons which contributed to the change.

9.14 NON-LINEAR BREAK-EVEN ANALYSIS

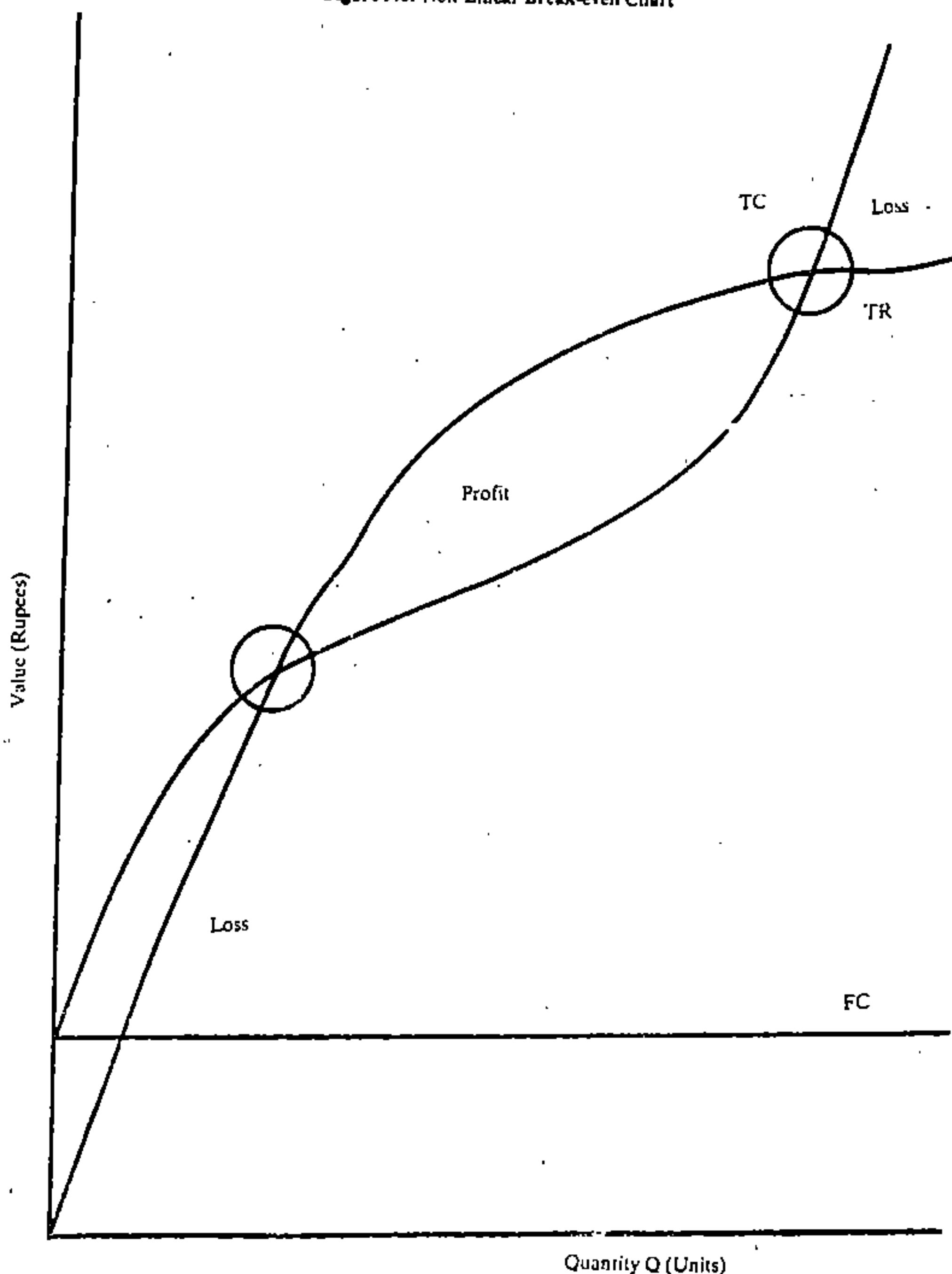
In the foregoing discussion on break-even analysis, a linear relationship was assumed between the variable costs and the volume production on one hand, and total revenue and output on the other.

In reality, the prices may be reduced consciously to gain additional volumes of sales and the market share, or simply in response to the competitors's action.

It may be stated that in general an increase in the volume of production is accompanied by greater economies of scale which may reduce variable costs successively. But, sometimes, beyond a critical volume of production, the variable cost may again increase. Under such circumstances the business operations will have another break-even point beyond which there is another loss region as shown in Figure 9.6.

Since non-linear situations are more difficult for mathematical analysis, graphical approach can be used to obtain break-even points by plotting the empirical data.

Figure 9.6: Non-Linear Break-even Chart



Market Forecasts and Pricing Divisions

Let us consider that the Marketing Department of a firm carefully studies the market and puts forward the following estimated market demand at varying prices.

Price	Rs. 100	Rs. 95	Rs. 90	Rs. 85
Market Demand	10,000	14,000	22,000	28,000

Considering that Total Cost = Fixed Cost + Variable Cost × Quantity

Total Revenue = Price × Quantity

Then, Profit = Total Revenue – Total Cost

= Quantity (Price – Variable Cost) – Fixed Cost

Thus, corresponding to the above mentioned prices and demands, Contribution

= Price–Variable Cost	Rs. 20	Rs. 15	Rs. 10	Rs.5
Break-even Point	5,000	6,660	10,000	20,000
Profit = Quantity × Contribution –Fixed Cost	1,00,000	1,10,000	1,20,000	40,000

Thus, from the foregoing calculations it may be seen that at Rs. 90 a piece, the profit is maximum at the estimated demand of 22,000 units. At higher prices, the contribution per unit is higher but, considering the estimated sales at these prices, the profits are comparable but marginally lower. On the other hand, as the prices are lowered to Rs. 85 per unit, the overall profitability also falls although a higher market penetration has been achieved.

A manager must keep in mind the dynamism of running a business as mentioned above, and then carefully analyse the costs and benefits of each option, and develop his strategy accordingly.

Assumption of Break-even Analysis

Whereas break-even analysis is a handy tool for quick strategy formulation with respect to pricing it must be kept in mind that underneath this simplified model lie a number of unrealistic assumptions, such as :

- Fixed costs are fixed for all production volumes,
- Variable costs do not fall with increasing level of production,
- The total costs and total revenues vary in a linear relationship with output,
- The original fixed costs can support any output level, and
- Maximising profit before interest and tax is the desirable business objective.

However, in reality these assumptions may not strictly hold true and suitable modifications have to be made to account for the more realistic influences. This will be discussed in the next section.

Activity 4

In Activity 2 you had ascertained the break-even point of the major product or service of your organisation. Study the cost, output and revenue data over the past five years. Plot the data on a graph and then note the behaviour of data carefully. What conclusions do you draw in terms of linearity and non-linearity of such data?

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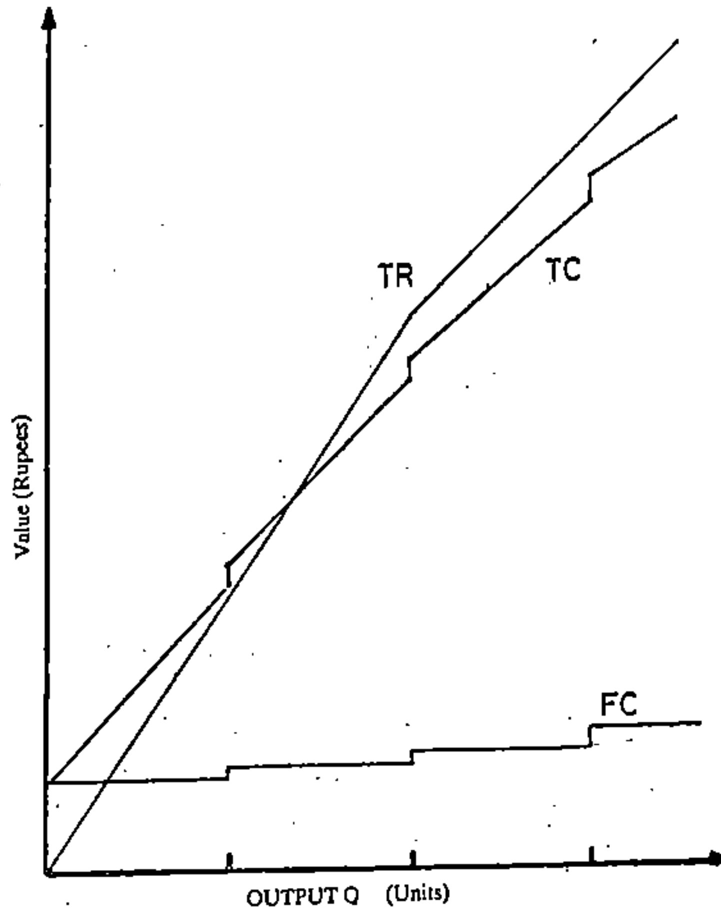
9.15 GENERALISED BREAK-EVEN ANALYSIS

As stated above, so far break-even analysis has considered only very simplified and essentially linear operating conditions.

Figure 9.7 shows a more realistically varying relationships for fixed costs as well as the variable costs, with discrete increases in product volumes. This illustrates that the

Figure 9.7: Generalised Break-even Curve



earlier simplified relationships assumed in break-even analysis are the approximations of the step functions and gradual shifts in cost and price behaviour with changes in volume.

Here the fixed costs have successively higher layers due to increasing volume. This may be in the form of higher overhead costs, such as due to overtime required for producing more etc.

Similarly, with volume the Variable Cost (VC) may rise less steeply due to economies of scale effects.

Beyond certain limits, the additional volume of goods may have to be sold by giving promotional incentives in terms of commissions, volume discounts etc. with lower realised prices. Thus, the total revenue beyond certain level would rise less steeply with output than in the earlier range.

Activity 5

Assume yourself to be the operating manager of a company which sells one product. The sales price is Rs. 25 per unit and it remains constant regardless of volume. The sales last year were 7,500 units and operating profit was Rs. 1 lac. Fixed costs depend on production levels, as shown below :

	Annual Production Range (units)	Annual Total Fixed Costs (Rs.)
Level 1 (day shift)	0 – 10,000	50,000
Level 2 (day and night)	10,001 – 18,000	82,000

Variable costs per unit are 40 per cent higher for level 2 (two shifts) then for level 1 (day shift only), because of additional labour costs due primarily to higher wages required to be paid to employ workers for the night shift. Last year's cost structure and selling price are not expected to change this year. Maximum plant capacity is 18,000 units. The company can sell all that it can produce.

a) Compute the contribution margin per unit for last year for each of the two production levels.
b) Compute the Break-even Point for last year for each of the two production levels.
c) As an operating manager what volume in units you would like to have so that you can have maximum operating profits? Defend your choice.

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9.16 RELATIVE COST ADVANTAGE AND COMPETITIVE STRATEGY

Bhattacharyya and Venkataraman[1] have commented on recent successes of Modis in Tyre Industry, Nirma in detergent industry and Hero in cycles, based mostly on relative cost advantages. Modis initially entered only into the largest product segment, i.e. truck tyres and aimed at dominant market share. Their latest technology helped them. They initially priced their products lower than industry leaders, and offered "good value for money" to truck operators. Subsequently they matched the market leaders' price and displaced him by capturing higher market share.

Nirma has used relative cost advantages in three areas: production, distribution and promotion. By adopting semi-manual production process and concentrating in the North and West Zone urban markets, and by cost effective distributor incentive schemes and spots on Vividh Bharti (initially), Nirma kept their costs low in three areas and offered a highly price competitive product.

Hero cycles by dropping the irrelevant product attributes and by sub-contracting the production of parts to small units, it achieved cost advantages which helped the company in processing their products very competitively.

9.17 SUMMARY

The cost levels in Indian industry in general are high and this is having an adverse effect on the demand of the products, both in the domestic and the international markets. To illustrate this point, we cited the examples of cost levels in textiles, tyres and tubes, aluminium, and steel industry. A number of factors such as high government levies (excise, custom, and sales tax), uneconomic production levels and high manufacturing costs are responsible for this.

What would be the role of cost depends upon the nature of the market, i.e. whether it in buyers' market or sellers' market. While cost is of critical importance to a producer operating in a buyers' market, it is relatively of little significance where he is operating

in a sellers' market. The reason being that in the latter case he can pass on increase in cost to the buyers. As such he has no motivation to control or cut down costs.

The Experience Curve, developed by the Boston Consulting Group, is a method of understanding the behaviour of costs which is based on accumulated experience of the past. As the quantity of production of standardised product increases, the cost per unit goes on declining in a systematic manner. This is known as the Experience Curve Effect. Since experience curve effect is basically a trend effect, as much historical data as is possible should be collected before one sets it to analysis in order to improve its reliability. A number of factors have a bearing on the experience curve. Some of them are improved productivity of labour, increased specialisation, innovation and application of modern production techniques.

The experience curve effect should be developed in real money terms, that is, after removing the effect of inflation. Further, joint costs should be carefully allocated to different products. Where there is a common cost experience, the costs may be grouped together. Unit costs based on grouped costs may be developed for different points of accumulated experience by plotting them on a log-log graph paper and then fitting a straight line along the average unit costs.

Break-even analysis is a technique which can help a producer in deciding about strategic alternatives involving varying cost-volume-profit relationships. By simulating various changes in prices, fixed and variable costs, and volume, a strategy of suitable mix of these factors can be decided upon. In general, a linear relationship is assumed in break-even analysis. However, in reality a non-linear situation may be observed. The total variable cost or total revenue may not increase in direct proportion to increases in volume. In such conditions, more than one break-even-point may be observed on the break-even graph. Practically speaking, therefore, some of the assumptions of break-even analysis may not appear to be very realistic.

9.18 KEY CONCEPTS/TERMS

Experience Effect
Experience Function
Generalised Break-even Analysis
Non linear Break-even Analysis
Value Engineering

9.19 SELF-ASSESSMENT QUESTIONS

1 It is often stated that Indian economy is high-cost economy. Do you agree with the statement? Support your answer with some facts and figures.

2 What are the causes of high cost levels of Indian products and what are their consequences?

3 Examine the role of cost in: (i) sellers' market, and (ii) buyers' market.

4 What are the underlying assumptions of Break-even Analysis? Critically evaluate these assumptions.

5 What is Sensitivity Analysis in relation to Break-even Analysis and why is it done?

6 Distinguish between Linear and Non-linear Break-even Analysis.

7 What are the relative merits and demerits of volume strategy of Experience Curve vis-a-vis segmented market niche based strategy?

8 Consider the factors due to which the auto manufacturing in India, particularly in LCV segment, did not expand as anticipated earlier.

9 Experience Curve Effect assumes that demand (and therefore, production volume) is exclusively determined by the price of the product. Prove or disprove.

10 Enumerate and discuss the products which have followed the Experience Curve Effects, and the ones which will not.

11 Describe in Experience Curve with K = 100%. Which Experience Curve has a stronger experience effect with (a) K = 70% (b) K = 80%? Plot these on a log-log graph paper.

12 The Hindustan Enterprises sells a single product for Rs. 20 per unit. The fixed costs total Rs. 2,50,000. The variable cost per unit is non-linear and can be approximated as follows :

Volume	Variable Cost
0–20,000	Rs. 12
20,001–40,000	11
40,001 and above	10

With the help of the above information :

a) Find the break-even volume.

b) At what volume would the firm have to operate in order to earn an after-tax income of Rs. 1,20,000 if the tax rate is 50%.

c) Instead of the fixed costs being Rs. 2,50,000, suppose they behave as follows :

Volume	Fixed cost
0–10,000	Rs. 2,50,000
10,001–30,000	3,00,000
30,001 and above	3,20,000

Find the break-even point.

9.20 FURTHER READINGS

Boston Consulting Group, 1972, *Perspectives on Experience*, BCG Inc.:Boston.

Henderson, Bruce D. 1979, *Henderson on Corporate Strategy*, Abt Books: Cambridge.

Bhattacharyya S. K. and N. Venkataraman, 1983, *Managing Business Enterprises—Strategies, Structures and Systems*, Vikas Publishing :New Delhi.

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UNIT 10 PORTFOLIO ANALYSIS AND DISPLAY MATRICES

Objectives

The objectives of this unit are to :

- highlight the importance of portfolio analysis and the need for balancing the portfolio
- familiarise you with various types of display matrices used for portfolio analysis
- examine the extent of relevance of the use of portfolio analysis and display matrices.

Structure

10.1 Introduction
10.2 What is Portfolio Analysis?
10.3 Balancing the Portfolio
10.4 Display Matrices
10.5 BCG's Growth Share Matrix
10.6 GE's Strategic Business Planning Grid
10.7 Shell's Directional Policy Matrix
10.8 Pims Model
10.9 Arthur D. Little Company's Matrix
10.10 Hofer's Product/Market Evolution Matrix
10.11 Utility of Display Matrices
10.12 Portfolio Analysis and Indian Industry
10.13 Summary
10.14 Key Concepts/Terms
10.15 Self-assessment Questions
10.16 Further Readings

10.1 INTRODUCTION

An important element of corporate strategy is to identify ways and means of optimum deployment of resources available with a company. In general, a company may have diverse business activities in different markets involving different amounts of investments, and correspondingly bringing different returns. These returns, however, are dynamic—changing with time and competition in the industry. Thus, one of the major tasks of a senior level manager is to integrate the different parts of the corporate puzzle to arrive at the final picture of the whole corporation, in terms of cash flow and its financial requirements.

Managers know that they must judiciously diversify to survive in the long run. Diversification means choosing options, taking some resources from one activity into some other activity with more potential immediate or future. When the multiplicity of products or divisions increases, there are competing pulls on the company's resources. Such multi-dimensional requirements need to be accommodated while taking decisions regarding investments and cash flows.

These investment and financial decisions must consider the entire portfolio of the firm rather than considering individual businesses only. For instance, a business with a mature product may be generating surplus cash and wanting to use this within the division, though it has poor prospects for growth in the future. On the other hand, another business with a product on the growth stage would require more cash, although its present returns are not commensurate with its cash requirements. The manager's dilemma is how should the funds be used and generated across the organisations.

10.2 WHAT IS PORTFOLIO ANALYSIS?

Portfolio analysis is an analysis of the corporation as a portfolio of different business with the objective of managing it for returns on its resources. The business may be in

the forms of organisational units, such as different subsidiaries or divisions of a parent company or Strategic Business Units (SBUs).

Thus, portfolio analysis looks at the corporate investments in different products or industries under the common corporate jurisdiction. The corporate manager analyses the future implications of their present resource allocations and continuously evaluates which operations or products to expand or add, and which ones to be curtailed or disposed off, so that the overall portfolio balance is maintained or improved. The focus is on the present as well as the future.

The activities of a company and its effectiveness in the market place also depend on what the other competing companies are doing. Therefore, the portfolio analysis takes into consideration such aspects as the company's competitive strengths, resource allocation pattern and the industry characteristics.

The popularity of the portfolio analysis is also due to its simplicity. It provides managers with data on source and uses of funds in different operations, in a more readily understandable form. The portfolio analysis helps the manager to see the operations of the company in an integrated manner, think and discuss about its competitive position and evaluate resource allocation from the long term point of view.

10.3 BALANCING THE PORTFOLIO

Portfolio analysis is primarily concerned with the balancing of the company's investments in different products or industries and is useful for highly diversified multi-product companies operating in a limited market. The different subsidiaries or strategic business units have to be balanced with respect to the three basic aspects of running the business:

- Net Cash Flow
- State of Development
- Risk

Net Cash Flow

The different businesses behave differently in terms of their cash flow characteristics. A growing new business may be profitable, but it will also require additional cash because of its investment requirements. On the other hand, mature businesses though less profitable, do not require such investments and may be net cash generators. Thus, portfolio analysis must balance different businesses, which together must give an overall cash-flow position in harmony with the desired financial strategy and condition of the company.

State of Development

As indicated above, different businesses at different stages in their life cycles, have different cash flow characteristics. All businesses or products are likely to go through a life-cycle of embryonic development, high growth, maturity and decline. If a company is depending on one product alone, it would also go through such a cycle towards its decline and doom. When a product is in its decline stage, it may be too late to start a new product or project because of the time lag involved in the life-cycle, and wait till it achieves a growth. For the overall stability of a company, it is better to match different businesses at different stages in their life-cycles—to achieve the extended corporate 'immortality'. Thus, the individual business units grow, mature and decline while the firm continues to grow.

Risk

Another major objective in developing a corporate portfolio is to reduce the risk of critical financial setback. The aim is to put together diverse business activities with different or even opposite key market forces affecting sales (or supplies in some cases). One solution may be to diversify internationally, because markets in different countries may be subject to different economic forces resulting in different business cycles of development, growth and decline. The opposing (or out of phase) exchange rate movements may also have similar effect.

In the context of the domestic markets, businesses with different seasonal sales cycles may be combined to ensure a more stable and smoother financial performance of the overall corporation. However, the macro-economic trends at the national level

sometimes may affect all the business sectors, be they consumer goods, durable goods or the industrial products.

10.4 DISPLAY MATRICES

The purpose of portfolio analysis is to optimally allocate resources for the best total return, with focus on the corporate strategies. Many different approaches involving different display matrices have evolved over the years, with the common objective of successful diversification.

Boston Consulting Group's Growth-Share Matrix

This is a two-by-two product portfolio analysis using Market Growth Rate with Relative Market Share. It identifies its segments as Dogs, Cows, Stars and Question Marks (also called Wild Cat or Problem Child). These different businesses are categorised in terms of cash flow. Each segment is then populated by bubbles whose size is proportional to the size of the business activity, expressed in terms of sales, assets or some other measure.

McKinsey Matrix

This matrix is generally associated with General Electric and Shell Companies. It is a three-by-three matrix which divides Industry Attractiveness and Business Strength, into low, medium and high segments each. The parameters are compound variables of different factors, to be either subjectively judged or objectively computed based on weighted judgments.

Strategic Planning Institute's Matrix

Strategic Planning Institute's programme on Profit Impact of Market Strategy (PIMS) compares the company's profitability with the average profitability of the associated industry. PIMS matrix is based on business average profitability (PAR ROI), an industry characteristic, determined by a cross-sectional, multi-dimensional regression study of the profitability of different businesses. This method avoids the judgmental weightages of the previous approach, but some criticise this approach because of its heterogeneous population of dissimilar businesses.

Arthur D.Little Company's Matrix

This matrix uses Life Cycle Stages (Embryonic, Growth, Mature and Decline) with Business Strength (Weak, Tenable, Favourable, Strong and Dominant). The grid segments are then classified into Build, Hold, Harvest and Unpredictable ROI.

Hofer's Product/Market Evolution Matrix

This is a very similar matrix as above plotting businesses in terms of their product/market evolution and the competitive position.

Besides the above, there are other matrices associated with different consultants who have developed them to suit their specific needs for market differentiation. We will now discuss some of the abovementioned matrices in detail, starting with the pioneering BCG matrix.

10.5 BCG's Growth-Share Matrix

BCG's Portfolio Analysis is based on the premise that majority of the companies carry out multiple business activities in a number of different product-market segments. Together these different businesses form the Business Portfolio which can be characterised by two parameters:

1) Company's relative market share for the business, representing the firms competitive position, and
2) the overall growth rate of that business.

The BCG model proposes that for each business activity within the corporate portfolio, a separate strategy must be developed depending on its location in a two-by-two matrix of high and low segments on each of the abovementioned axes. These parameters are discussed in detail below.

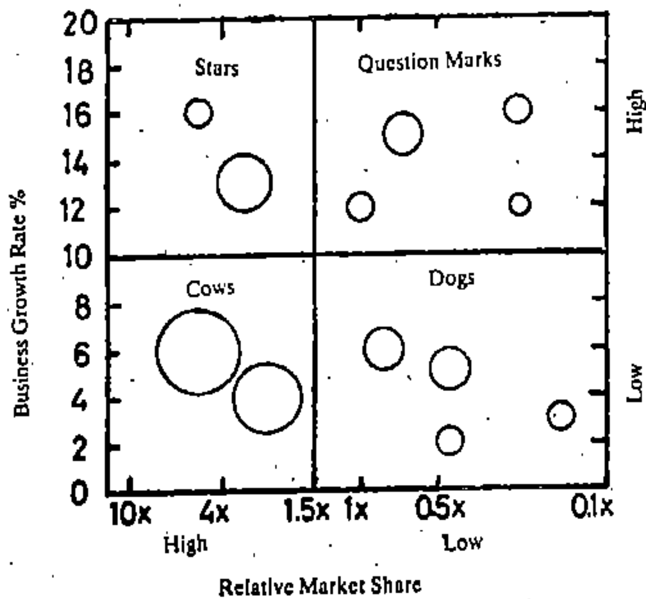
Relative Market Share is stressed on the assumption that the relative competitive position of the company would determine the rate at which the business generates cash. An organisation with a higher relative share of the market compared to its competitors will have higher profit margins and therefore higher cash flows. (This point of view can be debated, and will be discussed later. A high market share per se may or may not be be linked to high profitability or growth in future.)

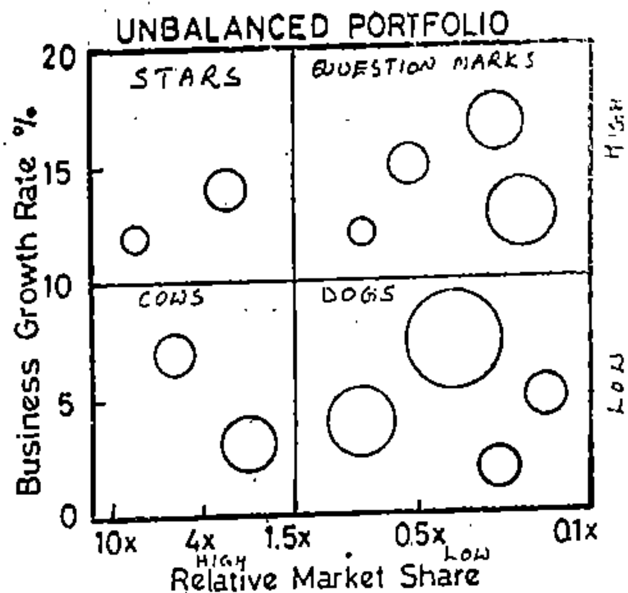
Relative Market Share is defined as the market share of the relevant business divided by the market share of its largest competitor. Thus, if Company X has 10 per cent, Company Y has 20 per cent, and Company Z has 60 per cent share of the market, then X's Relative Market Share is 1/6, Y's Relative Market Share is 1/3, and Z's Relative Market Share is 60/20 = 3. Company Z has Company Y as its leading competitor, whereas Companies X and Y have Company Z as their lead competitor.

The selection of the **Rate of Growth** of the associated industry is based on the understanding that an industrial segment with high growth rate would facilitate expansion of the operations of the participating company. It will also relatively easier for the company to increase its market share, and have profitable investment opportunities. High growth rate business provides opportunities to plough back earned cash into the business and further enhance the return on investment. The fast growing business, however, demands more cash to finance its growth.

If an industrial sector is not growing, it would be more difficult for the participating company to have profitable investments in that sector. In a slow growth business, increase in the market share of a company would generally come from corresponding reduction in the competitors' market share.

Figure 10.1 : BCG Matrix





The BCG matrix classifies the business activities along the vertical axis according to the 'Business Growth Rate' (meaning growth of the market for the product), and the 'Relative Market Share' along the horizontal axis. The two axes are divided into Low and High sectors, so that the BCG matrix is divided into four quadrants (refer to Figure 10.1). Businesses falling into each of these quadrants are classified with broadly different strategic categories, as explained below :

Cash Cows

The businesses with low growth rate and high market share are classified in this quadrant. High market share leads to high generation of cash and profits. The low rate of growth of the business implies that the cash demand for the business would be low. Thus, Cash Cows normally generate large cash surpluses. Cows can be 'milked' for cash to help to provide cash required for running other diverse operations of the company. Cash Cows provide the financial base for the company. These businesses have superior market position and invariably low costs. But, in terms of their future potential, one must keep in mind that these are mature businesses with low growth rate.

Dogs

If the business growth rate is low and the company's relative market share is also low, the business is classified as DOG. The low market share normally also means poor profits. As the growth rate is also low, attempts to increase market share would demand prohibitive investments. Thus, the cash required to maintain a competitive position often exceeds the cash generated, and there is a net negative cash flow.

Under such circumstances, the strategic solution is to either liquidate, or if possible harvest or divest the Dog business.

Question Marks

Like Dogs, Question Marks are businesses with low market share but the businesses have a high growth rate. Because of their high growth, the cash requirement is high, but due to their low market share, the cash generated is also low

As the business growth rate is high, one strategic option is to invest more to gain market share, pushing from low share to high. The Question Mark business then moves to a STAR (discussed later) quadrant, and subsequently has the potential to become cash low, when the business growth rate reduces to a lower level.

Another strategic option is when the company cannot improve its low competitive position (represented by low market share). The management may then decide to divest the Question Mark business.

These businesses are called Question Marks because they raise the question as to whether more money should be invested in them to improve their relative market share and profitability, or they should be divested and dropped from the portfolio.

Stars

Businesses which have high growth rate and high market share, are called Stars. Such businesses generate as well as use large amounts of cash. The Stars generate high profits and represent the best investment opportunities for growth.

The best strategy regarding Stars is to make the necessary investments and consolidate the company's high relative competitive position.

Methodology for Building BCG Matrix

The Boston Consulting Group suggests the following step-by-step procedure to develop the business portfolio matrix and identify the appropriate strategies for different businesses.

- Classify various activities of the company into different business segments or Strategic Business Units (SBUs).
- For each business segment determine the growth rate of the market. This is later plotted on a linear scale.
- Compile the assets employed for each business segment and determine the relative size of the business within the company.
- Estimate the relative market shares for the different business segments. This is generally plotted on a logarithmic scale.

- Plot the position of each business on a matrix of business growth rate and relative market share. The size of the business is represented by a bubble, a circle with a diameter corresponding to say the assets employed in that business.
  For precise plotting, it has been recommended that the radius of a bubble corresponding to a business/product may be defined as :

$$r = \sqrt{p.\ R^2}$$

Where, R = radius of the large circle representing total company sales, and

p = sales of a product as percentage (expressed in decimal) of the total sales.

The four quadrants are divided by arbitrary lines. According to a BCG director, a 10 per cent volume growth is the typical dividing line between high and low growth businesses, and a relative market share of 1.5T may separate Stars from the Question Marks in high-growth industries. On the other hand, the recommended relative market share dividing Cows and Dogs is 1T for low growth industries. It is, however added that these dividing lines are merely approximate guidelines and may be changed if desired.

Strategic Implications

Most companies will have different segments scattered across the four quadrants of the BCG matrix, corresponding to Cash Cow, Dog, Question Mark and Star businesses.

The general strategy of a company with diverse portfolio is to maintain its competitive position in the Cash Cows, but avoid over-investing. The surplus cash generated by Cash Cows should be invested first in Star businesses, if they are not self-sufficient, to maintain their relative competitive position. Any surplus cash left with the company may be used for selected Question Mark businesses to gain market share for them. Those businesses with low market share, and which cannot adequately be funded may be considered for divestment. The Dogs are generally considered as the weak segments of the company with limited or no new investments allocated to them.

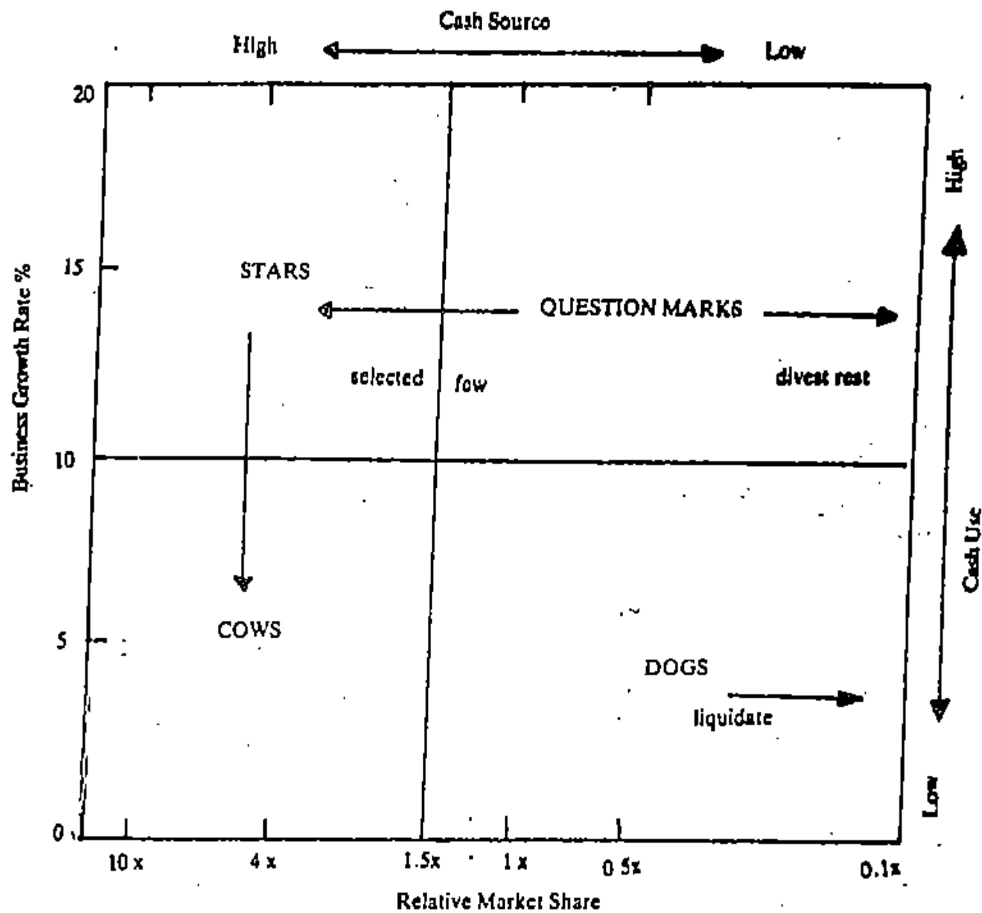
The BCG Growth-share matrix links the industry growth characteristic with the company's competitive strength (market share), and develops a visual display of the company's market involvement, thereby indirectly indicating current resource deployment. (The sales to asset ratio is generally stable over time across industries). The underlying logic is that investment is required for growth while maintaining or building market share. But, while doing so, a strong competitive business in an industry with low growth rate will provide surplus cash for deployment elsewhere in the Corporation. Thus, growth uses cash whereas market competitive strength is a potential source of cash. In terms of BCG classification, the cash position of various types of businesses can be visualised as in Table 10.1.

Table 10.1
Cash Positions of Various Businesses

Business Type	Cash Source	Cash Use	Net Cash Balance
1 COW	More	Less	Funds available, so milk and deploy
2 STAR	More	More	Build Competitive position & grow
3 DOG	Less	Less	Divest and redeploy proceeds
4 QUESTION MARK	Less	More	Funds needed to invest selectively to improve competitive position

In a sense, the BCG matrix can be regarded as a pictorial representation of the sources and uses of funds statement. Market Share is considered valuable because it is a source of profits. Profits are the fruits of accumulated experience giving rise to cost advantage. The model assumes that high market growth of star businesses will subsequently slow down, permitting the market leader to take cash out of the Cow business. Some of the underlying assumptions may not always hold true for some businesses. For instance, some electronic appliances and the so-called fashion goods have very short life-cycles, whereas staples like bread have very extended life-cycles. These businesses may therefore not follow the typical behaviour pattern assumed by BCG growth-share matrix as depicted in Figure 10.3.

Figure 10.3 Typical Behavioural Pattern of Businesses



Portfolio Balancing

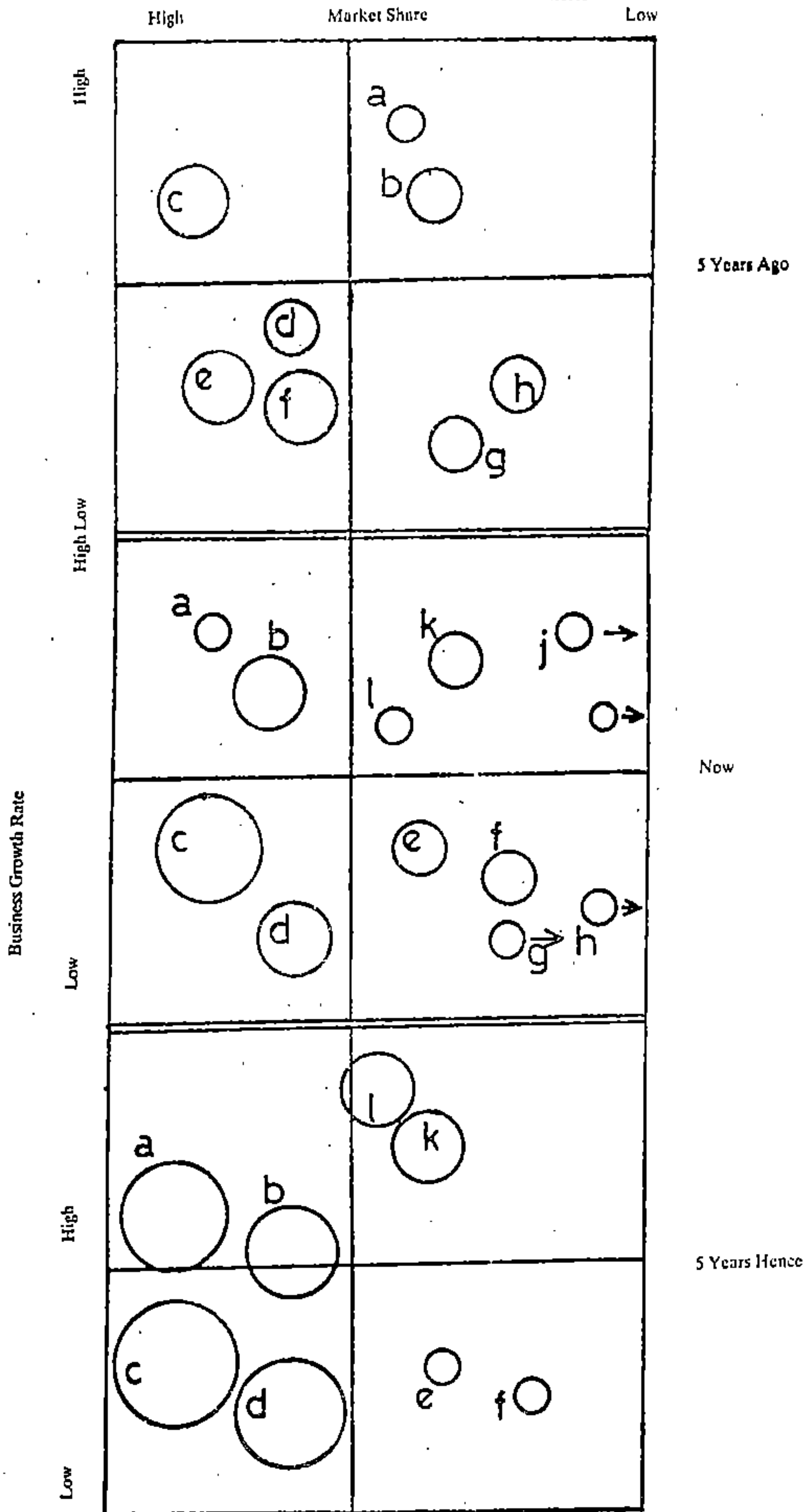
Figures 10.1 and 10.2 show the business portfolios of Company A and Company B. Company A has stable cash source in two Cash Cows. Growth opportunities are provided by two Star businesses, whose size is such that their investment requirements can be fulfilled by Cash Cows. Out of the four Question Mark businesses, may be two can be developed into Star businesses by additional investments, whereas the other two may be gradually divested. The four Dog businesses require careful attention for cash management and may be liquidated or divested. Thus, Company A has a well balanced portfolio.

On the other hand, Company B has no major source of cash, with only small cash flow businesses. Furthermore, in terms of future potential, the company has not developed any major Star businesses. Looking at the portfolio mix, one realises that for most of the businesses, the company has poor relative competitive position with many Question Mark businesses (but no funds to revive or convert them into Star businesses) and Dog businesses.

Time Dependence

A useful interpretation of portfolio approach can be made by developing BCG Growth-Share Matrix at different points in time. As shown in Figure 10.4., various businesses should be classified into four categories and plotted as they stand at present, as they stood three or five years ago, and as they are expected to stand three or five years ago, and as they are expected to stand three to five years from now. Thus, the impact of strategies employed by the management can be determined, and the directions in which the businesses are moving can be evaluated.

Figure 10.4 Past, Present and Future of Various Businesses



Over a period of time, the slowing down of growth in the star businesses may turn them into Cash Cows provided they are able to maintain their relative competitive position and high market share. However, with competition and passage of time, they may also lose their market share. If this happens then they turn into Dog businesses and require a totally different strategic attention.

Limitations of BCG Matrix

The Growth-share BCG Matrix has certain limitations and weak points which must be kept in mind while using portfolio analysis for developing strategic alternatives. These are now briefly discussed.

Predicting Profitability from Growth and Market Share

BCG analysis assumes that profits depend on growth and market share. The attractiveness of an industry may be different from its simple growth rate, and the firm's competitive position may not be reflected in its market share. Some other sophisticated approaches have been evolved to overcome such limitations.

There have been specific research studies which illustrate that the well-managed Dog businesses can also become good cash generators. These organisations relying on high-quality goods, with medium pricing and judicious expenditure on R & D and marketing, can still provide impressive return on investment of above 20 per cent.

Difficulty in Determining Market Share

There is a heavy dependence on the market share of a business as an indicator of its competitive strength. The calculation of market share is strongly influenced by the way the business activity and the total market are defined. For instance, the market for helicopters may encompass all types of helicopters, or only heavy helicopters or only heavy military helicopters. Furthermore, from geographical point of view the market may be defined on worldwide, national or a even regional bases. In case of complex and interdependent industries, it may also be quite difficult to determine the market share based on the sales turnover of the final product only.

No Consideration for Experience Curve Synergy

In the BCG approach, businesses in each of the different quadrants are viewed independently for strategic purposes. Thus, Dogs are to be liquidated or divested. But, within the framework of the overall corporation, useful experiences and skills can be acquired by operating low-profit Dog businesses which may help in lowering the costs of Star or Cash Cow businesses. And this may contribute to higher corporate profits.

Disregard for Human Aspect

The BCG analysis, while considering different businesses does not take into consideration the human aspects of running an organisation. Cash generated within a business unit may come to be symbolically associated with the power of the concerned manager. As such the manager running a Cash Cow business may be reluctant to part with the surplus cash generated by his unit. Similarly, the workers of a Dog business which has been decided to be divested may react strongly against changes in the ownership. They may deem the divestiture as a threat to their livelihood or security. Thus, BCG analysis could throw up strategic options which may or may not be easy to implement.

BCG Modifications

It was in 1981 that the Boston Consulting Group realised the limitations of equating market share with the competitive strength of the company. They have admitted that the calculation of market share is strongly influenced by the way business activity and the total market domain are defined. A broadly defined market will give lower market share, whereas a narrow market definition will result in higher market share resulting in the company as the leader. It was, therefore, recommended that products should be regrouped according to the manufacturing process to highlight the economies of scale manufacturing, instead of stressing the market leadership.

On the other hand, BCG still maintain that for branded goods it is important to be the market leader so that the advantages of economies of scale and price leadership can be fully utilised. But they also concede that such advantages may still be achieved even if the company is not the largest producer in the industry. Some other versions of portfolio

analysis have however developed much beyond those minor modifications of BCG analysis.

Activity 1

Consider a company with which you are familiar. Collect information regarding its various businesses and describe them using the BCG growth-share matrix. First give the chronology of year-wise business development and then draw the matrix.

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10.6 GE'S STRATEGIC BUSINESS PLANNING GRID

General Electric (or McKinsey) matrix uses market attractiveness as not merely the growth rate of sales of the product, but as a compound variable dependent on different factors influencing the future profitability of the business sector. These different factors are either subjectively judged or objectively computed on the basis of certain weightages, to arrive at the Industry Attractiveness Index. The Index is thus based on a thorough environmental assessment influencing the sectoral profitabilities.

Factors determining Industry Attractiveness:

		Typical weightage
1	Size of market	10%
2	Rate of growth of sales and cyclic nature of business	15%
3	Nature of competition including vulnerability to foreign competition	15%
4	Susceptibility to technological obsolescence and new products	10%
5	Entry conditions and social factors	10%
6	Profitability	40%
		100%

Against each of these factors, the concerned business is rated on a scale of 1 to 10, and then the weighted score is determined from a maximum of 10. This gives the **Industry Attractiveness Index** for the business under consideration.

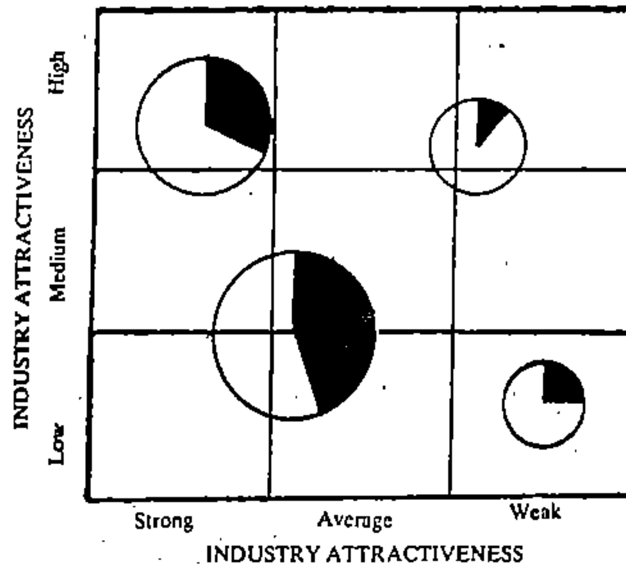
Factors determining Competitive Position of the Company as with Industry Attractiveness, the Competitive Position of the company is analysed not only in terms of company's market share, but also in terms of other factors often appearing in the Strength and Weakness analysis of the company. Thus, product quality, technological and managerial excellence, industrial relations etc, are also incorporated beside market share and plant capacity.

A typical scoring of company's Competitive Position would be illustrated below :

	Factor	weightage	rating (1 to 10)	score
1	Market Share & Capacity	20%	7	1.4
2	Growth Rate	10%	7	0.7
3	Location & Distribution	10%	5	0.5
4	Management Skill	15%	6	0.9
5	Workforce Harmony	20%	7	1.4
6	Technical Excellence including Product & Process Engg.	20%	8	1.6
7	Company Image	5%	8	0.4
		100%		6.9

The Industry Attractiveness Index is then plotted along the vertical axis and divided into low, medium and high sectors. Correspondingly, the Competitive Position is plotted along the Horizontal axis divided into Strong, Average and Weak segments. For each business in the portfolio, a circle denoting the size of the industry is shown in the 3 × 3 matrix grid while shaded portion corresponds to the company's market share as shown in Figure 10.5.

Figure 10.5: GE's Business Planning Matrix



GE rates each of its businesses every year on such a framework. If Industry's Attractiveness as well as GE's Competitive Position is low, a no-growth red stoplight strategy is adopted. Thus, GE expects to generate earnings but does not plan for any additional investments in this business. If for a business the Industry Attractiveness is medium and GE's Competitive Position is high, a growth green stoplight strategy is evolved for further investment. But if a business has high industry Attractiveness index and low GE's Competitive Position, this is branded as yellow stoplight business that may be moved either to growth or no growth category. Such grids are developed at different managerial levels. The final strategic decisions are made by GE's Corporate Policy Committee comprising the Chairman, the Vice-Chairman and Vice-Presidents of Operational areas, including finance.

10.7 SHELL'S DIRECTIONAL POLICY MATRIX

As in the case of GE's approach, the Business Prospects and Competitive Capabilities are plotted in Shell's Directional Policy Matrix. The three-by-three matrix as shown in

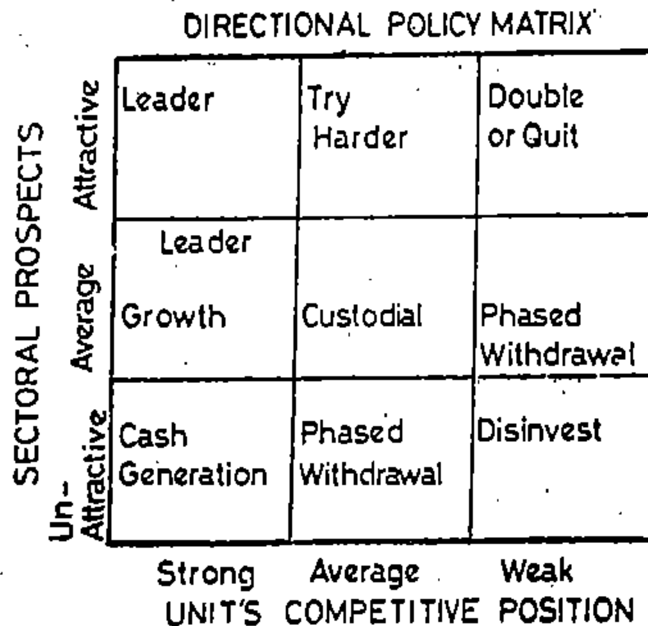


Figure 10.6 identifies different strategies for each grid sector. These are explained below :

Strategy	Business Prospects	Competitive Capability	Recommended Strategy
1 Leader	High	Strong	High priority with all necessary resources to hold high market position.
2 Try Harder	High	Medium	Allocate more resources to move to leader position.
3 Double or Quit	High	Weak	Pick products likely to be future high flyers for doubling and abandon others.
4 Growth	Average	Avg. Strong	May have some strong competition with no one company as leader. Allocate enough resources to grow with market.
5 Custodial	Average	Average	May have many competitors, so maximise cash generation with minimal new resources.
6 Phase Withdrawal	Low	Average	Slowly withdraw to recover most of investment.
7 Cash Generation	Low	Strong	Spend little cash for further expansion, and use this as a cash source for faster growing businesses.
8 Disinvest	Low	Weak	Assets should be liquidated as soon as possible and invested elsewhere.

While using the above analysis, Shell realised that the various zones were of irregular shape, sometimes with overlapping boundaries.

10.8 PIMS MODEL

A programme for the Profit Impact of Market Strategy (PIMS) was started at General Electric, and was later used by the Strategic Planning Institute. The PIMS programme analyses data provided by member companies to discover 'general laws which determine the business strategy in different competitive environments producing different profit results'.

Unlike the earlier approaches using judgement for multidimensional factors, the SPI uses multidimensional cross-sectional regression studies of the profitability of more than 2,000 businesses. It then develops an industry characteristic, Business Average Profitability, and compares it with the performance in the concerned company. This model uses statistical relationship estimated from past experience in place of the judgmental weightages assigned for the importance of different factors behind Industry Attractiveness and Competitive Position in previous approaches. This scientific objective approach has been criticised that the analysis of relationship in it is based on heterogeneous population, i.e. different types of business, taken at different time periods.

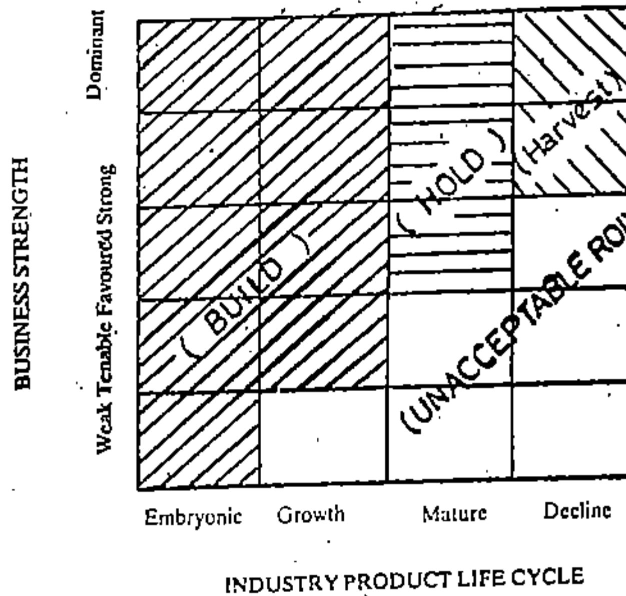
Profitability is closely linked with market share. A 10 per cent improvement in profitability is linked with 5 per cent improvement in Return on Investment. This has since been rationalised by a number of arguments, such as 'the Experience Curve Effect' which implies reduction in average cost with increase in accumulated production. The larger company can use better quality management, and thus can exercise greater market power.

10.9 ARTHUR D. LITTLE COMPANY'S MATRIX

Arthur D Little Company's matrix links the stages of the product life cycle with the business strength. On the vertical axis, the businesses are classified with respect to their business strength: Weak, Tenable, Favourable, Strong, or Dominant. Along the horizontal axis four stages in the life-cycle, Embryonic, Growth, Mature and Decline are marked. (see Figure 10.7).

In the Embryonic and Growth stages the businesses are recommended for Build strategy, except when the Business Strength is weak. For Mature stage businesses with

Figure 10.7: Arthur D. Little Co.'s Matrix

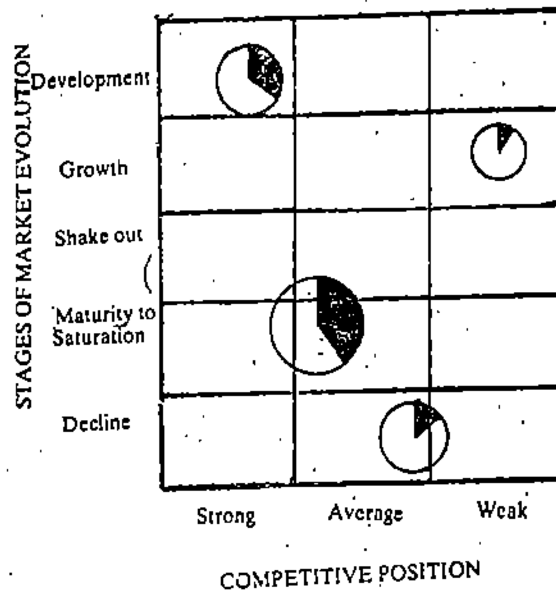


Dominant to favourable strength, HOLD Strategy is recommended. Harvest strategy is proposed for businesses in Decline stage, with Strong or Dominant position. For weaker businesses in Mature/Decline stage unacceptable ROI is marked.

10.10 HOFER'S PRODUCT/MARKET EVOLUTION MATRIX

Charles Hofer has proposed a three-by-five matrix where businesses are plotted in terms of their product/market evolution and the competitive position. Relative sizes of industries are shown by circles wherein the market share of the company is shaded (Figure 10.8).

Figure 10.8: Hofer's Market Evolution



- A business in the Development or Growth stage has a potential to be a Star. If the market share is large in these growth oriented stages, more resources must be invested to develop competitive position. But if market share is low, a strategy to improve the same must be developed. If the industry is relatively small and market share is low despite high growth stage, management must consider divesting and redeploying resources in other more competitive businesses.
- A business in the Shake-out or Maturity stage has a potential to be a Cash Cow Investments could be made to maintain high market share.
- A business in Decline stage with a low market share would be a Dog business. Though in the short run it may generate cash, in the long run, however, it should be considered for divestment or liquidation.

10.11 UTILITY OF DISPLAY MATRICES

It is important to note that whereas the specific names of axes differ from matrix to matrix, they are based on quite similar principles. In one form or another most portfolio approaches try to correlate industry growth or profitability with market share, either as a direct single variable or as an index based on multiple variables. Further, these matrices are meant to facilitate a graphic display of the diversity of an organisation rather than to provide precise analytical tools. The matrices help to raise critical questions about improper deployment of funds and gross mismatches in businesses, and not so much to give precise answers where and how should the next unit of money be used.

Experience shows that the portfolio analysis is not applicable where market share is not so critical, or the capital cannot be easily withdrawn. Similarly, extra care is required in utilising portfolio analysis if value added is low or cost can be lowered without experience, or technology is transferred rapidly by suppliers. Seasonality of and cyclic businesses, patent restrictions and low economies of scale also complicate the strategic outcomes from portfolio analysis.

To conclude, the models discussed here must be used to stimulate managers to think about their businesses in an integrated manner. Some companies like General Electric, Shell, and Dexter in USA. have successfully utilised these conceptual frameworks to improve their performances. General Electric improved its return of profit from 3.7 per cent in 1970 to 5.9 per cent in 1976, and to 8.2 per cent in 1984. Some companies reported doubling of their return on total capital over a period of ten years by simple and systematic documentation of their resource deployment. In general, these models should be used not in isolation but in conjunction with other analytical tools to help define questions in a better way so that better solutions can be worked out. After two oil shocks and heavy inflation rates coupled with depressed market conditions, most of the companies do not have unlimited resources, to expand all their businesses at the same time. Portfolio analysis will help distinguish the ones to be promoted from the ones to be dropped.

Activity 2

Meet a local representative of any diversified enterprise (e.g. ITC, DCM, Shaw Wallace) and gather information on its portfolio. Give your comments.

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10.12 PORTFOLIO ANALYSIS AND INDIAN INDUSTRY

In general, the freedom underlying the corporate portfolio development is not available to Indian managers. The industry is regulated to a great extent by the government policies and it is not solely in the hands of the corporate managements to add new activities or delete old ones. Starting of new industrial ventures is subjected to many procedural and time-consuming clearances from the Ministries of Commerce,

Industry and the Cabinet Committee. Monopolies and Restrictive Trade Practices Commission takes an exceptional view of large organisations with the objective of curbing concentration of financial powers in the hands of the few. The Foreign Exchange Regulation Act restricts excessive involvement of large multinational and foreign companies. The plant capacities are closely regulated and, till recently, it was difficult to attain economies of scale as the licensed capacities were allowed small increments only. Fortunately, the governmental agencies have realised the need to have viable capacities and have permitted certain amount of freedom to industries in the form of broadbanding. With these developments, corporate managements can take some actions to develop their competitive positions by increasing market shares. The companies which will move faster will benefit over others.

Unfortunately, due to a tradition of restrictive controls by the government since Independence, the Indian entrepreneurs are obsessed with the idea of accumulating industrial licences, irrespective of their competitive strengths. Projects for latest high-tech products are planned side by side with the mature and sometimes obsolete technologies. The portfolio thus emerges as highly unbalanced with no mutual congruence in terms of cash flows, risks or the stages in their life-cycles. The primary concern is to grab the licence, restrict others from entering the field, and quickly make as much profit as is possible without making any worthwhile effort to further develop the technology or the products. In sellers markets of yester-years, such a strategy could pay rich dividends, but not any longer. As buyers become conscious of the availability of options, the traditional blue-chip companies with monopolistic market shares in the past may fall prey to market competition. Their high sounding or ambitious diversification plans may not get to the implementation stage because of lack of availability of surplus cash for investment. In the present transition period, with government policies gradually moving towards more competition in the market place, the display matrices can be useful to carry out dynamic portfolio analysis over time.

Another peculiarity of Indian situation is the legal taboo associated with divestment or liquidation of Dog businesses. The labour is protected by legislation and it becomes impossible for the managements to close down businesses. Labour relations have an important role in building up a company's competitive strength. While the labour in the unorganised sector is exposed to extreme working conditions despite government rules, the workers in the organised sector are assured of absolute security irrespective of their contribution to company's competitive strength. Under such circumstances, the managements should be extremely careful in seeing that their businesses remain viable, that they do not become cases for liquidation. The Indian manager's task therefore is more challenging compared to that of his counterpart in the Western countries who has options to divest, liquidate or acquire businesses.

But, at the same time we must also concede that the Indian manager is fortunate in having an overall industrial development which is still in its early stages (compared to America or Japan). For him, there is huge domestic potential market which is still untapped. Almost any business is still in its high growth stage. The manager's will and his systematic approach nurtured by the top management are the two major critical factors for the stable growth of business in years to come. Hopefully, the framework provided by the display matrices would facilitate such systematic analysis for developing competitive strength and corporate growth.

Activity 3

The respective market shares (product-wise) of three leading brands of tyre for the period 1977-80 are given in Table 10.2.

Table 10.2
Tyre Industry—leading brand shares

PRODUCT CATEGORY	Dunlop				Modi				MRF			
	1977 Ms*	%	1980 Ms*	%	1977 Ms*	%	1980 Ms*	%	1977 Ms*	%	1980 Ms*	%
Truck Tyres	21.9.	127	16.65	88	15.46	71	18.85	119	12.82	59	17.07	91
Car Tyres	29.95	161	19.57	107	6.77	23	8.01	41	5.64	19	12.01	61
Truck Tyres	42.36	233	28:22	161	6.17	15	12.41	44	5.78	14	10.31	37
LT/Jeep Tyres	27.83	175	19.81	110	10.61	38	16.66	84	7.8	28	17.93	91

* MS : Market Share (based on volume).
% Percentage to the share of the largest competitor.
Source : Bhattacharyya, S.K. and N. Venkataraman, 1983 *Managing Business Enterprises — Strategies Structures and System*, Vikas Publications, p. 200.

a) Explain and interpret the table in terms of the changes or shifts that have taken place in the market shares over the period in the light of your own knowledge and understanding of the situation.

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) Make further enquiries about the market growth in respective product categories and draw the product portfolio matrices for various brands and periods.

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10.13 SUMMARY

Portfolio Analysis is an important task of a corporate strategist. It provides a framework for analysing the mutual compatibility of diverse operations of an organisation. The portfolio of operations need to be balanced with respect to net cash flows, states of development, and the risks associated with each business activity. After discussing the need for balancing the portfolio with respect to these aspects, different types of display matrices have been introduced in this unit.

The Boston Consulting Group's Growth-Share Matrix, being the pioneering model, was first taken up for discussion in detail.

The two underlying parameters and different quadrants of the BCG Matrix were explained. A methodology for building up BCG Matrix was proposed. The strategic implications, balancing of portfolio, and variations with time were covered next. Some of the limitations of BCG Matrix with respect to determination of profitability, market share and lack of consideration for experience curve synergy and human aspects associated with strategic actions were discussed alongwith some of the modifications proposed by Boston Consulting Group.

The essential features of other display matrices, such as General Electric's Strategic Business Planning Grid, Shell's Directional Policy Matrix, Strategic Planning Institute's Matrix (PIMS Model) and matrices based on product life-cycle or market evolution were explained in the context of their departures from BCG Matrix. The overall utility of Portfolio Analysis and the relevance of display matrices in the Indian context were commented upon towards the end.

10.14 KEY CONCEPTS/TERMS

Arthur D. Little Company's Product Life-cycle Matrix
BCG's Growth-Share Matrix
Cow Business
Dog Business
General Electric's Strategic Business Planning Grid
Hofer's Market Evolution Matrix
Market Growth Rate
Portfolio Analysis
Question Mark Business
Relative Market Share
Star Business
Shell's Directional Policy Matrix
Strategic Planning Institute's Matrix

10.15 SELF-ASSESSMENT QUESTIONS

1) What basic considerations have to be kept in mind while balancing portfolios?
2) Explain the methodology of constructing BCG Matrix.
3) Analyse the implications of BCG Matrix in terms of cash generation and cash use.
4) Discuss the limitations of BCG Display Matrix. What modifications have been made in it?
5) What advice would you give to the chief executive who has chosen to rely solely on BCG Matrix?
6) How does the GE Planning Grid differ from the BCG Matrix?
7) Explain Shell's Directional Policy Matrix. Is it different from GE Planning Grid?
8) Explain and also indicate the uses of—
   a) PIMS Model
   b) Arthur D. Little Company's Matrix
   c) Hofer's Product Market Evolution Matrix.
9) Discuss the application of portfolio analysis and display matrices in the Indian situation.
10) What is the experience curve? How does it relate to the growth-share matrix.
11) Define and distinguish the parameters used in different types of matrices.
12) Compare BCG Matrix with matrices based on product life-cycle or market evolution concept.
13) What other analytical tools would you like to use with display matrices? Illustrate this with respect to the balancing of portfolio.

10.16 FURTHER READINGS

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UNIT 11 OPERATING AND FINANCIAL ANALYSIS

Objectives

The objectives of this unit are to :

- understand the various techniques for strategic financial analysis
- apply the system of financial ratios to carry out strategic analysis of a company
- identify major parameters of financial health of a business and adopt specific tools of analysis.

Structure

11.1 Introduction
11.2 Techniques of Strategic Financial Analysis
11.3 Analysis of Materials, Production and Sales
11.4 Pareto Analysis of Inventory Items
11.5 Financial Ratios
11.6 Patel and Younger's Approach
11.7 Frontier Curve Analysis
11.8 Return on Sales and Investment
11.9 The Market Dominance/Capital Intensity Matrix
11.10 Summary
11.11 Key Concepts/Terms
11.12 Self-assessment Questions
11.13 Further Readings
Appendix

11.1 INTRODUCTION

In the previous two units of this block we looked into cost and portfolio profiles of a company to determine the required courses of action. In this unit we will consider some operating and financial tools which help us in further strategic analysis. To give you just one instance, several researchers in the last few years have highlighted the predicting value of financial ratios, especially in the context of industrial sickness. We will consider some of these financial ratios and will also introduce some financially-based display matrices which help us in analysing the strategy.

11.2 TECHNIQUES OF STRATEGIC FINANCIAL ANALYSIS

The financial techniques have two aspects. The first aspect involves applications like funds flow analysis, cash flow analysis, operating ratios including Dupont Chart etc. These techniques are extremely useful for short-term or operating level analysis of a business. We have covered all these techniques in detail in our basic course on Accounting and Finance (MS-4).

The second aspect concerned with cash generation and cash uses of products/businesses, assets deployment patterns, and long-term behaviour of material consumption, production and sales. Such applications are useful for long-term or strategic level analysis. The trend analysis based on various ratios, the graphical analysis of purchases, production and sales trends are amongst the most simple and practical tools for strategic financial analysis.

During the last two decades a whole new family of analytical techniques based on display matrices has emerged. These are mostly based on two major financial parameters of a business drawn in the form of two-dimensional matrices. For instance, Patel and Younger matrix is based on cash deployment and return on assets. The Frontier Curve Analysis is based on cash use and growth. A common feature of all these

techniques is that they deal explicitly with financial parameters e.g., ROS (Return on Sales) or ROI (Return on Investment).

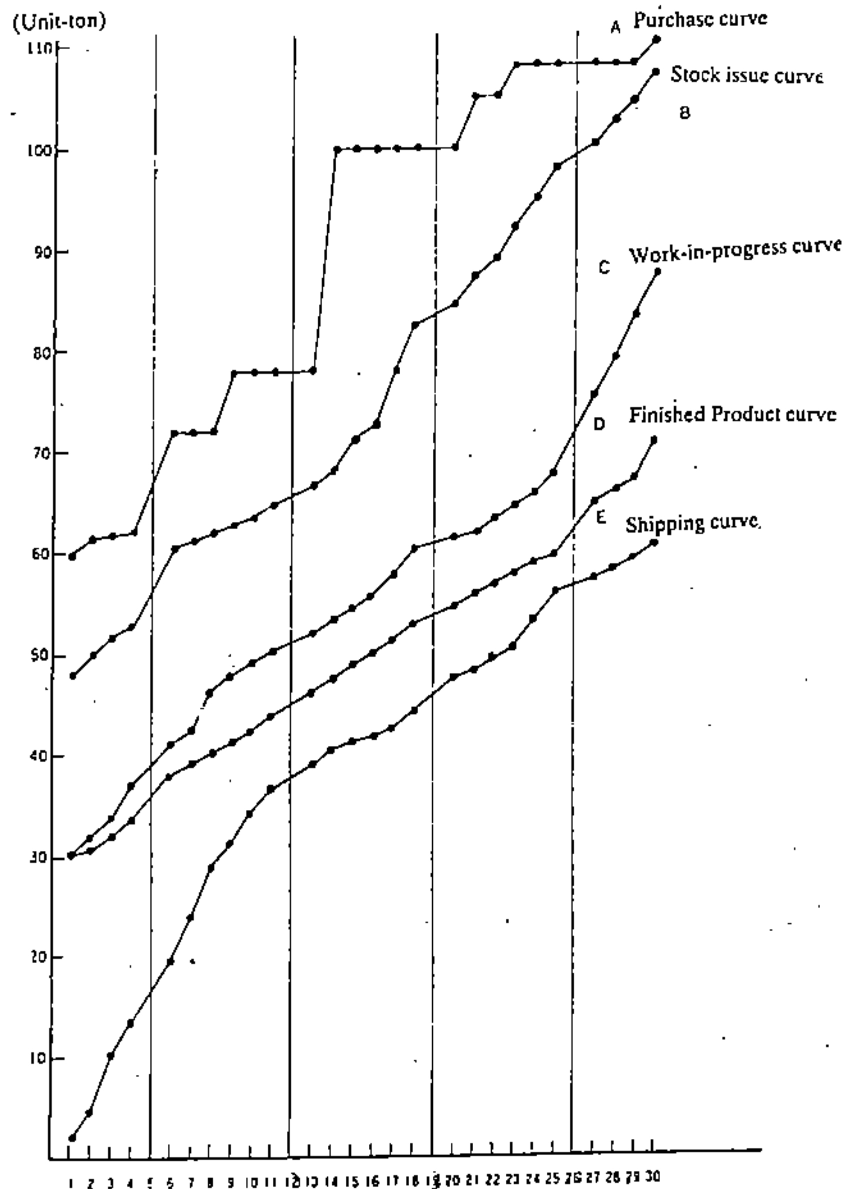
11.3 ANALYSIS OF MATERIALS, PRODUCTION AND SALES

The analysis of purchases, stocks, production and sales is one of the most practical approaches for financial analysis. All these areas of activities are interrelated and involve substantial financial resources of any enterprise.

A single chart of five curves based on cumulative values of purchases, stocks issued, work-in-progress, finished products and shipping of finished goods would indicate the extent of changes or movements occurring on these fronts on daily, weekly or monthly basis. These curves may be drawn for each month and then updated on daily basis. In Figure 11.1 dates are shown on the X-axis and cumulative values of these items on Y-axis.

The vertical differences between various curves would give us same idea as to what is happening with regard to the five items and what actions are called for.

Figure 11.1 : Curves of Current Purchases, Stocks, Production and Sales



The vertical differences can be measured as A-B, B-C, C-D and D-E. The difference A-B measures material on hand, B-C the amount of intermediate production in process, C-D the amount of semi-finished product in process and D-E the amount of finished product in stock. To illustrate, the following inferences can be drawn from Figure 11.1.

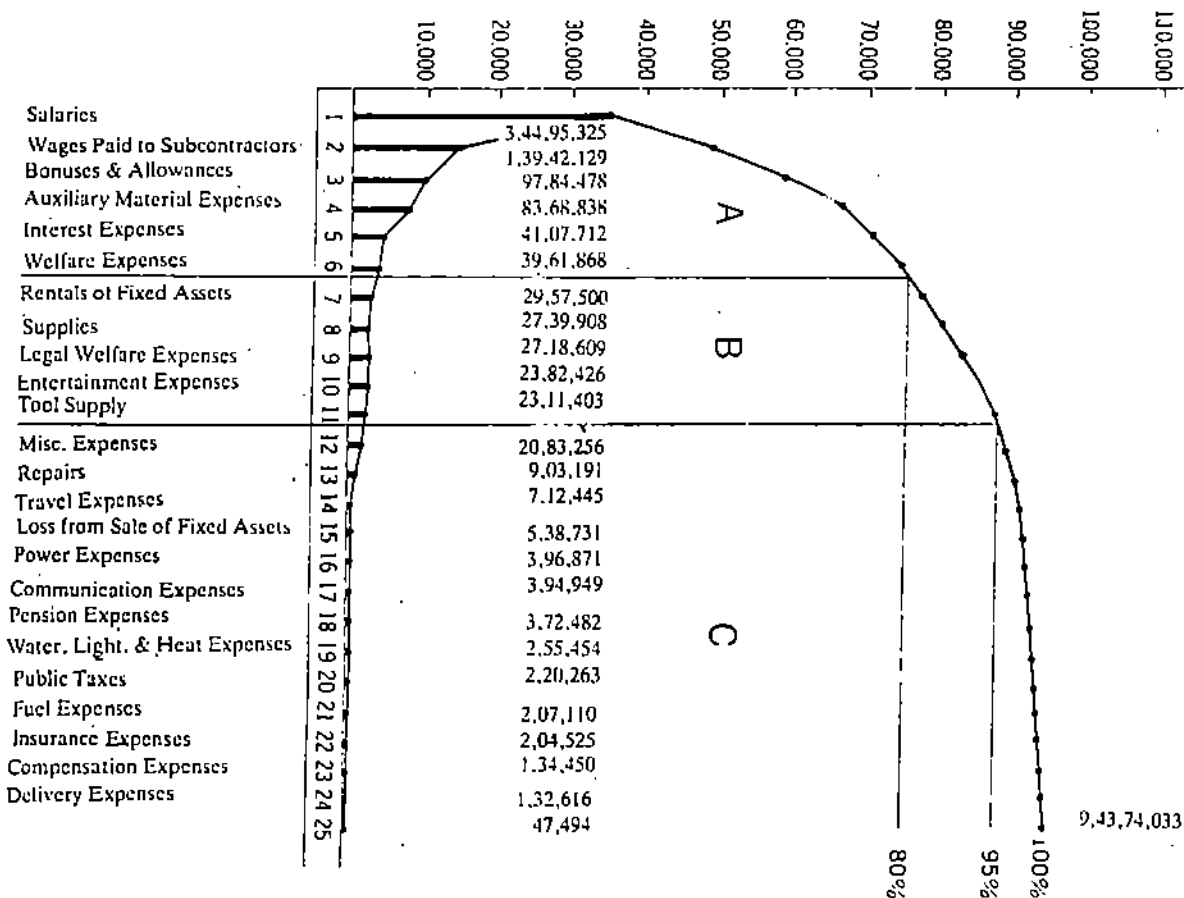
- There is high finished stock inventory at the beginning of the month.
- There is extreme shortage of material at the end of the month.
- The amount of goods-in-process increases sometime in the middle of the month and more or less continues so toward the end of the month.

All this could be indicative of the need for better production control and inventory management. The unusual differences may also indicate the need for improving production techniques and process controls. The differences along the expected lines on the other hand would indicate efficient operations management.

11.4 PARETO ANALYSIS OF INVENTORY ITEMS

The Pareto analysis or ABC analysis of cost items helps management focus its attention on monitoring and controlling the critical cost items. These critical cost items, though relatively fewer in number, may constitute the larger part of the total cost. The management should see to it that the critical cost items are effectively controlled, efficiently handled and managed.

In the Pareto analysis all costs are classified into different groups, depending upon their contribution to the total cost. All cost items (or expenses) of a business are shown graphically in the form of bars under various cost heads in descending order on the X-axis as shown in Figure 11.2. Amount is shown on the Y-axis.



If we add up costs relating to all items, we would get the total or gross business expenditure (cost). The cumulative cost points are plotted on the graph by adding costs of successive items to the total cost just preceding. The cumulative cost curve is obtained by joining these successive cumulative cost points. The point where this line ends indicates the total expenditure of the business or the point of total (100%) cost. In Figure 11.2 the 100% point is reached at Rs. 9,43,74,033.

For rational and more effective control of inventory, we might calculate 80% of this amount, cut the point on the cumulative cost curve and draw a line parallel to the X-axis. Then, draw a vertical line from the point of intersection on the cumulative cost curve parallel to the Y-axis. All items falling to the left of this vertical line may be called group 'A' items. Similarly, we may draw a vertical line at 95% point and call all items falling on its left (upto the earlier 'A' line) as group 'B' items. Those of the items falling to the right of the 95% line may be known as group 'C' items.

In term of cost, it is obvious that group 'A' items constitute the largest group, accounting for 80% of the total cost. Items in group 'B' account for another 15% of the total cost, so that 'A' and 'B' together make up 95% of the total cost. For effective cost control, the management needs to focus relatively more on cost items of groups 'A' and 'B' in that order and may not bother much about group 'C' items. The items in group 'C', though many more in number, represent only 5 per cent of the total business cost. It would be desirable to pay more attention to the 'critical few' rather the 'trivial many'.

You would find that ABC or Pareto Analysis is applicable to all types of business enterprises. The important thing is to identify the critical cost items and work for an effective systems to control them. This analysis can help management in effecting considerable cost savings by minimising wastages.

Activity 1

In Appendix 1 to this unit, we have included some parts of the 1987 Annual Report of Good-Year India Limited. Study the 'expenditure' part of the Profit and Loss Account and Schedules 11-15. Carry out the Pareto Analysis of various cost items based on this Annual Report.

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11.5 FINANCIAL RATIOS

Financial ratios are explained in detail in Unit 11 of MS-4 (Accounting and Finance for Managers). Here we will consider financial ratios as a tool for top management in assessing the implications of their various strategies or policies.

Financial ratios as a tool of strategic analysis can be used in two ways. Firstly, financial ratios are computed for different years and then used to evaluate the firms's performance over those years. Assessment, based on the trend of these ratios, is made as to whether there has been an improvement or deterioration. With the help of ratios, a firm can evaluate its present performance in relation to its past performance. It can also use this technique to evaluate whether it is keeping on course as per its plans.

Secondly, financial ratios may be used to compare the firm with identical firms within the same industry in the same period or against the norms of the same industry, if available. This type of comparison gives the firm an idea of how it is placed vis-a-vis its competitors, and can work towards improving its relatively unfavourable ratios. Though this kind of comparison is useful, however it is difficult to practise it because data pertaining to competitive firms is generally not available.

Ratios can be divided into four broad groups namely, profitability ratios, activity ratios, market valuation ratios and liquidity ratios. The profitability of a firm is a reflection of the sum total of all its decisions, including strategies and indicates how well the firm is being managed.

Profitability ratios: Profitability of a firm is the end result of all its decisions-product-market choices, functional strategies and policies and programmes. Therefore, the profitability ratios indicate the effectiveness with which a firm is being managed.

The operating profit and gross profit expressed as percentage of total income are amongst the simplest indicators of the competitive position of a business. The competitive position depends upon technology and product management. Inefficient technologies and products with low market share would always result in low percentages for these ratios.

The return on sales (ROS) and return on assets (ROA) are two very significant profitability ratios. The ROS ratio in case of a multiproduct firm indicates the effectiveness of the product mix decisions. A low ROS percentage may not only signify a weak product but also suboptimal combination of several weak products or some strong and many weak products, especially in the case of a multiproduct firm. The ROA indicates the asset deployment patterns in a multiproduct firm. A low ROA may be on account of a larger proportion of assets being utilised for weak or declining products.

The return on investment (ROI), though not very different from ROA, is also an important indicator of the profitability of a business.

The return on equity capital ratio is an important consideration in the minds of investment bankers and security analysts. This ratio is also assessed by equity owners in a business. During 1985 and 1987, as shown in Table 11.1, the profitability ratios of Indian Explosives show a declining trend. We shall look into some other ratios also to explain this decline.

Table 11.1
Indian Explosives Limited—Financial Highlights

In Rs. Crores

		1985	%	1986	%	1987	%
Income statement							
	Year ended 30 September						
1	Gross sales	449.23	98.78	7438.32	95.4	400.41	94.7
2	Sales & excise duty	65.62	14.4	53.68	11.7	55.41	13.1
3	Net sales (1-2)	383.61	84.3	384.64	83.7	345.00	81.6
4	Other income	71.42	15.7	75.00	16.3	78.00	18.4
5	Value of production (3 + 4)	485.03	100.0	459.64	100.0	423.00	100.0
6	Input costs (a to c)	287.00	63.1	285.14	62.0	238.19	56.3
	a. Raw materials	234.49	51.5	219.70	47.8	164.85	39.0
	b. Stores, spares etc.	7.04	1.5	7.12	1.5	8.90	2.1
	c. Power & fuel	45.47	10.1	58.36	12.7	64.44	15.2
7	Value added (5-6)	168.03	36.9	174.46	38.0	184.81	43.7
	Distribution of value added		100.0		100.0		100.0
8	Other costs (a + b)	110.58	65.8	121.19	69.5	135.92	73.5
	a. Salaries & wages	44.09	26.2	45.95	26.3	49.47	26.8
	b. Overheads	66.49	39.6	75.24	43.2	86.45	46.7
9	Operating profit (7-8)	57.45	34.2	53.27	30.5	48.89	26.5
10	Interest	13.84	8.2	15.67	8.9	20.36	11.2
11	Gross profit	43.61	26.0	37.60	21.6	28.53	15.3
12	Depreciation	21.15	12.6	11.80	6.8	19.38	10.5
13	Profit before tax	22.45	13.4	25.80	14.8	9.15	4.8
14	Tax	4.60	2.7	6.40	3.7	4.10	2.2
15	Net profit	1.86	10.7	19.40	11.1	5.05	2.6
16	Dividends (preference)	0.03	—	0.03	—	—	—
17	Dividends (equity)	9.19	5.5	9.19	5.3	5.10	2.8
18	Plough back (15-16-17)	8.64	5.2	10.18	5.8	(0.05)	(0.2)
19	Cash accruals (12 + 18)	29.79	17.8	21.98	12.6	19.33	10.3
Balance sheet *as at 30 September*							
1	Fixed assets (c + d)	150.61	62.6	153.43	60.0	165.06	55.1
	a. Gross block	326.11	135.6	340.84	133.2	365.00	121.9
	b. Accumulated depreciation	178.42	74.2	190.55	74.5	208.26	69.5
	c. Net block (a-b)	147.69	61.4	150.29	58.7	156.74	52.4
	d. Capital work-in progress	2.92	1.2	3.14	1.2	8.32	2.7
2.	Investments	1.13	0.85	1.57	0.6	1.70	0.6
3.	Current assets (a to c)	181.44	75.4	181.91	71.1	252.82	84.4
	a. Inventories	83.17	34.6	95.39	37.3	149.04	49.8
	b. Receivables	58.08	24.1	49.94	19.5	63.25	21.1
	c. Other current assets	40.19	16.7	36.58	14.3	40.53	13.5
4	Current liabilities & provisions	92.60	38.5	81.08	31.7	120.07	40.1
5	Net current assets (3-4)	88.84	36.9	100.83	39.4	132.75	44.3
	Total net assets (1 + 2 + 5)	240.58	100.0	255.82	100.0	399.51	100.0

Financed by :						
6 Net worth (a to c)	147.66	61.4	156.53	61.2	155.47	51.9
a. Equity capital	40.87	17.9	40.87	16.0	40.87	13.6
b. Preferential capital	0.31	0.1	—	—	—	–
c. Reserves (net of misc.)	106.48	44.3	115.66	45.2	114.60	38.22
7 Borrowings	92.92	38.6	99.29	38.8	144.04	48.1
a. Long term	92.92	38.6	99.16	38.7	143.09	47.7
b. Short term	—	—	0.13	0.1	0.05	0.4
Total liabilities	240.58	100.0	255.82	100.0	299.51	100.0
Ratio analysis						
Profitability ratios :						
1 Operating profit/total income		12.8		12.2		12.2
2 Gross profit/total income		9.7		8.6		7.1
3 Net profit/total income		4.0		4.4		1.3
4 Gross return on investment		18.1		14.7		9.5
5 Net return on investment		7.4		7.6		1.7
6 Return on capital employed		23.9		20.8		16.3
Activity ratios						
7 Assets turnover (times)		3.0		2.9		2.4
8 Inventory turnover (times)		5.4		4.6		2.7
9 Receivables/turnover (no. of days)		47		42		58
Market valuation ratios						
10 Return on equity (%)		106.7		92.0		69.8
11 Earning per share (%)		43.6		47.4		12.4
12 Price earning ratio (times)		11.9		30.9		39.1
13 Dividend pay out ratio (%)		49		47		104
Liquidity ratios						
14 Debt equity ratio		0.6:1		0.6:1		0.9:1
15 Current ratio		1.9		2.2		2.1
16 Quick ratio		1.1		1.1		0.9

Source : *Business Update*, 12-25 March 1988

Activity Ratios : The most commonly used activity ratio is the asset turnover ratio. This ratio indicates how efficiently the firm is using its assets to generate revenue. The asset turnover ratio of 3.0 in 1985 in Table 11.1 indicates that Indian Explosive Limited was able to generate sales of the order of three times the value of all its assets, or in other words it could turnover its assets three time. However, figures of 2.9 and 2.4 in subsequent years—1986 and 1987—indicate a less efficient use of its resources. Somewhere, there must have been some inefficiencies, or underutilisation of assets, or the company witnessed an early phase of expansion.

Another activity ratio is the inventory turnover ratio. This is computed by dividing sales by average inventory. In this ratio the type of product under consideration is an important factor. Low value items usually turnover at a much higher rate than high value items. But it is also a reflection of the inventory management policy of the firm. A low risk policy of carrying a large inventory entails not only a higher inventory carrying cost but leads to a lower inventory turnover ratio. In Table 11.1 we see that IEL had an inventory turnover ratio of 5.4 in 1985 which dropped to 4.6 and 2.7 in the subsequent years.

The third activity ratio is the receivables turnover ratio. This is a measure of the number of days taken to collect outstanding payments against sales. A high ratio indicates that too much capital is being tied up in the market and also that chances of bad debts are increasing. A too low ratio may imply a restrictive credit policy resulting in lower sales. This ratio would vary greatly from industry to industry, and in some instances from one firm to another within the same industry.

Market Valuation Ratios : These ratios are used in case of companies which have raised money from the market. These ratios indicate a firm's performance as reflected in valuation of its shares. The commonly used market valuation ratios are the return on equity, earning per share, price earning ratio (times) and dividend pay-out ratio.

Liquidity Ratios : Liquidity ratios indicate a firm's ability to meet its short-term obligations. The most commonly used ratio is the current ratio. A popularly prescribed norm is 2 to 3:1. A large current ratio may be indicative of inefficient use of a firm's working capital and is not a good indication.

The quick ratio is similar to the current ratio except that the current assets are computed as current assets minus inventories. Thus, this is a better assessment of a firm's liquidity and is useful in case of firms with a high degree of obsolete or slow moving items.

The debt-equity ratio is applicable to firms which use debt as a means of financing. The debt-equity ratio, which indicates the ratio of debt to equity, is calculated by dividing long term debt by equity. In many cases the debt-equity ratio is proscribed by the government and firms have not much choice in this respect.

In analy ing companies that manufacture of market more than a single product, the analyst should be careful to separate the financial ratio analysis by product when possible. For example, one product may supply 60 per cent of sales while the remaining three products may supply only 40 per cent of total sales. It may, however, be not always possible to do so because information is usually of consolidated nature given in financial statements. But some information on break up can be found in the schedules attached to Balance Sheet, and Profit and Loss Account. While changes in financial ratios can reveal serious problems, it should also be noted that seemingly significant improvements in ratios can be explained away as essentially irrelevant. Generally, therefore, financial ratios should not be used alone for decision-making purposes, but to identify areas which deserve further exploration. It is possible for management to maintain financial ratios within the expected ranges without violating accepted accounting practices while conditions of the firm steadily worsen.

Activity 2

The financial highlights of Burroughs-Welcome, a pharmaceutical company, are presented in Table 11.2. As you can see the company incurred losses during 1986 but partially recovered them during 1987. Analyse the performance of the company in strategic terms based on financial ratios. If possible, you may also get in touch with the company personnel to get some information on the company's diversification programme. Can you relate the financial performance of the company with diversification related decisions and activities?

Table 11.2
Financial Highlights of Burroughs Welcome

(in Rs. Crores)

	year ended 31 August	1985		1986		1987	
	Income statement						
1	Gross sales	44.34	111.9	47.08	107.4	52.73	104.1
2	Sales tax and excise duty	4.99	12.6	3.76	8.6	2.68	5.3
3	Net sales (1-2)	39.35	99.3	43.32	98.8	50.05	28.8
4	Other income	0.27	0.7	0.53	1.2	0.61	1.2
5	Value of production (3 + 4)	39.62	100.0	43.85	100.0	50.66	100.0
6	Input costs (a to c)	17.62	44.5	22.85	52.1	24.50	48.4
	a. Raw materials	16.95	42.8	21.83	49.8	23.57	46.5
	b. Stores, spares etc.	0.17	0.4	0.29	0.7	0.19	0.4
	c. Power & fuel	0.50	1.3	0.73	1.6	0.74	1.5
7	Value added (5-6)	22.00	55.5	21.00	47.9	26.16	51.6
	Distribution of value added		100.0		100.0		100.0
8	Other costs (a + b)	17.29	78.6	19.97	95.1	22.16	84.7
	a. Salaries & wages	10.21	46.4	7.08	33.7	7.24	27.7
	b. Overheads	7.08	32.2	12.89	61.4	14.92	51.0
9	Operating profit (7-8)	4.71	21.4	1.03	4.9	4.00	15.3
10	Interest	0.70	3.2	1.47	7.0	1.99	7.6
11	Gross profit/(loss)	4.01	18.2	(0.44)	(2.1)	2.01	7.7
12	Depreciation	0.61	2.8	0.15	0.7	0.70	2.7
13	Profit before tax/(loss)	3.40	15.4	(0.59)	(12.8)	1.31	5.0
14	Tax	1.75	8.0	—	—	0.13	0.5
15	Net profit/(loss)	1.65	7.4	(0.59)	(2.8)	1.18	4.5
16	Dividends (equity)	0.75	3.4	—	—	0.45	1.7
17	Plough back (15-16-1)	0.90	4.0	(0.59)	(2.8)	0.73	2.8
18	Cash accruals (12 - 18)	1.51	6.8	(0.44)	(2.1)	1.43	5.5
	Balance sheet						
1	Fixed assets (c + d)	6.71	36.4	8.92	37.5	9.37	41.1
	a. Gross block	9.11	49.4	10.79	45.4	11.83	51.9
	b. Accumulated depreciation	2.88	15.6	2.98	12.5	3.64	16.0
	c. Net block (a−b)	6.23	33.8	7.81	32.9	8.19	35.9
	d. Capital work-in-progress	0.48	2.6	1.11	4.6	1.18	5.2
2	Investments	0.02	0.1	0.61	2.6	0.02	0.1
3	Current assets (a to c)	18.68	101.4	22.60	95.0	21.69	95.2
	a. Inventories	8.40	45.6	12.15	51.1	11.33	49.7
	b. Receivables	4.89	26.5	6.70	28.2	6.77	29.7
	c. Other current assets	5.39	29.3	3.75	15.7	3.59	15.8
4	Current liabilities & provisions	6.98	37.9	8.34	35.1	8.29	36.4

5	Net current assets (3−4)	11.70	63.8	14.26	59.9	13.40	58.8
	Total net assets(1 + 2 + 5)	18.43	100.0	23.79	100.0	22.79	100.0
	Financed by :						
6	Net worth (a to b)	14.69	79.7	13.35	56.1	14.18	62.2
	a. Equity capital	3.00	16.3	3.00	12.6	3.00	13.2
	b. Reserves (Net of misc.)	11.69	63.4	10.35	43.5	11.18	49.0
7	Borrowings :	3.74	20.3	10.44	43.9	8.61	37.8
	a. Long-term	3.53	19.2	10.23	43.0	8.46	37.1
	b. Short-term	0.21	1.1	0.21	0.9	0.15	0.7
	Total liabilities	18.43	100.0	23.79	100.0	22.79	100.0

	Ratio analysis	1985	1986	1987
	Profitability ratios :			
1	Operating profit/total income	11.9	2.3	7.9
2	Gross profit/total income	10.1	(1.0)	4.0
3	Net profit/total income	4.2	(1.3)	2.3
4	Gross return on investment	21.8	(1.8)	8.8
5	Net return on investment	9.0	(2.5)	5.2
6	Return on capital employed	25.6	4.3	17.6
	Activity ratios			
7	Assets turnover (times)	4.6	4.0	4.1
8	Inventory turnover (times)	5.3	3.9	4.7
9	Receivables/turnover (no. of days)	40	52	47
	Market valuation ratios			
10	Return on equity (%)	133.7	(14.7)	67.0
11	Earning per share (%)	55.0	(19.7)	39.3
12	Price earning ratio (times)	37.0	—	34.0
13	Dividend payout ratio (%)	45.5	—	38.1
	Liquidity ratios			
14	Debt-equity ratio	0.3:1	1.0:1	0.8:1
15	Current ratio	2.7	2.7	1.4
16	Quick ratio	1.5	1.3	1.2

Source : *Business Update*, 9-22 April 1988

11.6 PATEL AND YOUNGER'S APPROACH

The product portfolio matrix described in previous unit relies mostly on market data. The financial implications of product mix, as you will see, are not very explicit and as such they cannot be directly measured.

To overcome this problem and to provide a practical approach to strategic planners, Patel and Younger have suggested a frame of reference for strategic development. This framework, applicable at business unit level as well as corporate level, gives explicit guidelines for assessing the strategic position of a company. It helps in formulating appropriate strategies and implementing them at the operational level. The framework is presented in Figure 11.3.

Figure 11.3: Strategic Guidelines as a Function of Industry, Maturity and Competitive Position

Competitive Position

Competitive Position / Industry Maturity	Dominant	Strong	Favourable	Tenable	Weak
Embryonic	All out push for share Hold positions	Attempt to improve position Push for share	Selective or all out of share Selectively attempt to improve position	Selectively push for position	Up or out
Growing	Hold position Hold share	Attempt to improve position Push for share	Attempt to improve position Selective push for share	Find niche and protect it	Turnaround or abandon
Mature	Hold position Hold share	Hold position - Grow with industry	Custodial or maintenance	Find niche and hang on or Phased Withdrawal	Turnaround or Phased Withdrawal
Ageing	Hold positions	Hold positions or Harvest	Phased Withdrawal	Phased Withdrawal or Abandon	Abandon

Source : Patel P. and M. Younger; A Frame of Reference for Strategy Development, Long Range Planning. April 1978, p. 8.

The strategic guidelines at the strategic business unit level are obtained in terms of possible combinations of 'Industry Maturity' and 'Competitive Position of Business' An amended version of their strategic guidelines is given in Figure 11.3. In many ways this is a more general version of Product Portfolio Matrix and resembles the Direction Policy Matrix. But in this framework, the key measure of the current performance and a good guide to its future potential is its "internal deployment" of funds. This is defined as the percentage of funds generated which are reinvested. The internal deployment of funds of a business unit is plotted against return on net assets to assess the strategic position of the unit.

Figure 11.4 shows the expected zones of a sample unit, within which various types of strategic business units should appear. Such a unit would normally lie in the 'mature' area marked in the Figure. However if the earlier analysis showed that the unit was actually in a growth industry, the enterprise may need to rethink its investment policy.

Figure 11.4 : Patel and Younger's Profitability and Cash Position Matrix

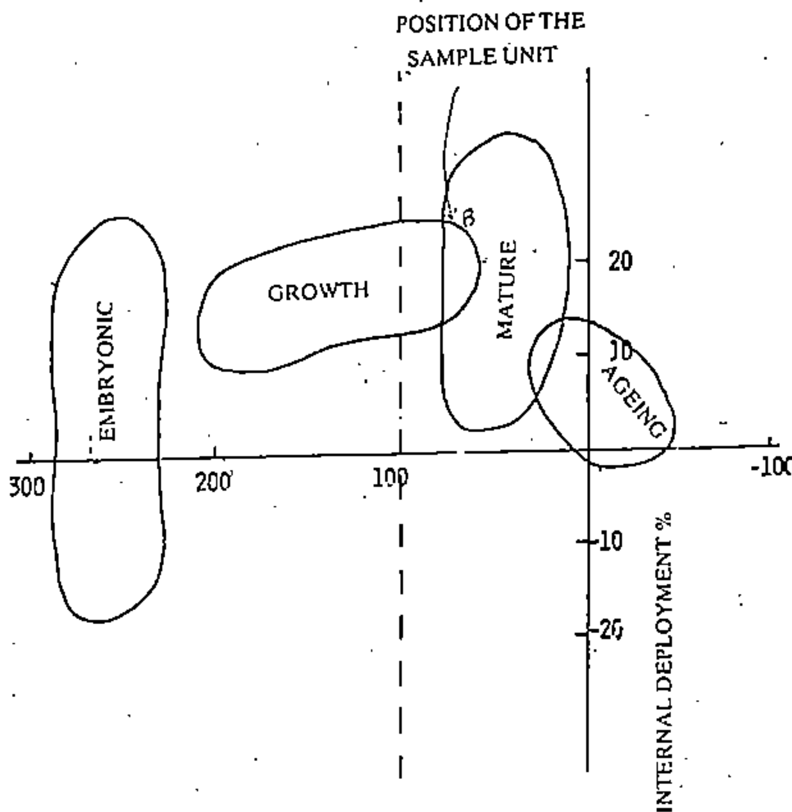


Figure 11.5 : Business Units and their Assets Broken Down by Industry Maturity and Competitive Position

Industry Maturity / Competitive Position	Embryonic Growth		Mature		Ageing		Total	
	NO. of Units	Corporate Assets %	No. of Units	Corporate Assets %	No. of Units	Corporate Assets %	No. of Units	Corporate Assets %
Dominant	1	5	1	2	1	25	3	32
Strong	1	3	4	60	—	—	5	63
Favourable	1	2			1	2	2	4
Tenable			1	1			1	1
Weak								
	3	10	6	63	2	27	11	100

Source : Patel and Younger.

Figure 11.6 : Patel and Younger's Profitability and Cash Position Matrix of a Corporation by Business Unit

Figures 11.5 and 11.6 describe the use of this approach at corporate level. This application is based on the analysis of individual units within the corporate structure. Figure 11.5 shows that the company has only 10 per cent of its assets in growth businesses and a hefty 27 per cent in ageing businesses. Figure 11.6 shows the internal deployment and return on assets picture of these businesses. From the placement of various businesses it is obvious that the corporation is 'milking' its largest growth businesses and putting money into some of its mature businesses. Thus Patel and Younger approach considers cash and return dimensions of a business unit explicitly and offers a rather simple framework for selecting strategic options.

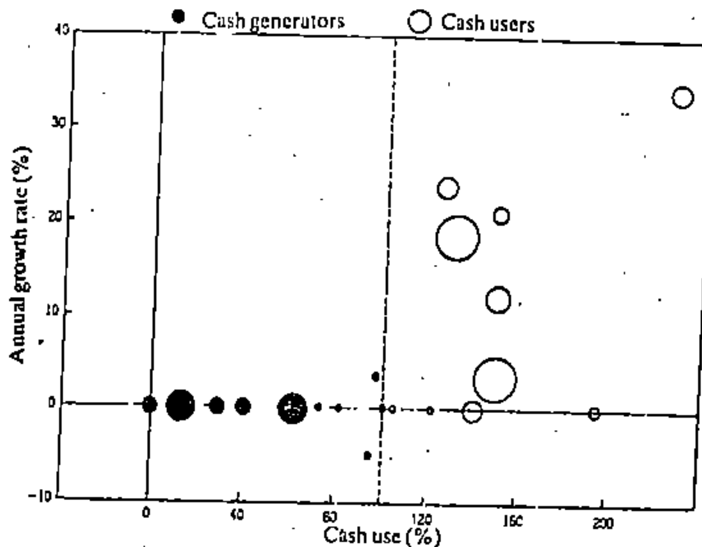
Activity 3

Study Figure 11.6 carefully and make your own conclusions about the position of various business units. What is your opinion about the business mix of the company shown in this figure.

11.7 Frontier Curve Analysis

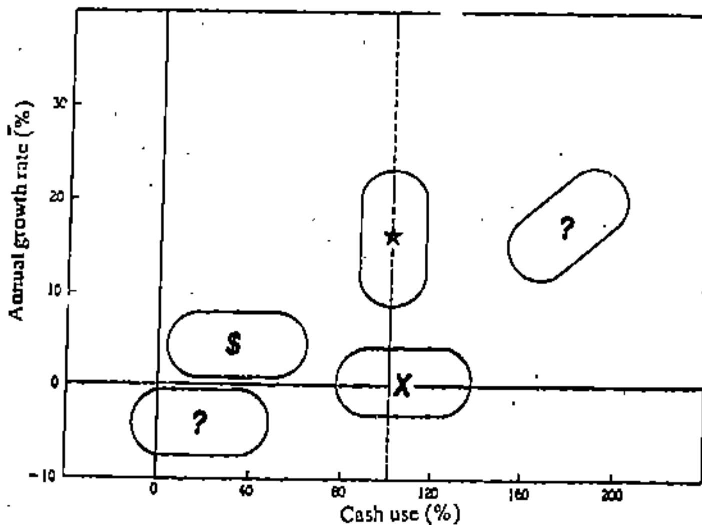
This technique developed by Boston Consulting Group uses a two-dimensional grid as shown in figure 11.7. Annual growth rate in profit is plotted on Y-axis and cash use as a percentage of earnings after taxes reinvested in business on X-axis. Thus when a company's various profit centres are plotted on this matrix in terms of their growth and reinvestment parameters, they may appear either as cash generators or users. A period of say 3 to 5 years for calculating these parameters should provide fairly stable data.

Figure 11.7: Frontier curves : Growth versus cash use (Moose & Zakon 1972)



On this matrix, it is possible to show the ideal zones for various types of businesses, such as, cash cows, dogs, stars and question marks as shown in Figure 11.8. Thus, stars should be ideally found in terms of

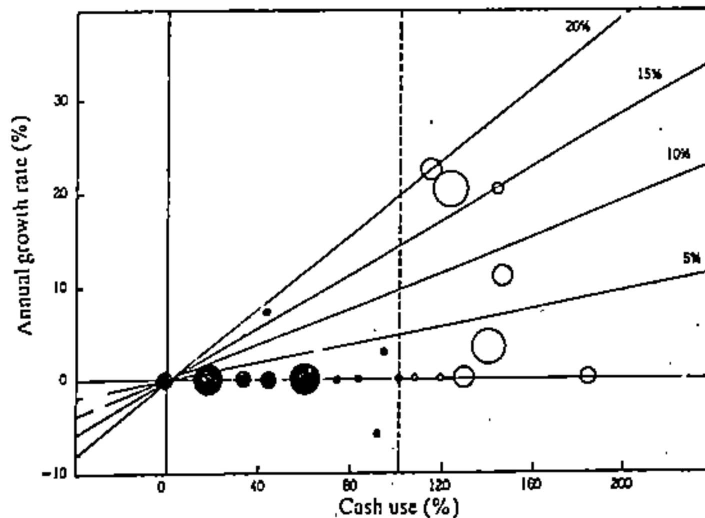
Figure 11.8 : Idealized positions on the frontier curve



100% cash use and between 3% to 8% growth rate. The profit centres which do not conform to the guidelines as shown in ideal zones are probably either misclassified or mismanaged. In addition to the position of each business on the grid, the net cash status of the enterprise can be visually assessed by showing the position of various businesses with circles proportional to the amount of cash used or generated..

In order to compare the performance of individual businesses in relation to corporate growth goal, frontier lines representing the growth percentage can also be depicted on this matrix. These frontier lines are calculated in terms of the sustainable growth rate of any business at a given debt to equity ratio and percentage of retained earnings.

Figure 11.9 : Frontier curves for different corporate growth targets (Moose & Zakon: 1972)



This growth rate is calculated as follows :

Suppose

g = the maximum sustainable rate of growth
D= the company's debt
E= the company's equity
r = the rate of return on assets
i = the rate of interest on debt
p = the percentage of earnings retained by the company
P= net profit of the company.

Now

Net profit, P = Profit before financial charge – financial charges
= r (Total Assets) – i (Total Debts)
= r (D + E) – i (D)
= D (r – i) + r(E)

Dividing both sides by E

$$\frac{P}{E} = \frac{D}{E}(r-i) + r$$

Now the rate of growth $G = \frac{P}{E}$

$$G = \frac{D}{E}(r-i) + r \qquad \text{......(1)}$$

this assumes that all earnings are retained, if, suppose, the company pays dividend, the percentage of earnings retained is only 'p' then maximum sustainable growth rate is obtained by multiplying both sides of (i) by p that is

$$g = \frac{D}{E}(r-i)\,p + rp \qquad \text{......(2)}$$

for given values of D, E, r and i for a company, and if they are constant, then 2 can be written as

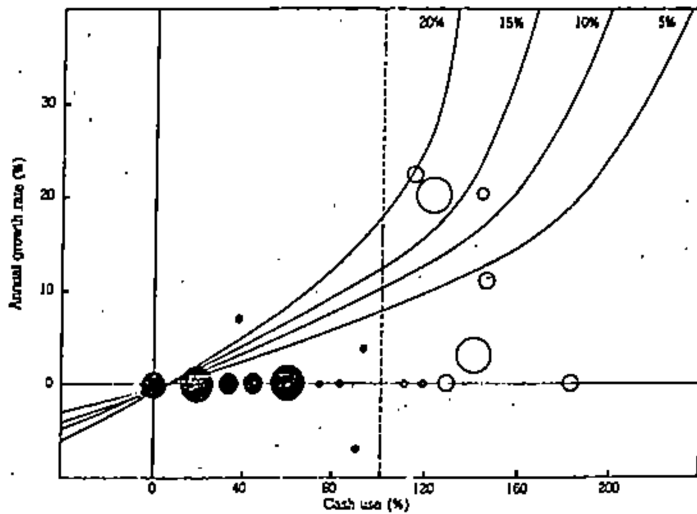
$g = Kp$ when K is a constant.

When p is 1 or 100% cash retention then g is equal to the sustainable maximum growth rate for the company. In this case it equals the desired growth rate. For various targeted rates a series of straight lines as shown in Figure 11.9 can be drawn. Suppose the company has a corporate growth goal of say 5%, and assuming that the company invests all its cash, a frontier line of 5% is drawn on the matrix. Businesses lying below this line are less attractive as compared to the ones above.

Businesses above this line are more attractive because of their ability to experience higher growth with same use of cash.

Frontier curves as shown in Figure 11.10 are obtained when the assumption of D/E being constant is relaxed. In fact it restores the reality of business situation because different businesses in a company will be leveraged differently to suit their size and growth characteristics. In such a situation, equation (2) can be used to generate frontier curves for different debt-equity ratios. The businesses above the curve represent higher growth opportunities as compared to the ones below it. The application of Frontier Curves technique requires accurate measurements based on internal records of the company. The BCG claims that frontier curve analysis can also be applied in differentiating between favourable and unfavourable investment opportunities under comparable conditions.

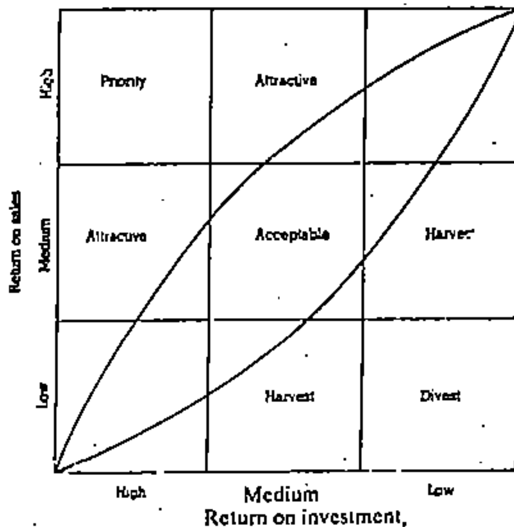
Figure 11.10: Frontier curves where the acceptable debt/equity ratio is negatively influenced by high growth rate



11.8 RETURN ON SALES AND INVESTMENT

Several researchers have stated the use of return on sales (ROS) and return on investment (ROI) as the two most important bases for determining the strategic options. Based on these parameters, many consultants and strategists who have access to company data use a two-dimensional matrix as shown in Figure 11.11. As per the industry norms businesses can be identified in any of the nine cells generated in terms

Figure 11.11: Return on Sales and Investment.



of low, medium and high combinations of ROI and ROS. Around one of the diagonal there is an acceptable zone. Businesses below it need to be harvested and/or divested. The ones above the acceptable area are highly attractive and must be pursued vigorously. Usually this matrix is used alongwith various other matrices such as product portfolio matrix or growth share matrix.

Activity 4

A number of matrices based on logical combinations of two financial ratios can be thought through. Try to generate one or two such matrices yourself and also indicate their use. In this process you may create something new!

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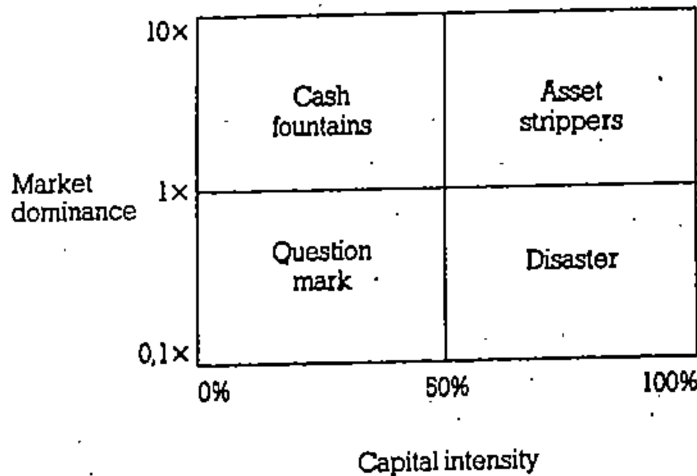
11.9 THE MARKET DOMINANCE/CAPITAL INTENSITY MATRIX

Figure 11.12 presents the market dominance and the relative capital intensity matrix of a business. These two parameters are crucial from the point of view of business survival, because high market share (dominance) results in higher cash and profits whereas high

Figure 11.12 : Market Dominance and Capital Intensity Matrix



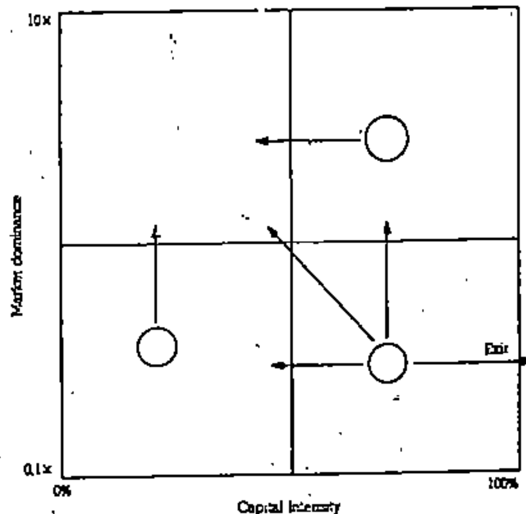
capital intensity in relation to sales has a negative impact on profits and cash flows. In this matrix the capital intensity is measured in relation to sales and is plotted on X-axis. A 100% capital intensity ratio means that every unit value in sales requires an equivalent unit of investment. The four strategic categories of businesses are identified as :

- **Cash fountains** represent high market share and low capital intensity, leading to high ROI and cash generation.
- **Question marks** represent low market share and low capital intensity. They need careful examination because low growth businesses may be useful cash generators, whereas high growth businesses will still enjoy high return on investment with negative cash flows.

- **Asset Strippers** represent high market share and high capital intensity; ROI will be moderate and cash may be negative. Such businesses need to be moved to cash fountains by improving product quality, capacity utilisation and management of working capital.
- **Disaster Business** low relative market share and high capital intensity; these businesses need to be harvested and/or divested. Sometimes reduction in asset base, and improvement in market share also helps.

Figure 11.13 shows the preferred movements of businesses for optimal ROI and ROA.

Figure 11.13 : Strategic moves and market dominance/capital intensity matrix



11.10 SUMMARY

The various techniques of strategic financial analysis described in this unit help in two ways. First, they can help in diagnosing a company's various businesses and thus can lead to development of ideal or balanced portfolio of businesses, depending upon their comparative cash and growth characteristics. Secondly, these tools of analysis will enable the company to judge whether its strategic moves are appropriate in the light of the strategic options decided upon and the existing financial policy. The product-market analysis and strategic financial analysis are complementary to each other and together they present a detailed strategic analysis of company.

11.11 KEY CONCEPTS/TERMS

Cash Deployment
Capital intensity
Maximum sustainable growth rate

11.12 SELF-ASSESSMENT QUESTIONS

1) Explain the utility of plotting data on a single graph with respect to purchases of raw material, issues to production, inventory of work-in-progress, quantity of finished goods produced, and shipments to customers. In what way such a technique can help in better planning and control of movement of goods.
2) What is Pareto Analysis of inventory items? Explain the technique of preparing the graph for Pareto analysis? What are its uses?
3) What ratios do you consider useful for strategic analysis? Give examples. What are their limitations?

4) Compare Patel and Younger's Profitability and Cash Position Matrix with any one of the matrix discussed in Unit 10 which you think is close to it. Discuss in what way Patel and Younger's approach is different from the other? Also critically examine Patel and Younger's matrix.

5) What is Frontier Curve Analysis and how it helps in assessing different portfolios and new business opportunities?

6) What is market dominance/capital intensity matrix and how is it different from BCG Matrix?

7) The Annual Report of Goodyear India Limited for the year 1987 is given in Appendix . In Activity 1, you have already analysed the costs. Now comment on the strategic profile of the company with the help of financial ratios. For product-market data you may get in touch with either the company personnel or the tyre dealers. You may like to talk to them for your analysis.

11.13 FURTHER READINGS

Jauch, L.R. and W.F. Glueck, 1988, *Business Policy and Strategic Management*, McGraw Hill International Editions: New York.

Robinson, Grant, 1986, *Strategic Management Techniques*, Butterworths: London.

Nagashima, Soichiro, 1987, *100 Management Charts*, Asian Productivity Organisation: Tokyo.

Patel P. and M. Younger, *A Framework of Reference for Strategy Development*, Long Range Planning, April 1978.

APPENDIX

Extract from Annual Report of Goodyear India Ltd.

GOODYEAR INDIA LTD.

DIRECTORS' REPORT

Your Directors are pleased to present their report and audited accounts for the year ended December 31, 1987.

PROFIT AND DIVIDEND

	1987 Rs.(000)	1986 Rs.(000)
PROFIT BEFORE TAX & DEPRECIATION	179400	160203
Less: Depreciation (excluding on account of revaluation)	38683	24775
	140717	135428
Less: Taxation	54069	49990
Balance Profit	86648	85438

Your Directors recommend dividend for the year @ Rs. 3.00 per equity share against last year dividend of Rs. 2.50 per equity share to be paid out of current year's earnings.

PRODUCTION AND SALES

Production at Ballabgarh factory was 6,82,933 automotive tyres during the year as against, 7,60,037 tyres in 1986. Production was adversely affected due to restricted power supply and frequent power cuts on account of unprecedented drought situation experienced during the year. Diesel generator sets which were installed to supplement power shortages had to be extensively used. High absenteeism and go-slow also contributed to lower production during the year.

The turnover for the year was Rs. 173 crores against Rs. 180 crores last year, reflecting lower output at the Ballabgarh plant. As a result, the Company was not able to meet the demand for its products which continue to enjoy the highest quality reputation.

Inflationary price trends of basic raw materials like natural rubber, nylon, carbon black etc. had increased our production cost and the Company could not fully recover the additional cost impact. However, tight control over operating expenses and better working capital management enabled the Company to achieve improved results.

FINANCE AND ACCOUNTS

During the year loan repayments amounting to Rs. 40 lacs were made. At the end of 1987 the Company's total reserves stood at Rs. 4539 lacs consisting of Revaluation Reserve of Rs. 2072 lacs and other reserves of Rs. 2467 lacs as detailed in Schedule 2 to the Accounts.

During the year under review the Company had accepted deposits amounting to Rs. 344.54 lacs from the public/shareholders under the Companies (Acceptance of Deposits) Rules, 1975. As at the year-end the total amount of deposits held by the Company stood at Rs. 462.47 lacs. An amount of Rs. 5.8 lacs of matured deposits remain unclaimed at the end of the year.

FUTURE OUTLOOK

The Company continues to be affected by the power shortages brought about by the severe drought. Its own diesel generating capacity is, however, being improved to deal with this situation, so that it can meet the continued strong demand of the market.

The modernisation programme inaugurated in 1986 continues to be implemented though it has been stretched out due to the power shortage. Completion is now expected by late 1989/early 1990. Loans requested from all financial institutions have been deferred.

During 1988 the Company will introduce new product sizes into the market place to complement the passenger radial and high mileage truck tyres which have already made their mark.

Your Company continues to receive invaluable technical assistance, training facilities and product innovation from The Goodyear Tyre & Rubber Company, USA, the largest tyre company in the world and the tyre company whose investment in Research and Development is unsurpassed in the industry.

DIRECTORS

Mr D A MacDonald was unanimously appointed by the Board effective September 15, 1987 as Additional Director to head the Production Division of the Company subject to the approval of the Central Government and the shareholders of the Company. Mr. J R Glass, Director, resigned from the Board effective September 15, 1987 and at the Board Meeting held on September 15, 1987 Mr H J Wilson was unanimously appointed Director to fill the vacancy so caused. The Directors express their thanks and appreciation to Mr Glass for the valuable guidance rendered.

Mr J R Sardas is retiring by rotation at this Annual General Meeting, and being eligible, offers himself for re-appointment. Messrs D A MacDonald and H J Wilson hold office in terms of Section 260/262 of the Companies Act, 1956 upto this Annual General Meeting, and being eligible, offer themselves for reappointment.

AUDITORS

Messrs A F Ferguson & Co., Chartered Accountants, retire at this Annual General Meeting, and being eligible, offer themselves for reappointment.

PERSONNEL

Employee relations, for the most part, were cordial during the year. Training and development programme to achieve high levels of efficiency and productivity continue to receive full management attention.

Statement of particulars of employees of the Company in terms of Section 217(2A) of the Companies Act, 1956 is annexed.

ACKNOWLEDGEMENTS

Your Board wishes to place on record its appreciation for the continued technical and management support provided to your Company by The Goodyear Tyre & Rubber Company, USA. Your Directors also thank the Company's esteemed shareholders, customers, employees, financial institution & banks, the State and the Central Governments for their continued support.

By Order of the Board

Gian Prakash, IAS (Retd.)
K Sankaranarayanan
P L Sharma
P S Sarma
D A MacDonald
} *Directors*

V Narayanan
Chairman

Hardev Singh
Managing Director

New Delhi
March 10, 1988

GOODYEAR INDIA LIMITED

BALANCE SHEET AS AT 31ST DECEMBER, 1987

	Schedule No.	1987 Rs. '000	1986 Rs. '000
I. SOURCES OF FUNDS			
SHAREHOLDERS' FUNDS			
Capital	(1)	7,48,28	7,48,28
Reserves and Surplus	(2)	45,38,59	41,55,11
LOAN FUNDS	(3)		
Secured Loans		19,24	2,16,70
Deferred Credits		59,32	80,11
Unsecured Loans		4,82,49	5,09,26
		58,47,92	57,09,46
II. APPLICATION OF FUNDS			
FIXED ASSETS	(4)		
Gross Block		73,92,91	70,38,23
Less Depreciation		32,99,63	26,89,98
Net Block		40,93,28	43,48,25
Capital Work in Progress including advances		2,85,29	1,67,62
		43,78,57	45,15,87
CURRENT ASSETS, LOANS AND ADVANCES			
Inventories	(5)	26,09,80	22,52,82
Sundry Debtors	(6)	20,00,86	29,70,38
Cash and Bank Balances	(7)	2,92,25	60,12
Loans and Advances	(8)	7,31,53	6,59,49
		56,34,44	59,42,81
LESS: CURRENT LIABILITIES AND PROVISIONS	(9)		
Liabilities		38,50,80	44,77,16
Provisions		3,14,29	2,72,06
NET CURRENT ASSETS		14,69,35	11,93,59
TOTAL		58,47,92	57,09,46
NOTES TO THE ACCOUNTS	(16)		

As per our report attached

For A.F. FERGUSON & CO.
Chartered Accountants

R. SUBRAMANIAM
Partner

V. NARAYANAN
Chairman

HARDEV SINGH
Managing Director

GIAN PRAKASH
P.L. SHARMA
D.A. MACDONALD
P.S. SARMA
K. SANKARANARAYANAN
} *Directors*

S.K. JAIN
Secretary

NEW DELHI
March 10, 1988

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1987

	Schedule No.	1987 Rs. '000	1986 Rs. '000
I. SALES AND OTHER INCOME	(10)	173,13,44	179,05,00
II. EXPENDITURE			
Raw Materials Consumed	(11)	76,17,75	77,47,91
Work in Process and Finished Goods	(12)	5,36,00	7,75,92
Excise Duty		43,62,27	46,68,46
Manufacturing, Selling and Administrative Expenses	(13)	27,53,87	27,93,86
Depreciation		6,38,22	4,89,90
Interest	(14)	2,49,55	3,16,82
Provison for Taxation	(15)	5,40,69	4,99,90
		166,98,35	172,92,77
III. PROFIT AFTER TAX		6,15,09	6,12,23
Investment Allowance Reserve		—	1,90,00
Export Reserve		7,00	11,00
		6,08,09	4,11,23
Investment Allowance Reserve Written Back		6,50	—
		6,14,59	4,11,23
IV. APPROPRIATIONS			
Proposed Dividend (Subject to deduction of tax at source)		2,24,49	1,87,07
General Reserve		3,90,10	2,24,16
		6,14,59	4,11,23

NOTES TO THE ACCOUNTS (16)

As per our report attached

For A.F. FERGUSON & CO.
Chartered Accountants

R. SUBRAMANIAM
Partner

V. NARAYANAN
Chairman

HARDEV SINGH
Managing Director

GIAN PRAKASH
P.L. SHARMA
D.A. MACDONALD
P.S. SARMA
K. SANKARANARAYANAN
Directors

S.K. JAIN
Secretary

NEW DELHI
March 10, 1988

SCHEDULES TO THE ACCOUNTS

	1987	1986
	Rs. '000	Rs. '000
(1) CAPITAL		
Authorised		
1,00,00,000 Equity Shares of Rs. 10 each	10,00,00	10,00,00
Issued and Subscribed		
74,82,846 Equity Shares of Rs. 10 each	7,48,28	7,48,28

Notes :

1. 44,84,200 shares are held by the Goodyear Tyre & Rubber Company, Akron, Ohio, U.S.A. and its nominees, of which 12,03,926 shares are allotted as fully paid pursuant to a contract without payment being received in cash.
2. 46,76,533 shares are allotted as fully paid up by way of Bonus Shares by capitalisation of General Reserve Rs. 3,93,65 and Share Premium Account Rs. 74,00.

(2) RESERVES AND SURPLUS

Rs. '000

	As at 31.12.86 Rs.	Additions Rs.	Deductions Rs.	As at 31.12.87 Rs.
Share Premium	6	—	—	6
Revaluation	23,29,32	—	2,57,73 (d)	20,71,59
Bad and Doubtful Debts	5,86	—	78 (a)	5,08
Investment Allowance	4,59,81 (c)	—	6,50	4,53,31
Export	11,00	7,00 (b)	11,00 (e)	7,00
General	13,49,06	6,52,49	—	20,01,55
	41,55,11	6,59,49	2,76,01	45,38,59

(a) Transferred (from)/to Sundry Debtors Rs. 87 Loans and Advances Rs. (9).
(b) Transferred from Profit and Loss Account.
(c) Investment Allowance Reserve has been utilised for purchase of Plant and Machinery in accordance with Sec. 32A(5) of the Income Tax Act, 1961.
(d) Transferred Rs. 2,51,39 to General Reserve (Refer Note q of Schedule 16).
(e) Transferred to General Reserve on utilisation for the purpose of business.

(3) LOAN FUNDS

	1987	1986
Secured Loans	Rs. '000	Rs. '000
Banks	19,24	1,97,20
Financial Institutions	—	19,50
	19,24	2,16,70
Deferred Credits	59,32	80,11
Unsecured Loans		
Public Deposits	4,62,47	4,84,47
Interest accrued and due	20,02	24,79
	4,82,49	5,09,26
	5,61,05	8,06,07

Notes :

1. Secured
   (a) Banks
   Secured by hypothecation of stocks and book debts. Stocks and Book Debts are subject to a maximum charge of Rs. 33.90 crores (Rs. 31 crores) for all bank credit facilities/guarantees.
   (b) Financial Institutions
   Rs. Nil (Rs. 7,50) Secured by hypothecation of all movable assets (excluding Book Debts), subject to bankers' prior charge on stocks and specified items of machinery purchased under deferred credits.
   Rs. Nil (Rs. 12,00) guaranteed by banks. Bank guarantees are secured against hypothecation of specific machines.
   Due within one year Rs. Nil (Rs. 19,50).
2. Deferred Credits are guaranteed by banks. Bank Guarantees to the extent of Rs. 57,70 (Rs. 77,67) are

SCHEDULES TO THE ACCOUNTS

secured by hypothecation of specific machines purchased under deferred credits. Due within one year Rs. 18,72 (Rs. 20,78).

3. Unsecured
   Public Deposits—Due within one year Rs. 2,57 (Rs. 3,62,66).

(4) FIXED ASSETS

Rs. '000

	Gross Book Value				Depreciation	Net Book Value	
	As at 31.12.86 Rs.	Additions Rs.	Deductions Rs.	As at 31.12.87 Rs.	Up to 31.12.87 Rs.	As at 31.12.87 Rs.	As at 31.12.87 Rs.
Freehold Land	1,62,24	—	—	1,62,24	—	1,62,24	1,62,24
Railway Siding	28,16	—	—	28,16	7,69	20,47	22,51
Buildings	9,97,97	35,19	82	10,32,34	2,28,35	8,03,99	8,12,65
Plant and Machinery	56,95,27	3,35,06	24,14	60,06,19	29,48,14	30,58,05	33,06,10
Furniture and Fittings	92,68	4,21	3,93	92,96	78,72	14,24	17,32
Motor Cars and Trucks	61,91	19,02	9,91	71,02	36,73	34,29	27,43
Total	70,38,23	3,93,48	38,80	73,92,91	32,99,63	40,93,28	
Previous Year	59,20,97	11,25,58	8,32	70,38,23	26,89,98		43,48,25
Capital Work in Progress including Advances						2,85,29	1,67,62
						43,78,57	45,15,87

Notes :

1. During 1984 Land, Railway Siding, Buildings and Factory Plant and Machinery were revalued and Rs. 28,15,68 added to fixed assets on revaluation was credited to Revaluation Reserve.
2. Estimated amount of contracts remaining to be executed on Capital Account and not provided Rs. 2,94,11 (Previous Year Rs. 4,61,00).

	1987 Rs. '000	1986 Rs. '000
(5) INVENTORIES		
Valued at lower of cost or estimated market value		
Raw Materials	11,35,78	8,81,67
Work in Process	2,79,56	1,92,25
Finished Goods	4,21,04	4,68,05
Stores and Spare Parts	7,73,42	7,10,85
	26,09,80	22,52,82

	1987 Rs. '000	1986 Rs. '000
(6) SUNDRY DEBTORS		
Debts over six months		
Unsecured—good	86,64	1,67,84
Considered Doubtful Rs. 19,19 (Rs. 18,32) and fully provided for.		
Other Debts		
Secured	1,52,78	54,86
Unsecured—good	17,61,44	27,47,68
	20,00,86	29,70,38
(7) CASH AND BANK BALANCES		
Cash and Cheques on hand	1,25	1,09
With Scheduled Banks		
On Current Account	53,55	58,53
On Deposit Accounts	2,37,45	50
	2,92,25	60,12

SCHEDULES TO THE ACCOUNTS

(8) LOANS AND ADVANCES

Unsecured—Considered good unless otherwise stated		
Advances recoverable in cash or in kind or for value to be received Considered Doubtful Rs. 3,39 (Rs. 3,48) and fully provided for.	3,55,17	2,54,80
Income Tax Refundable	34,77	1,78,42
Balance with Customers and Excise	47,99	58,69
Deferred Taxation (Net)	2,71,74	1,47,21
Companies Deposits (Surcharge on Income-tax) Scheme (Including Interest accrued thereon)	21,86	20,37
	7,31,53	6,59,49

(9) CURRENT LIABILITIES AND PROVISIONS

Liabilities :		
Acceptances	—	2,96,50
Sundry Creditors	35,29,45	38,95,16
Security Deposits	2,81,36	2,16,39
Unclaimed Dividends	8,97	7,70
Interest accrued but not due	31,02	61,41
	38,50,80	44,77,16
Provisions :		
Taxation (Net)	89,80	84,09
Proposed Dividend	2,24,49	1,87,07
	3,14,29	2,72,06
	41,65,09	47,49,22

(10) SALES AND OTHER INCOME

SALES

Class of goods sold	Unit	1987 Quantity (000)	1987 Value Rs. '000	1986 Quantity (000)	1986 Value Rs. '000
Automotive Tyres	(Nos)	6,89	154,08,40 (Tyres and Flaps)	8,05	160,82,67 (Tyres and Flaps)
Flaps	(Nos)	2,19		2,31	
Automotive Tubes	(Nos)	6,49	11,41,01	7,49	12,56,02
Repair Materials	(Kg)	7	1,52	87	22,41
Transmission Belting	(Metres)	10,59	4,28,30	9,36	3,88,06
Industrial V Belts	(Nos)	4,07	2,35,41	3,36	1,81,49
Fan Belts	(Nos)	2,06	49,77	1,21	27,87
Other Rubber Products			5,84		5,66
Accessories, Spare Parts and other Miscellaneous Products			23		1,63
			172,70,48		179,65,81
Less Rebates and Cash Discounts			1,28,37		1,66,70
			171,42,11		177,99,11
OTHER INCOME					
Profit on Sale of Fixed Assets (Net)			15,89		4,44
Interest			92,07		43
Export Duty Drawback Received			—		26,78
Cash Assistance on Exports Received			16,55		26,78
Royalty			2,56		1,25
Miscellaneous Income			44,26		60,91
			173,13,44		179,05,00

Notes :

1. Unit Sales include inventory adjustments and debits raised for Company's own use.
2. Income-tax deducted at source during the year on interest income Rs. 1,69 (Rs. 1,76).

SCHEDULES TO THE ACCOUNTS

(11) RAW MATERIALS CONSUMED

	1987		1986	
	Quantity ('000 Kgs)	Value Rs. '000	Quantity ('000 Kgs)	Value Rs. '000
Rubber	1,27,64	29,74,33	1,36,23	30,52,32
Fabric	21,73	21,26,73	23,47	21,40,62
Carbon Black	54,14	10,52,89	61,72	11,45,58
Pigments and Chemicals	33,74	11,14,82	36,96	11,50,31
Beadwire	7,37	1,20,91	8,11	1,27,09
Others (Less Scrap Sales)		2,28,07		1,31,99
		76,17,75		77,47,91

(12) WORK IN PROCESS AND FINISHED GOODS

	1987 (Rs. '000)		1986 (Rs. '000)	
Opening Stock				
Work in Process	1,92,25		2,06,84	
Finished Goods	4,68,05	6,60,30	7,02,02	9,08,86
Add :				
Purchases of Finished Goods		5,76,30		5,27,36
		12,36,60		14,36,22
Less :				
Closing Stock				
Work in Process	2,79,56		1,92,25	
Finished Goods	4,21,04	7,00,60	4,68,05	6,60,30
		5,36,00		7,75,92

VALUE AND QUANTITATIVE BREAK-UP OF FINISHED GOODS

	Opening Stock		Purchases		Closing Stock	
	Quantity (000)	Value Rs. '000	Quantity (000)	Value Rs. '000	Quantity (000)	Value Rs. '000
Automotive Tyres (Nos)	25	2,63,35	—	—	19	2,67,38
	(70)	(5,08,60)	—	—	(25)	(2,63,35)
Flaps (Nos)	9	3,74	—	—	16	6,87
	(11)	(6,15)	—	—	(9)	(3,74)
Automotive Tubes (Nos)	65	63,42	—	—	37	42,74
	(67)	(65,91)	—	—	(65)	(63,42)
Repair Materials (Kgs)	12	3,73	—	—	5	1,80
	(–)	(9)	—	—	12	(3,73)
Rubber Dock Fenders (Kgs)	1	27	—	—	1	27
	(1)	(27)	—	—	(1)	(27)
Transmission Belting (Metres)	206	70,41	952	3,42,82	99	40,58
	(224)	(81,50)	(918)	(3,31,67)	(206)	(70,41)
Industrial V Belts (Nos)	116	51,15	401	1,88,95	110	53,86
	(71)	(31,60)	(381)	(1,63,47)	(116)	(51,15)
Fan Belts (Nos)	55	10,13	175	34,17	24	4,22
	(26)	(4,67)	(150)	(27,91)	(55)	(10,13)
Other Rubber Products		18		4,70		50
		(61)		(3,96)		(18)
Accessories, Spare Parts and Other Miscellaneous Products		1,67		5,66		2,82
		(2,62)		(35)		(1,67)
		4,68,05		5,76,30		4,21,04
		(7,02,02)		(5,27,36)		(4,68,05)

SCHEDULES TO THE ACCOUNTS

	1987	1986
(13) MANUFACTURING, SELLING AND ADMINISTRATIVE EXPENSES	Rs. '000	Rs. '000
Salaries, Wages and Bonus	7,93,29	7,98,67
Contribution to Provident and Pension Funds	52,17	51,59
Workmen and Staff Welfare Expenses	92,16	94,20
Retirement Gratuities	12,94	12,04
Consumption of Stores and Spare Parts	93,32	98,25
Power and Fuel	6,18,91	5,98,48
Repairs to Buildings	21,02	21,78
Repairs to Machinery	2,64,38	2,43,54
Rent (Net)	75,25	57,08
Insurance	24,66	24,80
Rates and Taxes	72,81	68,07
Freight, Transport and Delivery	2,52,35	2,89,90
Advertising	21,43	69,25
Commission	4,77	7,92
Miscellaneous	3,54,41	3,58,29
	27,53,87	27,93,86

	1987	1986
Notes : (1) Payment to Directors:		
Managerial Remuneration (including Rs. 5 paid in excess of Central Government approval)	7.63	8.75
Directors' Fees	2	2
(2) Auditors' Remuneration:		
Statutory Auditors		
(a) As Auditors	1,40	1,25
(b) In other Capacity		
Various Certification/Other Work	29	44
Tax Audit (for 1984)	—	25
Management Services	5	—
(c) Out of Pocket Expenses		
—Audit	14	20
Cost Auditors		
(a) As Cost Capacity	8	—
(b) In Other Capacity		
Various Certification Work	7	—
(c) Out of Pocket Expenses		
— Audit	2	—
— Other Capacity	4	—

	1987	1986
(14) INTEREST		
Fixed Loans	89,03	86,48
Others	1,60,52	2,30,34
	2,49,55	3,16,82

	1987	1986
(15) PROVISION FOR TAXATION		
Income-tax	5,22,84	4,80,00
Surtax	—	60,75
	5,22,84	5,40,75
Add/(Less) Deferred Tax Provision/(Benefit)—Net [See Note (p)]	17,85	(40,85)
	5,40,69	4,99,90

	1987	1986
	Rs. '000	Rs. '000
(16) NOTES TO THE ACCOUNTS		
(a) Contingent Liabilities		
(i) Claims against the Company not acknowledged as debts	58,64	50,44
(ii) In respect of Departmental appeals against Tax Holiday claims allowed to the Company	48,84	48,84
(b) Included in Loans & Advances		
Due from an officer of the [maximum amount due during the year Rs. 25 (Rs. 27)].	21	25

GOODYEAR INDIA LIMITED

SCHEDULES TO THE ACCOUNTS

(c) No provision has been made for liabilities towards retirement gratuities. The estimated liability for retirement gratuities as at December 31, 1987 which is not actuarially determined, has been estimated as per the provisions of the payment of the Gratuity Act, 1972 and the Company's scheme on the basis of the amount payable if all employees had to withdraw from the service of the Company as at December 31, 1987.

— Gross	4,08,64	2,76,7[illegible]
— Net of Tax	1,94,10	1,38,[illegible]

(d) CIF Value of Imports

Raw Materials	3,47,89	5,47,[illegible]
Components and Spare Parts	46,48	1,09,[illegible]
Capital Goods	16,12	90,51

(e) Break-up of expenditure incurred on employees :

(i) Employed throughout the year on the aggregate remuneration (excluding gratuity) of at least Rs. 36.

(a) Salaries, Wages and Bonus	3,25,43	3,92,70
(b) Company's contribution to Provident and Other Funds	26,88	28,75
(c) Number of Employees	722	921

(ii) Employed for a part of the year on an aggregate remuneration (excluding gratuity) at a rate of at least Rs. 3 per month.

(a) Salaries, Wages and Bonus	13,54	16,98
(b) Company's contribution to Provident and Other Funds	96	1,20
(c) Number of Employees	44	42

(f) Expenditure in foreign currency during the year on account of:

Commission on Exports	3,62	7,61
Travel	4,83	6,15

(g) Amount remitted during the year in foreign currency on account of dividend :

(i) Number of non-resident shareholders	1	1
(ii) Number of shares held by non-resident shareholders on which dividend was due	44,84,200	44,84,200
(iii) Amount remitted (net of tax)	84,08	84,08
(iv) Year to which dividend related	1986	1985

(h) Earnings in Foreign Exchange:

(i) FOB value of goods exported	1,21,33	1,99,76
(ii) Interest received	13	—

(i) Computation of Net Profit/(Loss) in accordance with Section 349 of the Companies Act, 1956 for calculation of commission payable to Directors.

	1987 Rs. '000	1986 Rs. '000
Profit as per Profit and Loss Account	6,08,09	4,11,23
Add :		
Managerial Remuneration	7,65	8,77
Depreciation	6,38,22	4,89,90
Adjustment on account of Sale of Assets	7,15	3,31
Provisions for Doubtful Debts	—	5,00
Provision for Taxation	5,40,69	4,99,90
Investment Allowance Reserve	—	1,90,00
Export Reserve	7,00	11,00
	18,08,80	16,19,11
Deduct :		
Depreciation computed u/s 350 of the Companies Act, 1956	5,45,70	5,19,26
Profit on Sale of Assets (Net)	15,89	4,44
Surtax	—	60,75
Net Profit for the year Under Section 198 of the Companies Act, 1956	12,47,21	10,34,66
Commission thereon restricted to	1,80	1,58

(j) Quantitative information in respect of each class of goods manufactured during the year (Quantity '000)

	Automotive Tyres (Nos)	Automotive Tubes (Nos)	Repair Materials (Kgs)	Rubber Dock Fenders (Kgs)
Licensed Capacity	11,74 (11,74)	11,74 (11,74)	18,14 (18,14)	1,00 (1,00)
Installed Capacity	10,74 (10,74)	10,74 (10,74)	18,14 (18,14)	1,00 (1,00)
Actual Production	6,83 (7,60)	6,21 (7,47)	— (99)	— (–)

SCHEDULES TO THE ACCOUNTS

Notes : 1. Actual Production of flaps 2,26 Nos. (2,29 Nos.)

2. The installed capacity is as certified by the Production Director and has been accepted by Auditors without verification.

(k) **Consumption of Raw Materials, Stores, Spare Parts and Components :**

	1987		1986	
	Raw Materials	Stores, Spare Parts and Components	Raw Materials	Stores, Spare Parts and Components
	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Imported	6,23,56	72,13	11,49,54	98,35
%	8.2	21.7	14.8	29.6
Indigenous	69,94,19	2,60,27	65,98,37	2,33,91
%	91.8	78.3	85.2	70.4
Total	76,17,75	3,32,40	77,47,91	3,32,26

(l) The tax proceedings in respect of the statement filed to The Securities and Exchange Commission In U.S.A. by The Goodyear Tyre & Rubber Company, referred to in the Director's Report for the year 1977 are pending in appeal and no provision has been made towards any liability that may be finally determined.

(m) Managerial remuneration paid and charged to the accounts of earlier years for which Central Government's approvals are still awaited Rs. 6,41 (Rs. 6,41).

(n) In respect of the Company's claim for excise duty prior to October 1975 since legal objections have been raised by the Authorities basically on the question that claims are time-barred, Management has decided to account for these as and when a decision in Company's favour is pronounced or when the refunds are received.

(o) As per past practice export incentives are being accounted for on receipts basis. The accrual of such incentives as at 31st December, 1987 is Rs. 1,05,36 (Rs. 1,50,18).

(p) The Company is following deferred tax accounting in respect of unpaid statutory liabilities referred to in Section 43-B of the Income-tax Act, 1961. In the opinion of the Management there will be sufficient future liabilities to set off against this deferred tax.

(q) Depreciation charge for the year includes Rs. 2,51,39 (Rs. 2,42,15) necessitated on account of revaluation of certain Fixed Assets carried out as at 31st Dec. 1984. An amount equivalent to this additional charge has been transferred from the Revaluation Reserve directly to the General Reserve.

(r) The current year's figures of raw materials consumption are inclusive of excise duty on inputs under Modvat Scheme to make them comparable with those of previous year.

(s) Previous year's figures have been recast, wherever necessary, to make them comparable to those of the current year.

Schedules 1 to 16 form an integral part of the Accounts.

V. NARAYANAN *Chairman*	HARDEV SINGH *Managing Director*	GIAN PRAKASH *Director*
P.L. SHARMA *Director*	D.A. MACDONALD *Director*	P.S. SARMA *Director*
K SANKARANARAYANAN *Director*		S.K. JAIN *Secretary*

New Delhi
March 10, 1988

NOTES

NOTES

NOTES

Uttar Pradesh
Rajarshi Tandon Open University

MBA-3.1

Corporate Policies and Practices

Block

5

STRATEGIC CHOICES

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BLOCK 5 STRATEGIC CHOICES

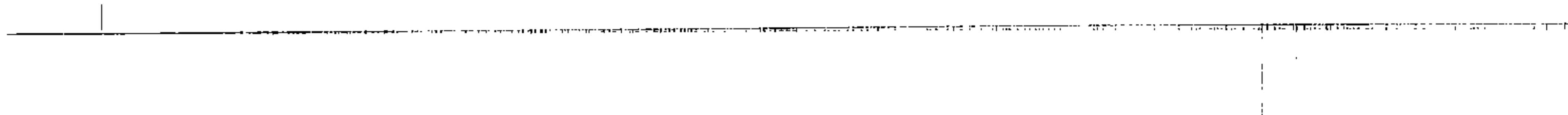
The earlier four blocks dealt with the concept of strategy, corporate planning, role and skills of top management, analysis of competitive environment, analysis of internal strength and weaknesses of a firm and finally analysis from the cost, financial and portfolio point of view. In this block, we intend to discuss some generic business growth strategies that may be used by a firm. Which one of the strategies would be the most appropriate for a particular firm will depend upon several factors, including its corporate objectives. The most appropriate strategy may change from time to time. In the emerging competitive environment a business firm must grow. It cannot afford to remain standstill if it is to avoid stagnation and death.

This block has three units.

Strategic alternatives which a firm could consider are dealt with in Unit-12. Each strategic possibility is briefly described. The detailed discussion of some of these strategies is taken up in the next two units. The procedure for generating alternatives in small and large organisations is first discussed. It is then followed by a classification of strategic alternatives, including some specific approaches for classifying the alternatives. The Indian environment with regard to strategic alternatives is also touched upon.

A business enterprise may seek expansion, including integration and diversification, either internally (organically) or externally through acquisition of running businesses or merger with existing businesses. Growth through the internal process is the subject matter of Unit-13. Various types of diversification, including integration, are explained with the help of suitable examples, short case histories and diagrams. Different types of synergies and their relevance are discussed. The need for planned diversification is emphasised. Finally a brief account of corporate diversification activity is provided.

Mergers and acquisitions are dealt with in Unit-14. What motivates a company to merge with or acquire another company is discussed. In what way a company can arrive at merger or acquisition decision scientifically and how it can manage an acquired business are explained. Toward the end, the emerging trends on the international and Indian scene with regard to mergers and take-overs are discussed.



UNIT 12 STRATEGIC ALTERNATIVES

Objectives

The objectives of this unit are to:

- familiarise you with various strategic alternatives a firm can adopt
- explain how strategic alternatives in small and large organisations can be generated
- discuss how a particular strategy is selected and what factors affect the final choice

Structure

12.1 Introduction
12.2 Strategic Alternatives
12.3 Generating Strategic Alternatives
12.4 Classifying Strategic Alternatives
12.5 Selection of Strategy
12.6 Management Factors and Strategy
12.7 Summary
12.8 Key Concepts/Terms
12.9 Self-assessment Questions
12.10 Further Readings

12.1 INTRODUCTION

This unit attempts to provide an appreciation of what strategic choices top managers may be confronted with from time to time in order to seek growth and viability for their organisations. Hopefully one day you will be in charge of some organisation. You will then be expected to guide the direction of growth of your organisation. One of the important tasks of top management is to provide direction to the organisation in an ever changing environment. Sometimes the top management is involved in planning expansion by entering into or discovering new markets or by buying business units from other managements. Many a time top managements take decisions for establishing new businesses or for undertaking inhouse production of raw materials. All these and several other such decisions are collectively called strategic alternatives. What strategic alternatives a firm could consider and how can it generate alternatives? How can a firm select a strategy and what factors affect the final choice? These are some of the important questions we will be concerned with in this unit.

Activity 1

Try to recall a situation when your organisation changed the course of its activities or added new activities. What factors started such changes? What were the options available at that point in time? What alternative was chosen and why?

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In a way you have attempted what in technical terms is known as the strategic analysis including the identification of strategic alternatives

12.2 STRATEGIC ALTERNATIVES

Strategic alternatives refer to different courses of action which an organisation may pursue at a point in time. These alternatives are crucial to the success of the organisation. More often than not, these are influenced by factors external to the organisation and over which the organisation has limited control. For example, consider a situation where a firm is experiencing increased competition of its products. How should the organisation respond? Should it reduce price? Should it improve the quality of the product? Should it use a mix of the two? Should it improve the distribution network? Should it improve promotional effort? Is there a set of guidelines which could be followed by the organisation? Alternatives external to the organisation such as mergers, acquisitions and joint ventures may also be considered. The list of alternatives will be incomplete without the alternative of disinvestment. There are situations when withdrawal from an existing business is the most suitable course of action. In fact, it may be wrong to consider that continuing to produce a particular product or service is a must.

A firm may consider withdrawl from a business if the present value of the anticipated stream of earnings from that business is less than its present worth. Thus, if the present value of the stream of earnings from the textile unit of a corporate group is less than the net worth of the textile business, the organisation should withdraw from the textile business. Sometimes there may be obstacles if the organisation wishes to withdraw. The most serious opposition may come from the Government in its anxiety to protect workers likely to be rendered unemployed. This kind of a situation is being faced by the DCM Limited, a highly diversified group. Any organisation contemplating to withdraw from a particular business should attempt to foresee the constraints and evolve ways to overcome them. Some obvious alternatives include:

i) offering alternative jobs to workers in other units;

ii) providing attractive retrenchment terms to workers so that they would not easily turn down the offer (the golden handshake).

12.3 GENERATING STRATEGIC ALTERNATIVES

How does an organisation identify alternative courses of action for its survival and growth? The procedure may differ from organisation to organisation depending upon its size, style of management, work ethos and industry characteristics.

Small Organisations
In a small organisation all decisions are made by the owner himself or by the chief executive. These decisions deal with what an organisation should do under alternative situations. What new businesses should be added or what existing businesses should be done away with. The success or failure of the organisation depends upon the experience and technical competence of the chief executive. Thus, in small organisations strategic alternatives are identified by the owner-manager. Of course his decision may be influenced by some bureaucrats, industrialists, etc. with whom he interacts. The procedure used for identifying alternatives may be intuitive rather than based on a well-defined procedure. The process of implementing alternatives in small business is however reasonably fast.

Large Organisations
In organisations of medium to large size, the following mechanisms may be employed for identifying strategic alternatives.

- brain-storming sessions;
- special meetings for the purpose;
- services of outside consultant;
- joint meetings of the consultant and the senior employees of the organisation.

Brain Storming Session
In most organisations strategic alternatives are identified during the brain-storming sessions. In such meetings participants are encouraged to come out with any course of action which they feel is possible. At this stage no importance is attached to relative merits and demerits of the alternatives. In the next stage each alternative is reviewed and subjected to a close

scrutiny. The alternatives which are considered fairly appealing are further examined and analysed for final selection of one or more alternatives.

Consider the case of power shortage in an organisation which produces an energy-intensive product such as aluminium. What should the organisation do? Since the decision is bound to affect the organisation crucially, the alternatives are of critical importance. These may include:

i) buy a generator;
ii) start producing those products which are not very energy intensive;
iii) have a stand-by generator for meeting part of the requirements;
iv) introduce a change in the product-mix with an emphasis on those products which have a higher contribution per unit of investment.

The few alternatives listed above have their own implications in terms of financial, physical facilities, manpower requirements etc. The chief executive has to select the alternative which is the most appropriate in his opinion. The current resource position of the organisation will be a major influencing factor in this decision.

Special Meetings

Large organisations, recognising the significance of generating strategic alternatives, hold special meetings away from the place of their work in a hotel or a holiday resort. This is to ensure that the process of thinking is not disturbed by interruptions during the course of deliberations. The participants present alternative scenarios alongwith their recommended courses of action. Alternative scenarios may be based upon assumptions regarding:

i) rate of growth of the economy
ii) position regarding foreign exchange
iii) rate of inflation
iv) rate of unemployment
v) ideology of the political party in power
vi) rate of change in technology
vii) socio-cultural factors having a bearing on the profitability of the organisation.

Depending on the assumptions regarding the values and future trends of the above parameters, alternative courses of action are often recommended. An attempt is made through the discussions to arrive at a consensus. The turnaround strategy of a leading pharmaceutical company Burroughs Wellcome was conceived in a series of meetings the Chief Executive had with his senior managers.

Outside Consultants

This procedure of identifying strategic alternatives is based on the premise that an outsider can observe the phenomenon in an objective manner. It is recognised that the executives who have been actively associated with a particular project are often so involved with it that they tend to be subjective and over look its shortcomings. Others, from within the organisation, may also be unable to see its limitations. Under such conditions engaging an outside consultant may be a more effective way to generate strategic alternatives on an objective basis. The outside viewpoint is expected to be new and fresh, and thus can show up many new opportunities to the organisation.

Joint Meeting

Another desired way of generating alternatives is to hire the services of a consultant but also associate some internal members in the process. This method is able to combine the advantages of the new ideas contributed by outsiders being blended with workable solutions from within the organisation. In any case, an outside consultant may like to seek the opinion of the internal members on his proposals.

Activity 2
Recall the last major strategic change your organisation considered and implemented. What procedure was used to arrive at the final alternative?

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12.4 CLASSIFYING STRATEGIC ALTERNATIVES

From the point of view of an organisation, strategic alternatives may be classified on the basis of degree of risk involved. Thus we have:

- low risk strategic alternatives;
- moderate risk strategic alternatives;
- high risk strategic alternatives.

Within this broad classification there may be a number of specific courses of action. The above classification provides the following strategic options in that order of risk:

- Niche
- Vertical integration—backward and forward
- Horizontal expansion
- Diversification

Niche Strategy: Niche means concentrating around a product and market. It is a strategy involving very low degree of risk and represents the typical behaviour of the small companies. Such organisations, in general, are scared of growing big as it could entail them into legal, labour and management problems. They are content with their present position and wish to capitalise on their superior knowledge of local conditions and choose a very narrow segment of market. 'NIRMA' until recently followed this alternative with great success.

In India, the Government policy has always favoured small scale units. Such units have been accorded a favourable treatment in the matter of licencing, credit and supply of raw-material. Thus, the factors internal to the organisation and government policies have contributed to the growth of small companies in India.

Vertical Integration: This can assume two forms: backward and forward. Backward integration means inhouse production of critical inputs for the main business or going in for marketing of products by opening retail outlets. The company may also add to the existing products/processes by taking up the production of intermediate goods. In the case of forward integration the companies try to reach customers through their own distributional network. Organisations follow forward integration to take advantage of the closer contact with the customers and to ensure a control over retail price of their products. Reliance company has pursued this strategy very effectively. Integration is a moderate risk alternative.

Horizontal Expansion and Diversification

Horizontal expansion results when a firm adds new products or enters into new markets. Most pharmaceutical companies follow this strategy.

In diversification, an enterprise takes up new products or business which may related or unrelated to its existing business.

Diversification, in particular, involves high degree of risk as it amounts to manufacturing new products or entering into new markets unfamiliar to the organisation. There are two broad categories of organisations that follow diversification. The first category includes those which are not doing too well in the traditional lines and are exploring the possibility of other products or markets. The second category would include organisations which enjoy considerable resource strength and would like to expand operation by looking at new businesses.

Companies in India have followed both vertical integration and diversification. For instance, Walchand Group's activities cover mainly large construction projects, heavy engineering, specialised automobiles, Sugar, concrete pipes, confectionary, machine tools castings, and fabrication etc. Hindustan Lever has pursued a strategy of vertical integration for soaps and toiletory business. It has also followed diversification in basic chemicals. Some business

houses have gone in for large scale diversification i.e., DCM, Tatas Group, Birla Group, Thapar Group, ITC, etc. Larsen and Toubro has had major diversifications in recent times by entering into cement and shipping industry.

Activity 3

For the following business houses, identify their respective businesses and any inter-relationships. For indepth information, you may like to consult their Annual Reports, some well known business and economic journals/magazines, and newspapers.

Business Houses	Businesses
A) DCM Limited	1) Computers 2) Sugar 3) Textiles 4) Engineering Products 5) Fertilisers and chemicals 6) Foods 7) Rayons
B) Larsen & Toubro	1)
C) RPG Enterprises	1)
D) TVS Group	1)
E) Escorts	1)

Another classification is based on the desired rate of growth. The various alternatives provided are:

a) internal expansion (adding more capacity)
b) internal stability (by augmenting resources)
c) internal retrenchment (manpower or assets)
d) external retrenchment (by disposing company-owned outlets)
e) external expansion through mergers (joining with other business units)
f) a combination of the above strategies

Some of these alternatives are explained as follows:

Internal Retrenchment: This is also known as 'turnaround' in which the organisation starts generating profit after incurring losses for a number of years. This may be brought about through restructuring of capital, changes in management personnel and better control in functional areas. In the Indian context, Hindustan Photo films presents a good case of turnaround strategy.

External Retrenchment: This expression is used as synonym for divesture. Thus an organisation may like to withdraw from a business incurring a loss over a period of time. Obviously, the approach is the opposite of mergers. Subject of the clearance of the Government, the DCM wishes to divest out of its textiles business. ITDC, about a year back, decided to close Akbar Hotel.

Divesture is prompted by factors such as inadequate market, lower profits and availability of better alternatives, technological changes requiring investment which the management is unable to undertake. Divesture may include the following:

- A part of the unit may be floated as an independent unit
- It may be sold to employees
- It may be sold to an independent buyer
- It may be liquidated and its assets sold

Glueck [3] has classified strategic alternatives into the following categories:

i) stable growth strategies
ii) profit strategies
iii) stable growth as pause strategies
iv) sustainable growth strategies.

The first alternative is useful when a firm pursues its original objective or objectives similar to the original one, or when the focus of its main strategic decision is on the incremental improvement of functional performance. In this case, achievement level is fixed on the basis of past performance corrected for known rate of inflation. The underlying premises in this case are:

- a reasonably stable environment and
- management not being in favour of undertaking high degree of risk though it is not risk-averse.

Modi Xerox, since its inception, has followed a stable growth strategy in India. It has concentrated on a narrow range of products and quality aspect of after-sales service.

The second alternative is followed when the main aim of the strategic business unit is to generate surplus. In the process other objectives may be sacrificed. This aspect may get considerable importance during the phase of recession.

The stable growth alternative applies in those situations where a firm deliberately slows down to improve efficiency. Such a behaviour is observed among organisations who find it difficult to manage growth. This difficulty is usually experienced by organisations of small to medium size. But unmanageable growth has been experienced by large organisations too. A very large number of television manufacturers in India are forced to control their growth inspite of large market opportunities that exist before them. Since most of the TV manufacturers are small or medium sized firms, lacking substantial resources, they follow a stable growth strategy by focussing their efforts in certain geographical markets and around few products.

The sustainable growth alternative includes a modified incremental growth to take one of the unfavourable external conditions. These include:

a) internal growth strategies consisting of:
 —concentric diversification, and
 —conglomorate diversification
b) external growth strategies consisting of
 —mergers,
 —joint ventures
c) liquidation.

Concentric growth is an alternative where the firm goes into businesses which are related to the existing ones, say from manufacture of spare parts for passenger cars to the manufacture of spare parts for tractors. This no doubt is an example of the product related concentric growth. An example of customer related concentric growth is when a firm producing farm equipment decides to enter the business of chemical fertilisers.

Under the growth alternative of conglomorate diversification, a firm may acquire another firm which has surplus cash even though there may be nothing in common with the existing business. The RPG Enterprises have pursued this alternative within the scope of its limited resources.

Merger is an alternative where two firms join. There are different objectives of mergers including the need to tide over the financial crisis. The objectives of mergers and the procedures followed in negotiating a merger are discussed in detail in another unit in this block.

Joint venture is an alternative which can meet a number of needs such as rapid rate of growth desired by the firm, maintaining the risk within reasonable limit, and to tide over the constraint of resources. Thus a firm having constraint of production capacity can have a joint venture with a firm having surplus production capacity. Pepsi Cola (a US multi-national company), Voltas and Punjab Agro have recently joined hands to promote a joint venture in the area of agro industries.

Liquidation indicates a situation where the firm finds the business unattractive. There may be a dearth of people who have interest in the proposition. Neither the employees nor do outside parties find it an attractive proposition to be revived. Obsolete equipment is the usual cause. Disinvestment may be considered attractive when the present worth of expected earnings is less than its present worth.

Mergers and Acquisitions

The legal position about mergers (referred to as amalgamation of companies) is contained in sections 394 to 396 of the Companies Act. But these sections have to be interpreted in conjunction with section 94 (power of limited companies to alter share capital) 95, 97, 100 (dealing with special resolution for reduction of capital), 101, 102, 104 and 107. Some of the important provisions of the Companies Act deal with the power of the court, with whom an application for amalgamation has been pending, to make any alternation or modification in

the scheme for amalgamation. The most important aspect is the protection of the interests of the dissenting shareholders. Any scheme for transfer of whole or any part of an undertaking requires the approval of the nine-tenths in value and three-fourths in number of share holders of the company. Probably, the most important section is 396 dealing with the power of the Central Government to provide for amalgamation of companies in public interest. The sick units are being amalgamated with other companies or are being taken over by the Government.

In actual practice it is difficult to draw a distinction between mergers and acquisitions. Strictly speaking, in case of mergers, the existing companies lose their identity and a new company is formed, while in the case of acquisitions it is the purchase of a company by another company. Madura Coats is a company born out of the merger of Madura Mills and Coats India Limited in early seventies.

At times it is profitable to diversify through mergers. The process of mergers gives the advantage of not having to start from scratch. Amalgamations enable the companies to have advantage of fast changing technologies: the underlying assumption in this case is that one of the merged companies enjoys distinct strength in the area of R&D. Mergers may also enable reduction in administrative costs. Given the indivisibility of certain expenditure on personnel, the merger will result in better utilisation of their time. Further, the merger may facilitate the process of linking the products and may amount to vertical integration. This could be undertaken where for various reasons the merging companies individually would not have been able to implement vertical integration. The process often results in providing a complete product line. It goes without saying that some companies undertake merger as a means to plan their tax liability. (The most amusing example is provided by an advertisement which appeared in a reputed newspaper stating 'wanted companies which may have incurred a loss upto a specified amount').

Ansoff et al[3] have presented a detailed procedure for screening projects for diversification based on merger. The sequential steps are: (i) define the objective of merger (to reflect how better utilisation of resources is to be achieved and the manner in which the adaptability to the changing environment is going to take place), (ii) review the strengths and weaknesses, (iii) develop criteria to identify the most advantageous merger prospects, (iv) find out the financial resources available, and (v) develop strategies for choosing among the industries.

Desirably, the management of the buying company should be aware of the extent of its need for the other company because the price payable (or the exchange ratio) depends upon the bargaining power of the two managements. Management of the buying company has to convince the management of the selling company that the sale is in the latter's interests. One has to look to the alternative offers the selling company may be having. If the forecasts of resources generated after merger show a brighter picture, a generous price offer can be made. Nierenberg has discussed the steps in defining (i) the range within which the terms may be offered and (ii) other party's position. The steps involved in defining one's own position are:

- Study of relevant information and forecasts to identify the maximum price and the mode of payment.
- Incorporation of non-price terms in the final contract.
- Formulation of alternative course of actions and their implications with contingency provisions.
- Awareness of company's stand on ethics, integrity and honesty.
- Review of the related factors like timing of the negotiations, the person to negotiate and so on.

Steps in estimating the selling company's position are:

- Identify the alternatives that may be open to this company regarding price and the mode of payment.
- Substantiate or cross-check the information.
- Review the assumptions by approaching the problem from the seller's point of view.
- Identify the factors that could be important to the other company.

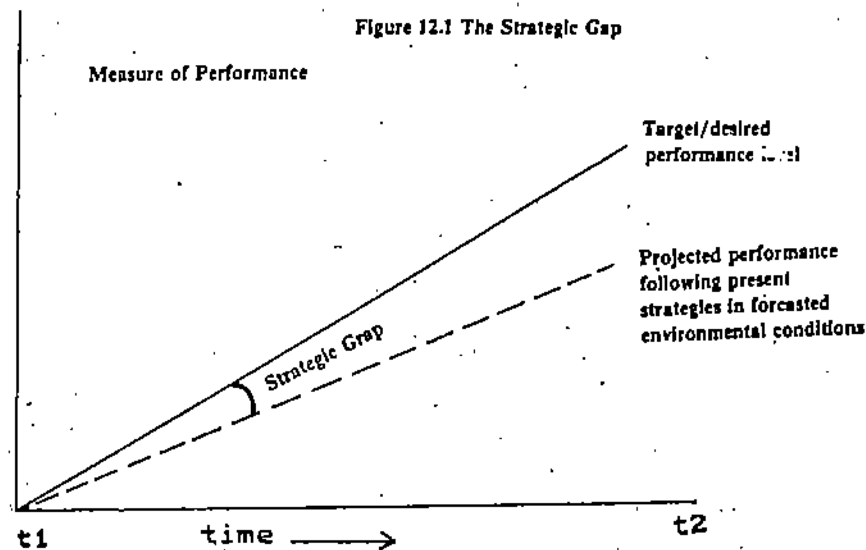
12.5 SELECTION OF STRATEGY

Once the analysis of current and projected performance of the company based on existing

strategies and the assessment of desired performance is done, the strategic gap is identified. Strategic alternatives are then generated to bridge the gap if the projected performance in future falls short of the expected or desired performance. A number of alternatives may be possible but only one or a few of them may finally be accepted as a strategy or strategies for future. "Strategic choice is the decision to select from among the alternative strategies considered, the strategy that will meet the enterprise's objectives. The decision involves focussing on few alternatives, considering the selection factors, evaluating the alternatives against these criteria, and making the actual choice".

The process of narrowing down a large number of possible strategic alternatives starts with the consideration of strategic gap. Strategic gap is the perceived difference between the targeted performance and projected performance following the present strategies (Figure 12.1). Strategic gap could be very narrow or quite large. If the perceived gap is narrow or the projected performance is likely to be better than targeted, one would expect that the stability strategy would be followed. A large gap could be caused by increase in targeted level of performance or the adverse changes in the environment which would lead to poor performance in future from the present strategies. In the former case the strategic gap may be said to be positive while in the latter it is negative. One would expect the growth strategy to be followed in case of large positive strategic gap and retrenchment strategy in case the strategic gap is negative and large. A large positive gap is likely to occur due to environmental opportunities and a large negative gap due to environmental threats. It must be noted that the importance of leadership in any situation cannot be underestimated. The same environment may be viewed by one as threatening and by another as providing an opportunity. Thus a large positive strategic gap is more likely to be associated with dynamic leadership which may have substantially higher aspiration levels of performance. The transformational type of leaders will, in all probability, have a large positive strategic gap.

Figure 12.1 The Strategic Gap



Like environmental conditions, the strengths and weakness of the organisation also determine the strategic alternatives to be considered. If the internal analysis shows strength, the growth strategies are more likely to be considered. Organisational weaknesses may push for retrenchment strategies.

The vehicle for effecting the strategy is likely to be internal if the gap is small or large positive. It is likely to be external if the gap is very large as the organisation may find it difficult to cope with the demands of implementation following internal approach. Same is the case with relatedness of strategies. Figure 12.2 captures the most likely alternatives of strategy selected for comparison and final selection.

It may be noted that while in small organisations and in some medium size organisations, only one of the strategies may be followed. In large, complex, multiproduct/business organisations a combination of strategies is most likely.

Figure 12.2 Perceived Gaps, Strategic Conditions and Alternative Dimensions

Strategic Gap	Narrow		Large
Environmental analysis	Shows Stability	Shows Opportunity	Shows Threats
Strength/weakness analysis		Shows Strength	Shows Weakness
Alternative Strategies to focus decisions	Stability	Expand	Retrench
	Pace Changes		Business Definition Changes
	Internal Change Related Change		External Change Unrelated Change

Source: Glueck, W.F., 1986, P.271.

It may be worthwhile to mention that there are certain sectoral patterns observed in terms of strategies. In a recent study it was found that compared to public sector companies and multinationals in India, large domestic private sector companies tend to prefer growth strategies. There are also instances of domestic private sector companies growing more than either the public sector companies or multinationals.

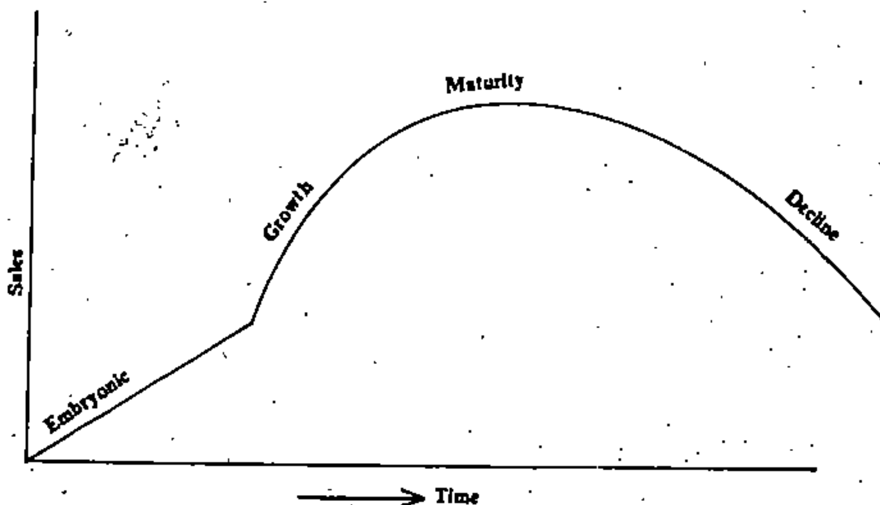
The high growth strategies followed by such companies may be attributed to the philosophy of encashing the environmental opportunities. It has also be observed that due to obvious reasons public sector enterprises and multinationals in India tend to follow related diversification more than unrelated diversification.

Various approaches can be helpful in the selection of strategy, one such approach is the Product Life Cycle approach.

Product Life Cycle Approach

Product life cycle describes the hypothetical passage of a product/service through a series of stages, namely, the embryonic (introduction), growth, maturity and decline (see Figure 12.3).

Figure 12.3 Product Life Cycle



Product life cycle is a useful concept in the selection of a strategy. The business strategy at different stages of the product life cycle would be different. For instance, in the growth phase huge investment in plant and machinery would be required. While in the decline phase it would be otherwise. In the embryonic stage the R&D requires significant attention and resources while in the maturity phase low cost efficient process requires more emphasis. Besides the appropriate functional strategies, the product life cycle approach also suggests appropriate overall strategy. It also helps us in timing the change in strategy and in assessing whether the corporate portfolio is balanced so that new products would be introduced while others pass through growth to maturity phase[4].

Apart from the product life cycle approach, some other conceptual models suggested by various writers can be extremely useful. These are: Patel and Younger's "Strategic Guidelines Based on Industry Maturity and Competitive Position", BCG Matrix, GE Planning Grid. All these models and ideas, as you will recall, were discussed in units 10 and 11.

12.6 MANAGERIAL FACTORS AND STRATEGY

In previous sections we have discussed how a firm could reduce the number of possible alternatives to a reasonable level. The choice of strategy as emerging from the process of narrowing down the alternatives is moderated by several managerial factors discussed below.

Managerial attitudes towards risk vary from high risk to risk-aversion. If the attitude is that of risk aversion then the stability strategy is likely to be accepted. If it is that of high risk taking, the growth strategy even with external change (acquisitions & mergers) may be pursued. Balanced attitudes are likely to favour combination strategies. The attitude towards risk also depends upon the stakes involved. If the whole of the firm is at stake, the risk assessment would be different than if only a part was at stake.

Another factor that influences managerial choice is the awareness about how strategies have worked in the past. The development of strategy builds up on past strategy. According to Mintzberg[3], the past strategies tend to become programmed and bureaucratic momentum keeps it going, and when the strategies begin to fail due to changing conditions, there is a tendency to graft new strategies onto the old ones. In many cases, therefore, more strategic changes are likely to come when the new chief executive or top management takes over.

Perceived external dependence too has an effect on the strategy. Many company's product lines are restricted by the technology e.g., most Indian companies bank on foreign collaboration. Aggressive growth strategies, therefore, depend technology available for import. Indeed, the very choice of business by a firm in India at any time is determined by the technology it could manage to import. Similarly most Indian companies depend on borrowed funds and changes in credit policies influence the choice of strategy.

The timing of choice is also a very important factor. Many strategies are bound by time. If delayed, the strategic alternative may not remain available. For instance, if the government decides to give licences for a particular product, they may be available only for a short period. If government approves import of technology it does not open the gate once for all. If the decision is delayed the licences may go to other companies and no more licenses may be available. If the company wants to increase market share by upgrading technology through imports, it may not have the opportunity open for ever.

The strategic selection process may not necessarily be a rational process always. More often than not, it is a political process. The power relationships in the organisation at times have a very important bearing on strategic choices. The political process may even influence the objectives (criteria for choice) and the way analytical approaches are used and interpreted. In Mintzberg's view the values and goals of key managers must be analysed, considered and incorporated in the choice process. The political process has overriding influence in as much as 30 per cent of the time. It is not a question of choice but is one of pragmatism. The strategies not acceptable to key managers are unlikely to be implemented successfully.

Perhaps the most important influence on strategic choice process is the key managers' perceptions of the ability of the organisation to implement the strategy. The implementation involves management of change and matching of several intricate factors. The demands of implementation to ensure proper matchings among the structure, the skills, the style, the staff, the shared values, and the strategy, are of administrative and creative nature. The assessment of the task of implementation and the skills available for change is quite difficult and subjective. The managers therefore tend to select strategies which put little demands on them in terms of effecting implementation. It is perhaps this factor which explains why many organisations do not go for high growth strategies and defer even retrenchment strategy from consideration.

12.7 SUMMARY

In this unit we have discussed what strategic alternatives a firm could consider. We had

pointed out in the very first unit of this course, as you will recall, that strategic management is inherently non-generative. The management, therefore, has to be proactive in generating strategic alternatives. What mechanisms a firm, both small and large, could employ in generating alternatives was explained at some length. This was followed by a classification of strategic alternatives based on desired growth, degree of risk involved, etc. Some specific contributions of certain writers were also presented. The various strategic choices, including mergers and acquisitions, were briefly explained.

Once a firm has identified the various strategic possibilities, it has to make a selection from among these alternatives. And this would depend upon its growth objectives, attitude towards risk, the present nature of business and the technology in use, resources at its command, its own internal strengths and weaknesses, Government policy, etc. There are several managerial factors which moderate the ultimate choice of a strategy. For a firm desiring immediate growth and quick returns, mergers and take-overs afford attractive opportunities as they obviate the necessity of starting from scratch. However, identifying the right candidate for merger or acquisition is an art at which only a few managements can really excel. Establishing joint venture, especially in the international arena, is a low risk alternative. Many firms prefer this approach.

12.8 KEY CONCEPTS/TERMS

Acquisitions
Diversification
Gap Analysis
High Risk Alternatives
Horizontal Expansion
Integration
Joint Ventures
Low Risk Alternatives
Mergers
Moderate Risk Alternatives
Niche
Product Life Cycle
Strategic Alternatives

12.9 SELF-ASSESSMENT QUESTIONS

1. If you were the chief executive officer of a large organisation operating in an environment of intense competition, what procedures or mechanisms you would like to use so that top management always remains strategically conscious and effective strategic alternatives are generated on a continual basis?
2. Will the procedure for generating strategic alternatives in a small organisation differ from that of a large organisation? From your own knowledge reaccount the story of an organisation which has grown big from a small or modest beginning. What factors you think were responsible for its spectacular growth?
3. How would you classify strategic alternatives based on growth and risk? Discuss specific contributions, if any, in this respect.
4. Distinguish between a merger and an acquisition. Under what conditions the two moves would be desirable?
5. How would you identify whether a particular firm selected for merger or acquisition is the right choice?
6. After you have identified the various strategic alternatives, how would you select a particular alternative (or alternatives)? What factors would you take into account and why?
7. How does the product life cycle concept help an organisation in choosing a strategy from among several causes generated by it?
8. How does a strategic gap differ from the poor performance which is often symptomatic of strategic or operating problems?
9. "Managerial factors moderate the choice of strategy". Explain the statement.
10. "Growth is the most frequently used corporate strategy". Discuss the reasons why a

firm must grow? Under what circumstances a firm may not consider growth a desirable strategy?

12.10 FURTHER READINGS

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5 Mintzberg, H. et al, 1974, *Structure of the Unstructured Decisions*, Mineograph, McGill University: Montreal, P.

UNIT 13 DIVERSIFICATION

Objectives

The objectives of this unit are to:

- explain the strategy in and types of diversification
- discuss vertical integration in the context of diversification
- consider diversification vis-a-vis expansion
- emphasise the need for and explain the steps involved in the planned diversification process.

Structure

13.1 Introduction
13.2 What is Diversification?
13.3 Types of Diversification
13.4 Related Diversification
13.5 Unrelated Diversification
13.6 Integration
13.7 Diversification and Synergy
13.8 Diversification vs Expansion
13.9 Planned Diversification
13.10 Corporate Diversification Activity in India
13.11 Summary
13.12 Key Concepts/Terms
13.13 Self-assessment Questions
13.14 Further Readings
Appendix

13.1 INTRODUCTION

With increasing industrialisation and frequent entry of new producers, markets are becoming more competitive and dynamic. As a result, there is an increasing pressure on the market share and profit margins of the existing producers. Furthermore, with the emergence of take-over tycoons and the fast-growing companies, there is an all round pressure to move fast in the industry. Companies which are complacent about their presently comfortable dominance in the markets are likely to get edged out by more aggressive entrepreneurs. With growth of technology and markets, competition and the associated risks have also grown.

The emerging situation demands that the company's fortunes are not solely dependent on one particular segment of the company. The company should distribute its dependence on different segments of the economy in such a way that if one segment of the economy goes through a slump or a recession, the entire operations of the corporation do not come to a standstill. For instance, if a company is exclusively involved in the agricultural goods, it should look for potential avenues in the industrial goods or the consumer products.

In this unit we will discuss what diversification strategy is, the different types of diversification strategies which a business firm can pursue and how planned diversification can be brought about.

13.2 WHAT IS DIVERSIFICATION?

As an individual with surplus disposable funds, you would like to invest your savings in several different assets. For example, you may put X amount in a house or other real assets, Y amount in fixed deposits and bonds, and Z amount in company shares. Some of these

investments are less risky and have lower returns, while others have a higher potential for return on investment, with much more associated risk as well.

The purpose behind an individual diversifying his investment portfolio is to avoid the risk arising from an unexpected failure of a particular channel of investment. Although investment in shares of a particular company might promise excellent profits, investing all savings in that company exposes the investor to the risk of facing crippling losses should a natural or man-made calamity strike the company. By buying shares of several companies an investor reduces the possibility of suffering an unexpected loss and simultaneously increases the possibility of having a stable and steady income, besides appreciation in his investment.

Companies in a similar fashion attempt to spread their risk by diversifying into several products or industries. They stretch their involvement into more products for a more stable growth and profitability. Corporate strategists have to approach the issue of diversification by asking practical questions like: What is our business? How many businesses are we in? How many businesses should we be in? How are these related to each other? And so on.

Corporate diversification involves broadening or enlarging the company's product range by introducing new products, or extending the range of existing products. The diversification strategy is concerned with achieving a greater market from a greater range of products in order to maximise profits. From the risk point of view, it translates the policy of "not putting all of one's eggs in the same basket" into action. For example, an air-conditioning company may add room-heaters in its present product lines, or a company producing cameras may branch off into the manufacturing of copying machines.

13.3 TYPES OF DIVERSIFICATION

The diversification choices can be broadly divided into two types:

- related diversification
- unrelated diversification

A related diversification is one where two or more products or businesses are related to each other by common manufacturing facilities and processes, R&D effort, staff, markets, distribution channels, or sales and advertising effort. Because of sharing of resources, related diversification has the potential of generating economies of scale on account of various kinds of synergies coming into play. An unrelated diversification often lacks this potential. In a related diversification therefore a combined business should be able to achieve a better ROI (Return on Investment) because of increased revenues, decreased costs, or reduced investment in the total business.

Unrelated diversification is one where a company moves or diversifies into product areas which are not related to the existing product(s) or to each other by common technology or markets etc. The products manufactured by a company which has gone into unrelated diversification usually belong to different industry or market groups.

13.4 RELATED DIVERSIFICATION

As you have already noted, this type of diversification takes place when a company enters into the manufacturing or marketing of related products or businesses. The different products manufactured by the company are related to each other by common technologies, marketing channels, etc. The company enters into related businesses by using its experience in marketing, production, technology or other functional areas for new businesses.

J.K. Synthetics is a company which has actively diversified into a number of related areas. From a textile background, J.K. entered the field of synthetic fibres and successively moved into different types of synthetic fibres based on related technology. For the year 1984-85, the sales turnover of Rs.4190 million included 32 per cent from polyester filament yarn, 17.6 per cent from polyester staple fibre, 10.5 per cent from nylon tyre cord, 15.5 per cent from acrylic staple fibre. The different synthetic fibres accounted for 75.5 per cent of the total turnover, while the rest came from cement (20 per cent) and other products (4.5 per cent).

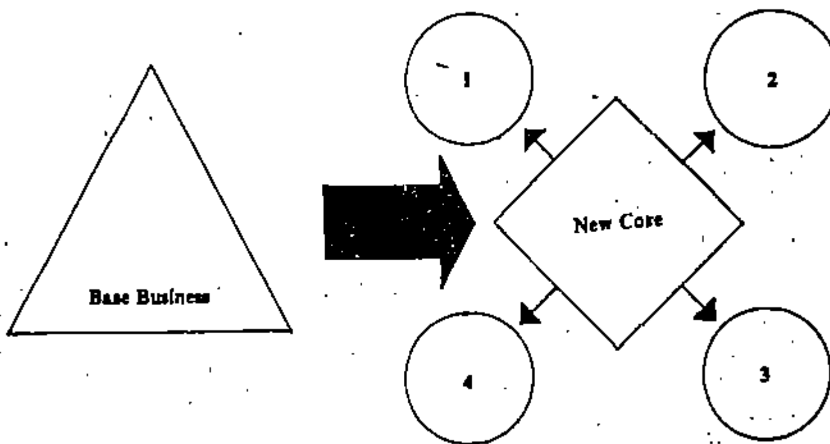
When the diversification strategy of the firm is such that there is a 'common thread' which relates the past, present and the future products and market, the insiders can easily guide the

future developments of the organisation, and the outsiders can guage where the company is going. This type of diversification strategy is also known as concentric diversification.

The related diversification can be of two types: **constrained** and **linked.**

Constrained or Controlled Diversification
Here the company's strategy is to diversify into products which are all closely related to the main product line as well as to each other. The new businesses are closely related to the core business by common technology or markets. Nirlon took off from Nylon filament yarn used for textile applications to Nylon tyre cord in the area of industrial applications. The company then decided to enter into the businesses of making conveyor belts, V-belts and tyres, all based on industrial grade nylon yarn. The basic idea in constrained diversification is illustrated in Figure 13.1.

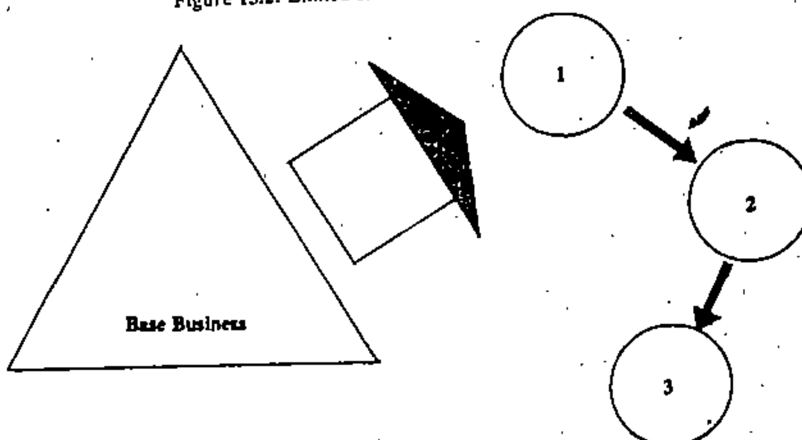
Figure 13.1: Constrained Related Diversification



Linked Diversification
In this case, the company's different product lines are not related to the core business, rather each product or business is linked to other product line as in a chain. The linkages between different businesses are in general weak and only based on a business relationship.

Indian Shaving Product Ltd., with a 24 per cent equity from Gillette, U.S.A., planned to diversify from blades to manufacturing of toiletories and writing products. These are also the product lines of the foreign collaborator. The company wishes to follow these diversifications because it has access to the technologies of the foreign collaborator. Further, these goods offer a 35 per cent return on operations, much more than what the blade industry can permit. Thus, the diversification is expected to strengthen the bottom line of the company. Figure 13.2 graphically presents the idea of linked diversification.

Figure 13.2: Linked Related Diversification



Before entering even into related areas a company must ask itself some important questions:

- Do the common skills and resources really exist?
- Will the economies/benefits resulting from sharing of skills and resources be substantial?
- Will the related diversification improve overall results?
- Will the related diversification lead to any difficulties or problems and does the company have the capacity to overcome those difficulties fast?

Activity 1

Give five examples of companies (other than those cited in the previous section) which have pursued related diversification. and classify them with respect to the direction of their diversification.

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13.5 UNRELATED DIVERSIFICATION

Contrary to related diversification, some companies follow the strategy of moving into unrelated and altogether dissimilar businesses. This may be accomplished by setting up new projects from grass-root level, or through mergers or takeovers of running businesses.

Hyderabad Allwyn has grown into a highly unrelated diversified company over the years. Starting over 45 years ago in 1942, it grew to cross the sales turnover of Rs. 1 billion in 1986-87. In 1946, the firm diversified in an allied field of bus body building, and in 1948 into the manufacture of domestic refrigerators. In 1966, the company pioneered the production of domestic gas cylinders through an in-house R & D effort. From 1970 to 1975, deep freezers, water coolers and air conditioners were added to the product range. In 1980, Hyderabad Allwyn entered into another unrelated diversification of watches. In collaboration with the world famous watch maker Seiko of Japan, Allwyn started making hand-wound, automatic and Quartz analog models, with an average annual growth rate of 35 per cent. In 1980, the firm also entered into collaboration with Mitsubishi of Japan for industrial sewing machines, and with Hitachi for hermetic compressors. In December 1981 an agreement was signed with Nissan Motor Company of Japan for production of Light Commercial Vehicles (LCV) through a subsidiary. This was an area with high growth potential. The fact that Allwyn had no prior experience in the auto business (except bus body building) did not deter the management from getting into this new area.

Shri Ram Fibers, moving from industrial synthetic yarn of setting up to a unit for automotive electricals, is also an illustration of the unrelated diversification, although there was some corporate synergy with its promotors the DCM Ltd which went in for automobile assembly. Similarly, from textiles the Lalbhai Group has diversified into electronics.

Companies producing mature products should avoid getting into other mature (unrelated) products. This should be so despite the fact that the former is a cash generator, and the latter would require new investment. Similarly, a company dealing in a 'new product' should refrain itself from taking up other 'new products' at similar stage of their product life cycles.

The cash generation ability of the diversification alternative and its status with respect to the product life cycle are two important criteria. Mature products must be matched with new products, because the former will generate cash for the latter and harmonize the spread over life cycles. The different possible candidates may then be plotted in a matrix of market characteristics (such as its average profitability, potential for growth and vulnerability to imports, etc.) versus the characteristics of the company (such as its market share, financial performance, etc.). These should be viewed in relation to the position of the present operations.

Unrelated diversification is also known as "conglomerate diversification", especially when new unrelated products are added by acquiring new businesses (companies). For example

RP Goenka, who had interest in Philips Carbon Black, Asian Cables, Murphy, and Agarpura Jute Mills, took over Ceat (tyre manufacturing company), Kamani Engineering (making electricity transmission towers), Searle India (making Agro-chemicals), and Gramophone Company of India. Bayar India (manufacturing rubber chemicals) and Dunlop (manufacturing tyres) were acquired by RPG in association with Chhabarias, both are well-known in the corporate world for their takeover activities. Additionally, Goenka has promoted India Polyfibers, Upcom Cables and Karnataka Telecables, Oak India and Maple Circuits, the last one for manufacturing computer peripherals and laminates for computer circuit boards. Haldia Petro-chemicals, a new joint venture with West Bengal government, is regarded as its most spectacular project.

13.6 INTEGRATION

The integration strategy can be best understood by the relationships in a family, which can be vertical or horizontal (see Figure 13.3). In vertical integration, businesses are related to each other like grand father to father to son or daughter. On the other hand, horizontal integration is like the relationship between uncles, nephews or nieces.

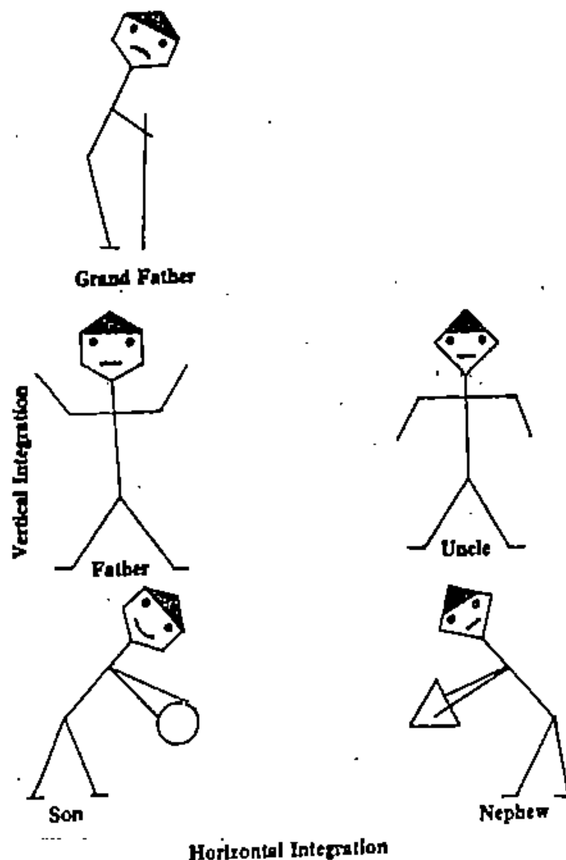
Horizontal Integration

Horizontal (lateral) integration refers to owning or controlling a number of similar but separate activities in the same kind of business. It usually refers to buying or taking control of competitors at the same level in the production or marketing process. In horizontal integration the firm acquires other firms or products that can use existing facilities. Usually the acquired firm is a competitor. For example, a firm already in auto service business may takeover another company which has auto service centres. As the facilities for manufacturing and marketing get shared, the cost per unit may be reduced. Horizontal integration therefore may enhance the profitability of the total enterprise.

Vertical Integration

Vertical integration may be of two types, backward towards the grand father or fofward towards the son.

Figure 13.3: Vertical and Horizontal Integration



Backward Integration

In general, a product manufactured by a company is made up of several parts or raw materials. A manufacturing company usually buys huge quantities of parts or raw materials from outside suppliers. One way to diversify is to add facilities for producing such parts, components, or raw materials.

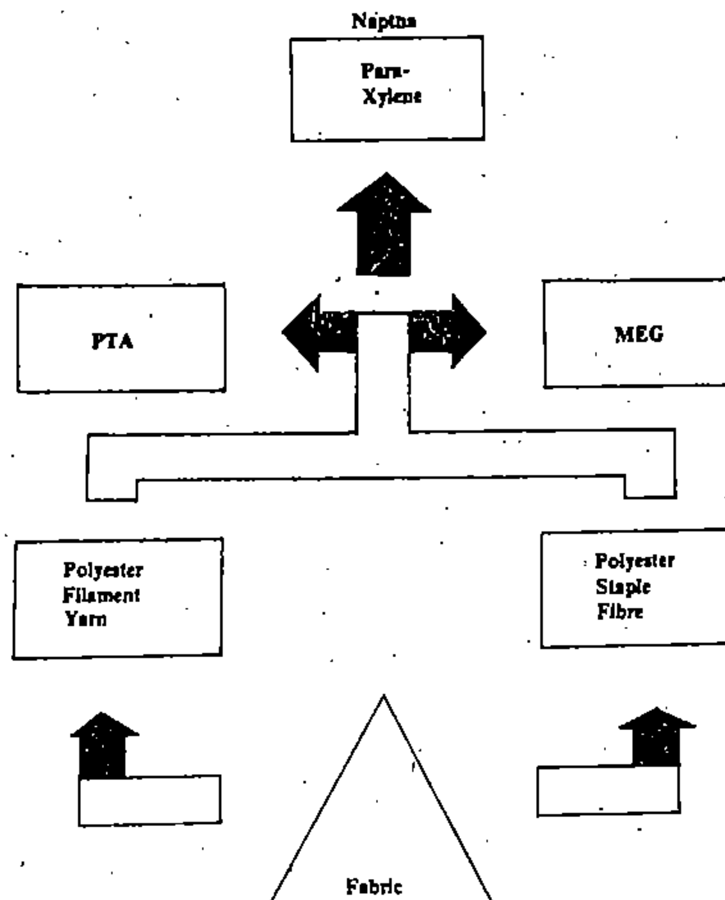
Backward integration, by diversifying into raw materials and other supplies for the company's products, may give the firm better control and reliable supply of essential inputs. A company may also be tempted to follow this strategy when it finds its suppliers reaping large profits. Backward integration may require additional technologies different from the ones already in use within the company. The company may also produce quantities of parts, components, etc. much in excess of its own requirements. It may thus enter into the market as a supplier in competition with its earlier suppliers. With quality control exercised on inputs, backward integration may enable a company to improve the quality of its final product.

Reliance Industries, promoted in 1977, is planned to be a highly vertically integrated unit, with stress on backward integration. The textile mill producing Vimal brand of fabrics moved into polyester yarn manufacture, while still selling its fabrics at a nationwide retailer network. For 1985, fabric sales accounted for 33 per cent of the revenue, whereas polyester yarn contributed a massive 65.8 per cent of sales. Later, the manufacture of polyster staple fibre was also added, and in 1986 when the plant was commissioned, it accounted for 5.6 per cent of the sales. The contribution of polyester staple fibre increased with the years.

In March 1988 a plant for purified terepthalic acid (PTA), an important raw material for making polyester, was commissioned with an annual capacity of 100,000 tonnes per annum set up at a cost of Rs.5,000 million. Earlier in November 1987, another plant for linear alkyl benzene, an important ingredient for detergents, was also commissioned.

The other major raw material for producing polyester, mono ethylene glycol (MEG), is also on the anvil with a capacity of 60,000 tonnes per annum at Hazira in Gujarat. The plant to make paraxylene, an intermediate for manufacture of PTA, was expected to go on stream in July 1988. With these projects Reliance is expected to market fabrics with enormous cost advantages. Figure 13.4 shows backward integration at Reliance.

Figure 13.4: Backword Vertical Integration at Reliance.

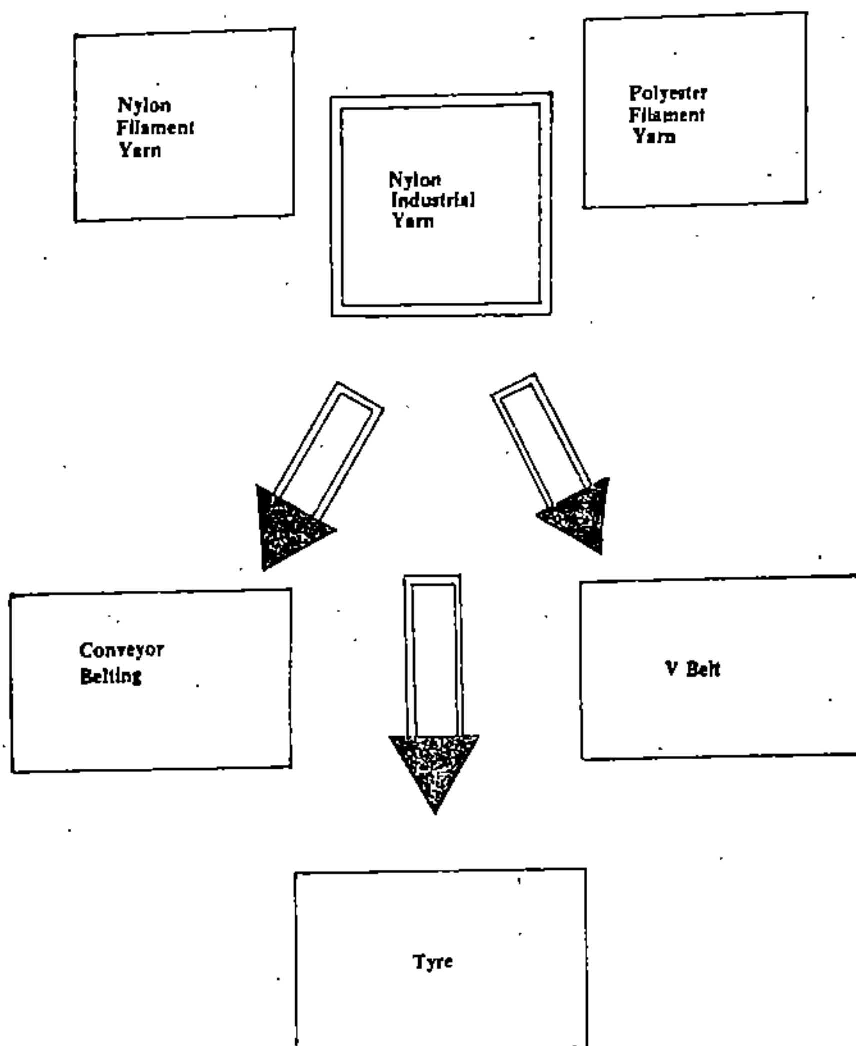


Forward Integration

This involves diversifying the business further down the line towards the final consumer. Forward integration facilitates a more direct control on distribution and logistic channels, thereby eliminating costly inventory build-ups or marketing bottlenecks. This may also be an attractive strategy when the distributors of the products have a high mark-up. As forward integration helps the company to control its distribution channels, it can relatively be assured of satisfying customer needs or wants more completely. After-sales service and warranty administration become easier.

Nirlon Synthetic Fibres & Chemicals Ltd. pioneered the production of industrial nylon yarn and nylon tyre cord in India in 1970. The latter was sold to tyre and belt manufacturers. The high strength nylon acts as reinforcement in these applications. These rubberised goods are processed under very severe conditions of temperature, pressure and chemical environment which have adverse effect on the properties of the synthetic fibres. If the finished goods, tyres or belts, do not perform up to the desired expectations, claims are preferred on the nylon yarn/cord supplier, though the fault could be at the latter stage. To ensure a good quality to the final consumer, Nirlon decided in 1978 to diversify into manufacture of V-belt and conveyor belts. This also ensured a captive consumption of the tyre cord produced by the company which was facing a stiff competition in the market place. To increase the internal control, the company also had plans to diversify into making a wide range of tyres which would ensure further captive consumption of its expanded capacity of tyre cord. Figure 13.5 depicts forward integration of Nirlon Synthetics.

Figure 13.5: Forward Vertical Integration at Nirlon.



Vertical integration, whether forward or backward, should be undertaken with a certain amount of caution. Integration generally increases the investment considerably. This may result into lowering of the return. In backward integration, scarce capital and talent of the company may be tied up in producing a raw material or component which could be bought from the market without much difficulty. Further, capital may not be used productively by an integrated business. This will happen particularly when the requirement for raw materials, components, etc. is not substantial and built-in capacity remains under-utilised. Similarly, the cost of output will also increase if built-in capacity is below the economical level. Permanent commitment in assets may also reduce the firm's flexibility. Similarly, in forward integration the firm may lock up its capital in trucks, warehousing and stocks at the outlets. All these functions can often be carried out rather more efficiently by outside agencies and market channels. In view of the possible adverse impact on profitability, it is essential that firms have a very clear idea of the objectives that they seek to achieve by integration. The firms must have an accurate and realistic view of the industry environment and its own strengths and weaknesses. Only when the firm believes that there are significant economies of scale to be gained by integrating backwards or forwards in the market, that it has resources to achieve this, and that there are no inflexibility costs attached to this strategy that the firm would be advised to follow this path. We shall now take up the concept of synergy which is particularly relevant in the context of related diversification and integration.

13.7 DIVERSIFICATION AND SYNERGY

Synergy or synergistic effect occurs when two or more products are manufactured together rather than separately. The total output may be greater quantitatively and better qualitatively. In ordinary arithmatic 2+2 is equal to 4. However, in organisational arithmatic, 2 units of input + 2 more units of input may give 3, 4 or 5 units of output. Three units of output represent unsuccessful, 4 units break-even, and 5 or more units represent successful organisation. In the last case, the combination of inputs has yielded more than their costs or inputs. More output sometimes may also be accompanied with better output. Thus, combining of resources may also have a quality dimension.

Synergy in general is known as '2 + 2 = 5' concept. To put it in another way, the synergistic effect arises because of joint efforts and shared costs. The synergistic effects can be obtained in many areas of a business. Let us go into what these different synergies are.

Production Synergy

The proposed new products may use similar or some of the already available facilities for production. This may also contribute towards higher capacity utilisation of the installed capital assets, either on a continuous or an alternate cyclic basis. For example, many of the makers of coolers, refrigerators and air-conditioners also get into manufacturing of room heaters, ovens and other products for fully utilising the manufacturing facilities during the different parts of a year. The economies of scale of production, however, vary from operation to operation. For example, in the steel industry, the optimum scale of operation for liquid steel is greater than that for rolling operation for different steel products. It is better to combine one steel making furnace with many finishing mills. Furthermore, as scale of production increases it becomes more viable to process the by-products obtained during the manufacturing process.

Marketing Synergy

Synergy is most significant in sales and distribution when the products are related and sold through the same outlets. For example, tennis balls and rackets can be commonly marketed, thereby saving on advertisement, sales administration and distribution. These different products can also be marketed by a common brand name.

In case of certain companies manufacturing consumer durables, developing a nation-wide marketing network is a must for making their products available to their customers spread far and wide. Maintaining an extensive network for a single product or product line otherwise may not be viable. The existing distribution network may be utilised for a number of different products going to the common customers, such as cigarettes, cold drinks, toiletries or other goods of day-to-day use. Thus, if a company produces one or more of such products, diversifying into other products becomes easier with the marketing synergy that might be existing already.

Sometimes the products even though they are related to each other, may not be sold through

common outlets. For example, washing machines may be sold through the appliance stores, while washing soaps may be sold through local grocery stores.

Financial Synergy

The identi... ation of new products for diversification may also be governed by the requirements of the cash flow and the working capital requirements of the company. For example, in the case of a fan manufacturer, there will be a build up of inventory during the winter months. The management may try to circumvent the continuous crunch on funds outflow by offering higher discounts on their products during the off-season phase. Alternatively, the company may diversify into another business which will keep it running with shorter cycle periods and quicker returns. Many small-time traders with limited financial resources understand and use this approach to keep running throughout the year.

Organisational Synergy

Another form of synergy is generated by the characteristics of the organisation. The organisation can exploit the skills built up over the years by entering into a number of different businesses. For example, a manufacturing organisation can get into trading business or into consultancy sector so that its existing staff and infrastructure may be fully utilised. The Toray Industries Inc., the leading chemical fibre manufacturer of Japan started a separate business centre for research. Toray Research Centre Inc., which utilises 60 per cent of its manhours for carrying out Toray's in-house research and 40 per cent of the resources for doing contract research for outside organisations. With its manpower fully utilised, the company can afford to install latest, most modern and expensive analytical tools available in the world from its own generation of funds.

Synergy of management can be particularly exploited where the current management resources in the organsiation are underdeveloped. But, if the diversification efforts demand too much time and effort, this may hamper the efficiency of even the existing operations. For instance, overseas consulting work is highly favoured by senior managers in some companies, but it takes much of their time away from the major operations, sometimes far too disproportionate to the present or the future returns.

Activity 2

Give three examples of fastest growing Indian companies and discuss how they have grown in terms of the strategy followed by them.

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13.8 DIVERSIFICATION Vs EXPANSION

Before a company diversifies, it is important to pause and consider the possibility of expanding in the existing product line. This would help to gain bigger market share for the present business of the company.

In terms of implementation, expanding the existing activities of the company is generally much easier than starting a new channel of activity as the managers are familiar with existing business. So one must consider diversification vis-a-vis expansion as a result of a clear-cut strategic move since the former entails taking up of relatively lesser known areas. Both the alternatives should be carefully weighed against their likely returns—tangible as well as intangible. As for tangible results, return on investment for the two alternatives should be compared, keeping in view the prevailing fiscal policies, taxation, depreciation, incentives for new investments, etc.

If the existing product is likely to have a steady and significant growth in its market size, and there is large unfulfilled gap between supply and demand, the company should consider further capacity expansion for its existing product(s), unless there are other strategic reasons against sole dependence on the product. Expansion may be more desirable because of experience curve advantages such as familiarity with the technology and equipment required, higher marginal productivity of labour and capital, and the availability of the

existing infrastructure. Often, there are possibilities of gaining additional production capacities by de-bottlenecking the manufacturing processes and adding balancing equipment.

Before implementing expansion, the company should consider the operational details of marketing the enlarged volume. It should review its existing marketing capabilities to take on the additional load. Otherwise, it must plan for augmenting and training its market force in advance i.e. before the product comes off the production line.

While considering expansion, a company must also consider the image that customers carry with regard to its product lines. If the brand image is low, the company should be careful in expanding further and must check whether enough customers exist for its products.

The possibility of the customers using the product more frequently or in higher quantities may also be explored. For example, larger packing of tea or detergent powder can be introduced. Companies sometimes do not exactly duplicate their existing products. They do some minor modifications and either go for the higher contribution segment or introduce more added-value products. They may also aim at a bulk market segment to utilise their higher installed capacity.

13.9 PLANNED DIVERSIFICATION

You may perhaps have realised that there are several options open to management:

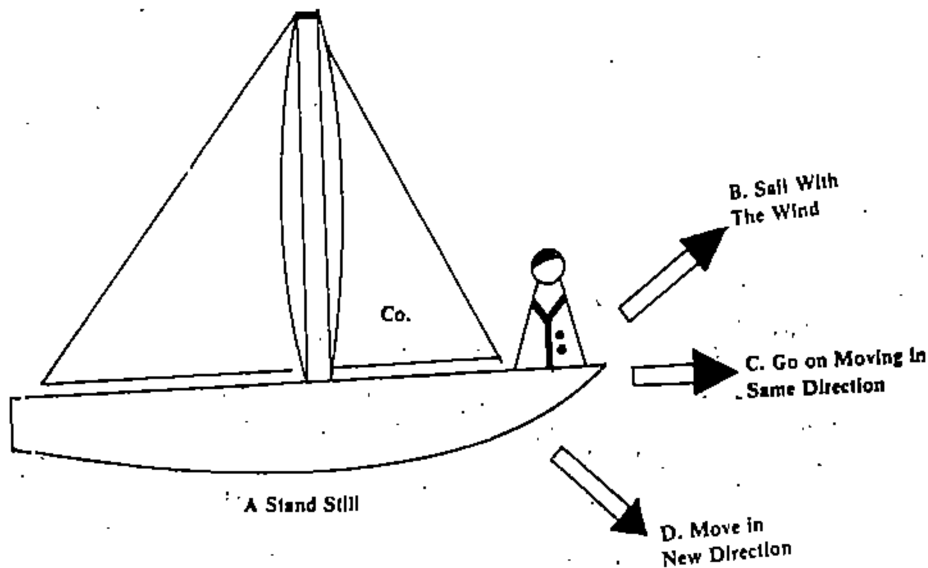
A Do nothing to change the status quo, and hope that the present profits will continue indefinitely.

B Sail with the wind. Here the firm rushes into areas where everyone else is going. If the present trend is to diversify into shipping, then the firm also tries to get into shipping. And if others are entering into electronics, the firm believes that this line must be profitable. So it also diversifies into electronics.

C Go on moving in the same direction. This may be done by expansion (or concentration) strategy.

D Move into new direction in a planned manner. This is the area with which we will be concerned here for elaboration. The options available to management are graphically presented in Figure 13.6.

Figure 13.6: Options Open to Management



Sailing with the winds is a convenient but often an erratic way to diversify. The firm drifts from one area to another just because it wants to do what others are doing. There was perhaps temptation earlier when the government believed in strict regulation of entry. Some firms rushed into new area by grabbing the licences before others could think of doing so.

Some market indicators may drive the potential promotors to rush into the so called highly profitable areas. Many entrepreneures moved into the manufacture (or assembly) of TVs and automobiles in 1982. Computers also had a similar tale. But soon these sectors were heavily crowded and became competitive with large influx of "me-too intrepreneurs," who had no 'distinctive competence' in these areas to survive the hard fought battles in the market place. With liberal licensing policy, the Government issued over 7,500 letters of intent in the first seven years of the 1980s, of which only 31 per cent were converted into industrial licences, 18 per cent expired, and over 50 per cent were kept hanging by the entrepreneurs. Thus, cornering of industrial licences has no longer a charm that it used to be earlier.

In the two wheeler sector heavy battles are pitched, with even the leading brands not yet contributing any profits to the promoters. In the TV sector heavy dealer discounts and other incentives as well as aggressive (and expensive) TV media campaigns have become a must for luring customers. All this cuts deep into the profit margins. These recent examples should convince the top managements in different firms that the days to sail with the winds are over. From now onwards the need is to carefully plan the diversification on the basis of the 'fit' with the firm's other activities so that the strengths are further consolidated.

Planning the Diversification

Diversification into new market with new products and new technologies must be carefully planned. The diversification strategy should follow a step-by-step approach or analysis in order to avoid the unpleasant outcome of failure or less than the expected success. A company must realise that an unplanned diversification can be just as damaging as no diversification over the years. The company must carefully plan in advance for acquiring and effectively utilising the needed resources, management expertise and technical skills.

You are already aware of the example of Nirlon that was given earlier. Massive expansion was undertaken by this company along with indiscriminate diversification. And all this was done without organising the necessary long-term funds. As a result, heavy interest burden was incurred on short-term funds of the company. The finished goods were not moving well into the market, leading to very serious cash flow problems. Eventually, no funds were available for buying raw materials, for paying excise on finished goods, and for paying custom duties for releasing the imported equipment lying in the bonded warehouses of Bombay Port.

Diversification is an Ongoing Process

Systematic diversification is a progressive way of doing business. If an organisation has been static with no new plans for many years, then to expect it to become dynamic overnight and move fast into new areas, just because the external threats demand so, would most likely land the company into disappointment. If a firm wishes to grow at a steady pace, then it must continuously evaluate new areas for diversification. The top management must encourage small and steady incremental efforts towards growth. The steady growth also aspires the professional employees to grow in the company. This develops their long-term loyalty.

Inertia, in physical as well as social systems, is a difficult thing to overcome. It is easier to pull a cart which is already moving than to pull a still cart. The top management must follow a consistent policy for diversification, and not practice on-now, off-now policies. Even when the firm is not in a position to diversify in a big way, it must continuously monitor the competitive environment and track what the other competitors are doing in terms of strategic alternatives.

Define Your Business

One of the first steps in deciding about the future course of the firm's diversification plans is to carefully define the business clearly. This seems simple, but it often requires a thinking beyond the promoter's immediate concern for making quick profits.

Depending on how clearly a firm has defined its business a number of new and logically related activities may emerge as automatic extensions of the present activities. For example, xerox insists that their business is to sell satisfactory copies and not just copying machines. Therefore, developing and manufacturing toner or leasing copying machines became natural extensions of their copier business. Similarly, a manufacturer or vacuum cleaner may define its business as selling cleanliness. Therefore, it may develop, manufacture and market other cleaning aids, from a simple duster cloth to different brooms and carpet washers. Defining the business clearly helps in defining certain natural business choices which can be easily developed and exploited by the firm.

SWOT Analysis

In the context of its business definition, the company should carefully analyse its internal strengths and weaknesses as well as opportunities and threats in the external environment in the form of the extent of competition, market potential, Governmental policies, constraints, etc. The SWOT audit of the present operations and analysis of the effects of the proposed new diversification activities may provide useful clues. A comparison of a firm's own ratings with the ratings of its competitors in the market can also help it to know its position. The identification of such a gap can then be taken as a basis for developing the short-term and long-term strategies.

GAP Analysis

A way of arriving at the new avenues for growth and diversification is to do a GAP Analysis. Here, the company tries to make an honest estimate of where the company *is* at present, and where it would *wish* to be in future. The identification of such a *gap* can then be taken as a basis for developing short-term and long-term strategies for further growth, for consolidating the present portfolio by dropping existing or introducing new products. However, as these strategies may have significant impact on the size and composition of the firm's manpower, especially when it decides to drop come products making any drastic or sudden changes would be almost turbulent compared to making small regular changes. For example, a firm has assets worth Rs. 1,000 million. Considering its reserves and investible resources, it feels that it can be in the club of companies with assets worth Rs. 5,000 million. The gap is Rs. 4,000 million worth of assets. The firm may then start considering carefully two or three projects with assets worth Rs. 500 to Rs. 1,500 million. The projects with this size of investment are medium-sized projects. The company should rule out large projects like petrochemical and mining which generally involve substantial investment as well as small projects like assembling of fans and other electrical appliances. Such an analysis would demarcate the permissible region within which the firm can effectively diversify. From the identified industries, then the market segments are specified, and finally the product(s) to be manufactured are identified based on the availability of technologies, raw materials, extent of competition etc. Such a sequencial screening will be better in the long run than working on some growth prospects in an ad-hoc manner.

Competition & Risk Analysis

Diversification implies risks. Therefore, while expecting reasonable returns, the company should prepare itself to absorb those risks also. Every new activity is associated with some unforeseen risks which may be reduced by planning but cannot perhaps be totally eliminated. The markets may change, competition may increase, or the government policies may become adverse. The top management must be prepared to accept risk, and may set certain tolerence limits for the purpose of planning. Otherwise, managers may put up rosy plans which may be fictitious and result in heavy cost and time overruns. Incurring of excessive risk is also not advisable, as it may jeopardise even the survival of the organisation.

In the interest of meaningful and stable diversification, a frank, open and two-way dialogue between the top management and the executive managers is a must. One-way orders will not produce results though it might appear that a lot is being done.

How a well known company in the private corporate sector, Shri Ram Fibres Ltd., went about its diversification plan is narrated in the Appendix.

13.10 CORPORATE DIVERSIFICATION ACTIVITY IN INDIA

Diversification for corporate growth has been actively pursued by many Indian companies and business houses in recent times. We hear about new products practically every day. We have had waves of diversifications into new product categories by all kinds of business units. In the early 80s it was mini computers, in close succession came televisions, light commercial vehicles, personal computers, EPABX systems and extruded food products. Starting now and in the next few years, we are going to have processed foods, washing machines, high fashion garments, cement plants, etc. What are the various reasons for prompting many Indian companies to undertake diversification in new areas? There are several national and international factors which have created an environment which encourages diversification. Some of the major dimensions of this new environment are as follows:

- a partial de-regulation of Indian economy by way of relaxation in policies, rules and procedures.
- willingness on the part of Indian entrepreneurs to think big and grow big. A somewhat easy availability of technological and managerial manpower in the country has helped in the growth of Indian corporate sector.
- an unorthodox and somewhat higher risk bearing attitude adopted by institutions dealing in finance. Consortium banking and large scale borrowings from European money markets have helped many Indian private and public sector companies.
- middle class confidence in equity market has helped to overcome the lack of venture capital. The Reliance Petro-chemicals Ltd. issue crossed the '1000 crore' rupee mark for the first time in the history of share markets in India.
- Shrinking demand for many consumer durables abroad has stimulated the interest of foreign companies in India. Many large and medium sized foreign companies are willing to collaborate with local manufacturers for starting joint ventures in India. The 'NRI' scheme is another conduit for flow of technology and finance in India.
- a massive expansion in the market size. Today we can boast of a middle class market of about 100 million people. They constantly aspire to improve their standard of living.

We thus find that it is the combination of several factors which has resulted into a large number of Indian companies undertaking diversification as a method of growth in recent times. The following guidelines should be helpful for successful diversification (Source : 'Diversifying into Disasters', *Business World*, September 28, 1988).

- If you are not big enough, do not try it.
- If you lack staying power, stay clear of grandiose diversifications.
- Look before you leap.
- If possible, be the first.
- Where feasible, float a separate company.
- Check whether you have the marketing skills necessary in the new business.
- Be ready to accept your limitations and compromise.
- If you are a small player, it is better to have a small ego.
- Tax saving alone is not a good enough reason to diversify.
- Ultimately, it is no crime to remain undiversified.

The above ten commandments of diversifications, though they might be based on limited experience, appear to be of great relevance for corporate strategists who might be thinking of treading on the path of diversification.

Activity 3

Study the products/activity of various companies in TVS group. This group is amongst the most successful business groups and concentrates most of its activities in South India. Upto 1985, the group depended on 12 of its major companies for corporate growth. These companies and their major products/activities are listed in Tables 13.1.

Table 13.1 : TVS Group

	Companies	Major Products/activities
1	T.V. Sundaram Iyenger & Sons	Sales and service of autos and auto parts
2	Sundaram Industries Limited	Manufacturing & sales of auto parts and other services
3	Southern Roadways Ltd.	Passenger & Goods Transport Fleet
4	Sundaram Fastners Ltd.	Fastners for various industrial uses
5	Sundaram Abex Ltd.	Brake linings and clutch facings
6	Wheels India	Wheel structure & parts
7	Brakes India	Foundation brakes & other components.
8	Sundaram Finance	Hire purchase
9	Sundaram Clayton Ltd.	Actuation systems for brakes in commercial vehicles
10	Ind Suzuki Limited	Motor Cycles
11	Lucas TVS	Automobile Electrical Parts
12	Srichakra Tyres Ltd.	Tyres and Tubes

Make 5 observations on this Group's diversification strategy

1) ....

2) ....

3) ....

4) ....

5) ....

During the mid 80s, the TVS groups has also diversified into electronics. From various information sources, such as journals and magazines and also the branch office of the company at your place, find the details of the TVS's new area of diversification.

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13.11 SUMMARY

Diversification is an important strategic alternative to growth. It results in new products being added to the existing ones. Diversification may be in related or unrelated areas. Related diversification may be either constrained or linked. A firm needs to be particularly careful before taking a decision in favour of integration or unrelated diversification. While unrelated diversification aims to reduce over all risks of the total organisation and thus ensures long term stability and growth, it often puts considerable strain, at times unbearable, on the existing managerial and technical resources. Several of the synergies which normally are available for related diversification and integration alternatives, not likely to arise in the case of unrelated diversification.

In many cases it may be more desirable to expand in the existing product lines rather than taking up new ones. In any case diversification activity must be properly planned and systematically executed.

Over the last decade or so, diversification activity in India has been witnessed on a resounding scale. Unfortunately, however, several of the enterprises have met with disaster. The reasons range from lack of planning to a sense of euphoria. Hence, the need for adequate planning and for a balanced view cannot be over emphasised.

13.12 KEY CONCEPTS/TERMS

Backward Integration
Constrained Diversification
Diversification
Forward Integration
Gap Analysis
Linked Diversification
Related Diversification
Synergy
- Production Synergy
- Marketing Synergy
- Financial Synergy
- Management Synergy

Unrelated Diversification
Vertical Integration

13.13 SELF-ASSESSMENT QUESTIONS

1 What do you understand by diversification? What motivates a company to diversify?

2 Distinguish between forward and backward vertical integration.

3 What are the advantages and disadvantages of various diversification strategies?

4 Explain why unrelated diversification is often said to be riskier than related diversification.

5 What advice would you like to give to a small business owner who is planning to diversify his business?

6 What are the major areas of synergy in (a) vertical integration decision, and (b) related diversification? Is it possible to develop any synergistic effects in case of unrelated diversification? If yes, how?

7 Under what conditions or circumstances an entrepreneur should prefer diversification over expansion and why?

8 "Various types of synergies may prompt a businessman to diversify." Examine these various synergies, giving suitable examples.

9 What step as an entrepreneur would you like to take before actually embarking upon diversification scheme? Discuss the importance of planned diversification in today's business.

10 Critically examine the corporate diversification activity in India. What suggestions you would like to make so that diversification activity in India proceeds on a sound basis?

13.14 FURTHER READINGS

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APPENDIX

Shri Ram Fibres : Diversifying into the Unknown*

Let us consider how companies diversify by sequencially following the development of a specific growth concept at Shri Ram Fibres. The company, since its commissioning in 1975, was heavily dependent on nylon tyre cord business, and in 1983 decides to get into automotive electricals. The project was set up as a separate subsidiary by the name of SRF-Nippondenso.

Shri Ram Fibres (SRF), after some teething troubles in the earlier years of its operations, was adjudged as a Mini Giant in 1983. The production capacity had been increased from about 1,000 tonnes in 1974 to 5,000 tonnes in 1983. In the first few years the company stocked high percentage of its production from 1979 onwards, however, the inventory levels were stabilised at about 10% of production. The profitability (net profit margin over sales) increased from 1.8% in 1978 to over 15% between 1980 to 1982. The profit before tax (PBT) also successively increased, from Rs. 2.5 million in 1978 to a peak of Rs. 67 million in 1982. From 1980 onwards, the company had funds available of the order of Rs. 50 million. Thus in 1983, the company was poised for high growth with high availability of funds and a managerial philosophy supporting growth.

* This case was prepared in 1986.

Internal Growth
SRF has fully exploited its internal growth potential, and emerged as a market leader in the nylon tyre cord business. In 1985 SRF gained 26% market share, with the maximum production capacity of 6,335 tonnes per annum in this sector.

SRF had started with a licenced capacity of 2,000 tonnes but produced much less in 1975 when the plant was commissioned. The First Oil Shock had created a severe recession and uncertainity in the auto industry. Till 1977 the production hovered around 1,000 tonnes level. In 1978 the sales position improved and the production was increased to over 2,150 tonnes, with the maiden profit of Rs. 2.5 million. With the recovery in the automotive industry, the company wiped off its accumulated losses in 1980, and 15% dividend was announced. Annual licenced capacity was increased to 5,000 tonnes per year in 1981, and to 6,335 tonnes endorsed in 1982, with 25% overrated capacity.

In view of its leading position in tyre cord business, SRF at one stage contemplated acquiring a supremacy by installing the production capacity of about 12,000 tonnes per year. However, this idea was later abandoned and a lower target of maximum capacity of 10,000 tonnes per year was adopted. The reasons behind this were :

- Higher cost of inputs.
- Growing competition from domestic producers as well as imports.
- Lower profit margins in recent years.
- Lower price realisation, due to control by a strong Tyre Manufacturers' Association.
- Depressed automobile and tyre industries due to power shortages, labour troubles, and slow pace of road construction.'

As a result of these factors, SRF management decided to dilute its total dependence on tyre cord business to about 50% with the other 50% contribution coming from non-tyre business. Thus decision to diversify into unrelated markets evolved in a logical manner.

Related Diversification
From nylon tyre cord, SRF first diversified into three related areas :

- Nylon fishnet twine
- Nylon industrial fabric
- Nylon moulding powder

In the case of fishnet twine, the nylon industrial yarn is twisted in different plies, to develop different grades of twines required in the fishnet and rope making. On the other hand, in the case of the industrial fabrics, the industrial nylon yarn is woven and if necessary rubberised or given other surface treatments. Average realisation on fabric is more than for industrial yarn/tyre cord (Rs. 94 versus Rs. 89 for nylon industrial yarn/tyre cord).

With the familiarity of processing of nylon polymer for tyre cord manufacture, SRF also diversified into nylon moulding powder. In 1980 an industrial licence for producing 500 tonnes per year was obtained. In 1986 the company produced 536 tonnes of nylon moulding powder, worth Rs. 31 million. This accounted for 4.6% out of a sales turnover of Rs. 665 million. This share was 3.3% in 1985. Average realisation from nylon moulding powder in 1986 was Rs. 58 per kg, which is expected to give a higher margin than for tyre cord (Average cost of caprolactam is Rs. 37.50 per kg).

Unrelated Diversification into Auto Electricals
Years ago, SRF realised that its fortunes were tied to one industry (in synthetic fibre), one product (nylon filament yarn) and one product segment (tyre yarn) catering to only one set of customers (the tyre manufacturers). This excessive dependence on a very narrow section of economy was further weakened by a very strongly knit Tyre Manufacturers' Association offering hard negotiated prices. Besides, some of the members of this Association had sister companies also supplying the tyrecord (such as J R Synthetics supplying to JK Tyres).

Thus the management decided to diversify into other unallied areas. However, being in the business of 'industrial intermediate product', SRF was familiar with only industrial marketing. On the other hand, SRF lacked the extensive distribution network required to reach national markets for the consumer products. The company was already supplying to the auto ancilliaries—the tyre makers. Thus the ideas of auto electricals matched well with its existing operations.

The concept of getting into auto electricals emerged in 1981. To an extent it was linked with the involvement of the parent company, DCM Ltd, with the manufacture of light

commercial vehicles (LCV) in collaboration with Toyota Motor Company of Japan. In the same year, Mr. Som Mittal, an engineer-MBA, who was earlier working with Escorts - Yamaha project, was recruited as Deputy Manager Project Planning. He brought the auto-engineering related experience to otherwise a strictly chemical company. The company thus obtained a letter of intent for auto ancilliaries.

Auto Boom

With the inception of Maruti in 1982, the government seemed determined to revolutionise the auto industry of India. The policies were announced to encourage state-of-art and fuel efficient vehicles in the country. This would require much more modern and sophisticated components than were being already produced. Thus, with the promise of the auto boom and linkages with the parent company, auto electricals seemed to be a promising new field to get into.

Selection Procedure

Initially the broad area of auto ancilliary was specified. However, after detailed discussions with DCM-Toyota, SRF identified auto electricals, brake and clutches, tie-rod, crankshaft etc. Applications for getting Letters of Intent for all these were made in July 1982. The company had decided to avoid a new business sector with dominating business competitors. Furthermore, the management decided to have a tie up with the best collaborator only. It was also wished that the spotted collaborator should also preferably have a wide range of products and technologies so that a long term relationship could be cultivated.

Two Japanese collaborators—Nippondenso and Issenseki were identified, and the Managing Director visited Japan to formally request them for collaboration. In view of the collaborator's limited knowledge about India, a detailed dosier was presented to them on economic and business environment in India, and the prevailing government policies. An invitation was extended to the collaborators to visit India. The initial contact with Nippondenso was facilitated by the fact that this company belonged to the Toyota group of Japan, with which DCM had already signed an agreement.

But the collaborator was already laden with a series of enquiries from other companies in India. Some of these other enquirers had advantage over SRF in that they were already in the field of auto ancilliaries, whereas SRF had no relevant past experience in the engineering field. The collaborator kept its options open and visited India for a survey of all the candidates. SRF managed to score over others because of the concern and the sensitivity it showed towards the collaborator and the Japanese way of doing business.

Resource Committment

SRF committs extensive resources for any diversification project only after a 3 step evaluation of the possible candidates, as given complete autonomy for day-to-day affairs.

On 22 November 1984 SRF-Nippondenso was incorporated with an industrial licence to manufacture :

1	Alternators/Generators with or without vacuum pump, complete with Regulators.	1,50,000 Nos/year
2	Starter Motors	1,50,000 Nos/year
3	Wiper Motors	1,00,000 Nos/year

Adopting Collaborator's Management Style

SRF also decided to whole-heartedly adopt the Japaness Management practices in terms of running their operations :

- There is low power-distance between the manager and the worker. A common uniform is used by all the employees alongwith sharing the same canteen, with frequent social gatherings organised.
- Low ratio of indirect to direct workers. Very few supporting staff members are employed compared to the direct production related workforce.
- Flexible training was imparted to all the employees, so that they can be used for a number of tasks.

Expected Difficulties

SRF had realised well in advance that they were entering a new field. It was therefore decided that the company must have very reliable vendors. An extensive 3 months long nationwide survey was carried out before deciding on the vendors.

Unforeseen Difficulties

At the planning stage, SRF had anticipated very good profitability and growth for the project. But the project ran into certain unforeseen difficulties.

Auto Industry : From Boom to Bust

When the project was conceived, the auto industry in general and the LCVs in particular were poised for boom. Soon after, however, this industrial sector started facing a chronic depression. Thus, the proposed production schedules had to be curtailed. The project commissioned in February 1986, was expected to break-even in about a year's time, but it was likely to do so much later.

High Yen Shock

At the time of conceiving the project, the fluctuations in exchange rates were not given much importance. But, the yen has appreciated over the first 2-3 years of operation from 22 yen to a Rupee to under 10 yen to a Rupee. This has put a critical burden on the finances of the company as well as the price of their products. Furthermore, as the DCM-Toyota project is also pegged to yen, the heavy appreciation of the Japanese currency has pushed the prices of LCV up, resulting in severe constraints on the demand and production of LCV.

Government Pressure

SRF-Nippondenso is also under constraint from the government insistence on over 90% indigenisation in less than 5 years. With low volumes of production, development of indigenous processing capacity for the necessary components has become a tough task.

On the positive side SRF is fortunate in getting *good support* from Nippondenso who have gone to the extent of giving some discounts on the imported components.

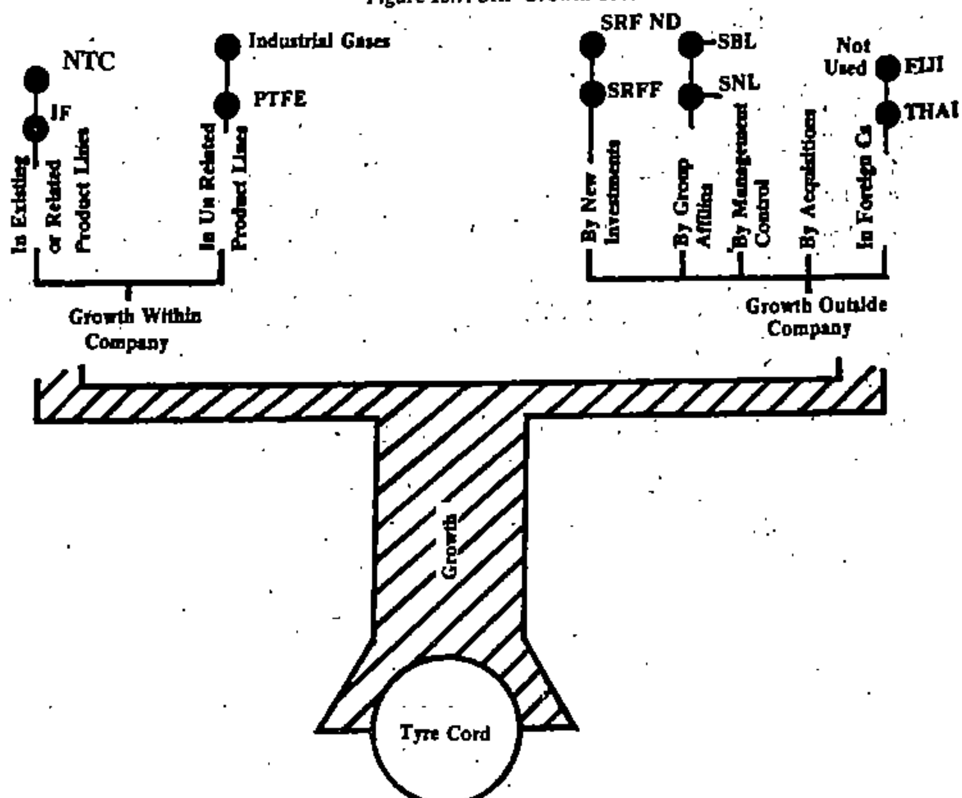
Future Prospects

Whereas the present status of the project is not very encouraging, SRF is hopeful that a recovery will take place in the automotive sector soon. Company is trying very hard to diversify its customer base beyond DCM-Toyota, to Maruti and the other LCV makers with the Japanese know-how. The company also hopes to introduce new products so that the manufacturing facilities can be utilised more effectively. Unfortunately, the company has no synergy with its tyre cord operations.

In the long run, SRF hopes to build further growth activity around this core foundation laid in the automobile ancilliary sector.

How SRF has grown internally and externally is depicted Figure 13.7.

Figure 13.7: SRF Growth Tree



UNIT 14 MERGERS AND ACQUISITIONS

Objectives

The objectives of this unit are:

- to define the strategic alternation of merger and acquisition.
- to enable you appreciate why companies grow through mergers and/or acquisitions.
- to suggest an analytical approach for taking merger or acquisition decision.
- to share the Indian experience with regard to business take-overs.

Structure

14.1 Introduction
14.2 Historical Perspective
14.3 Definitions
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14.1 INTRODUCTION

As discussed in Unit 12, mergers and acquisitions provide a short-cut to corporate growth. The last two decades have witnessed a large number of cases of corporate mergers. What are the motivation behind such mergers? What challenges are faced by managements in managing acquired business? How to select potential corporate candidates for mergers or acquisitions are amongst the issues we propose to discuss in the unit.

14.2 HISTORICAL PERSPECTIVE

Sometime back newspaper and magazine headlines highlighted the tussle for take over of two corporate giants, D.C.M. and Escorts by an investor (Mr. Swraj Paul), a non-resident Indian. The investor got interested because he saw that the promoters of these big companies owned only a small fraction of equity, but had control of the entire operations. So the investor quietly picked up some shares from the market and some even from the members of the promoter's family, and then demanded that these be transferred to him along with the enterprise's control. The intentions about take-over were understood by the promoter managements and they foiled these attempts by resisting his entry into the boardrooms and the court-rooms. The issue of transfer of acquired-shares was finally settled amicably without the take-overs, but the incident set in motion certain groundwork for rationalising the guidelines for mergers and acquisitions.

On the other hand, a local investor, R.P. Goenka has been known as the 'Take-over King' of the Indian business since 1979. Goenka has been very successful in his strategy of growth through acquisition, and almost all the companies taken over under his control are today running extremely profitably. These include Ceat, Kamani Engineering, Searle and Dunlop. He has also acquired some stakes in Bayer with Manu Chhabaria. The only company still making huge losses is Gramophone company, presumably because of the recording piracy in the unorganised sector. Goenka built up his independent industrial empire with lot of investable cash he inherited after the family division in 1979. Goenka got into the take-over act early, and he got the pick of the companies at cheap prices.

Companies can grow in a number of ways. Some companies grow internally by their gradual expansion of capacity and markets, or by setting up new plants to manufacture and launching new products into the markets. On the other hand, companies which are keen to have a larger and more diversified portfolio can also do so by looking at their growth options outside the company. They agglomerate and grow by acquisitions and mergers.

Many of the large multinational companies of the United States of America and the United Kingdom have grown like this. But, if one follows this trend, interestingly, the mergers and acquisitions have changed their focus and flavour with time depending on the changing conditions of the external environment. As India does not have a very old tradition of mergers and acquisitions, one can learn a few lessons from the way events have developed elsewhere over the decades.

Some major mergers and acquisitions took place in the U.S.A., with the onset of the twentieth century. Companies such as the United Steel and American Can came into being in 1901, International Harvestor in 1902, and Du Pont in 1903. These amalgamations came into being through a holding company device (through exchange of securities between participating companies) or by acquisition of majority assets by one company. They resulted in the establishment of large single firms with the advantage of large-scale purchasing, more controlled distribution, and significant influence on costs of supplies and selling price of finished goods. This wave of mergers ended in 1904 when Sherman Act was enacted.

Thereafter there was a lull, as three successive Presidents, Teddy Roosevelt, Taft and Wilson, opposed corporate mergers. In 1914, Clayton Act made it illegal to acquire the stocks of another company, if it would reduce competition.

But the subsequent Presidents, Harding and Coolidge, interpreted the antitrust laws lightly, and with the postwar prosperity, after the World War I, a second wave of mergers was set in around the late 1920s. Typical in the wave was vertical integration (or expansion) through which a manufacturer acquires a supplier's and/or distributor's businesses.

Thus, allied Chemicals, Bethelhelm Steel, General Foods and Borden Company emerged. This trend of corporate expansions practically ended the depression of '30s.

The next phase of growth by mergers and acquisitions developed after World War II. These agglomerations were typically after product or market extensions. 'The war economy generated enormous needs and with the victory of the Allied Forces, the U.S.A. emerged as the supreme democratic economic power. The American goods and the services were thus sought throughout the world, and the U.S. businesses had to go global. Some companies had to grow so much faster that they could not have possibly achieved this on their own, by internal expansions. So they either merged with others to have better control on supplies and sales, or acquired smaller companies to gain economies of scale.

Thus, merger and acquisitions have developed differently at different stages of time, to meet the requirements posed by the changing economic trends. The strategy of mergers and acquisitions promises some quick benefits, but if it is not implemented properly, it can create some problems as well. We shall now discuss such issues associated with mergers and acquisitions.

14.3 DEFINITIONS

When different companies combine together into new corporate organisations, with the objective of wealth maximisation, such a process is known with varying names such as mergers, acquisitions, take-overs, amalgamations etc. Many of these terms are used interchangeably, but they are different in details. The common underlying philosophy is that two companies can make more money together than when run separately. In other words, 2 + 2 becomes 5. The additional benefit or competitive advantage generated should in principle benefit all the shareholders and the employees of the combined corporation.

Merger

Strictly speaking, merger takes place when two or more companies roughly of equal size or strength, formally submerge their corporate identities into a single one in a friendly atmosphere. Under such circumstances, a holding company may be formed, and its shares are exchanged for the shares held by the share-holders of the merging companies.

Acquisition or Take-over

Take-over or acquisition takes place when a company offers cash or securities in exchange for the majority shares of another company. Generally, this happens when a merger is not agreed upon by the two participating companies. In fact, if one scans through the history of the corporate world on such combination efforts, disagreements and differences came to the fore. Both the parties involved in a deal view their situations differently, and there is a tussle for supremacy. Perhaps then an open war is declared, and the stronger party uses its market and money force, whereas the weaker company would try to win the media support, government intervention or public sympathy.

The more severe the battle, higher it pushes the price of the target company, and the acquirer must get ready for paying high premium. The typical premium may run upto over 100 per cent above the market price. A frequent allegation is that the managers of the target company overstate their profits, or that they try to sabotage once they have lost the battle to avoid the take-over, or enact 'golden parachuts' for themselves or devise poison pills to create digestive problems for acquirers.

Activity 1

Give five examples of mergers and acquisitions in India, explaining the motives that you think were behind such moves.

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14.4 MERGER MOTIVATIONS

As stated earlier, the mergers and acquisitions take place with a number of motivations culminating in a 2 + 2 = 5 relationship. Some of the perceived benefits of mergers and acquisitions are described below.

Improving Economies of Scale

One of the most frequent reasons given for mergers and acquisitions is to improve the economies of scale. Let us say there are three companies X, Y and Z, producing cold drinks and competing in a market. The total market demand is 5,000 units, and the market shares of the three competitors are: 3,000 units for X (60%), 1,800 units for Y (24%) and 800 units for Z (16%).

With this distribution, X is already a market leader with dominant market share. Furthermore, due to the Experience Curve Effect, the unit cost of production for X would be the lowest, and it would be the highest for Z. Thus with a 80% Experience Curve, if the unit cost for Z is 100, then it would be 90 for Y, and about 66 for X. Thus, due to economies of scale, X Co. has a significant cost advantage, and with this leverage it may offer lower price in the market to make the survival of the other competitors difficult, or alternatively, it may derive large margins and surplus profits, for further growth and diversification. The markets often change in a dynamic manner. For example, it may be estimated that over the next two years, there will be a 25% growth in the market demand. Now, let us assume that there is a technological break-through, so that a new process plant has been developed and is available with a minimum capacity of 500 units. It would reduce the unit cost of producing cold-drinks by 15 per cent. Assuming further that the market shares are maintained by all the competitors, their respective shares would be 3,750 units for X Co., 1,500 units for Y Co., and 100 unit for Z Co.

The additional demand for X is 750 units over the next two years, so they can go for the new technology process and set up a new plant with upgraded know-how reducing their unit cost further. On the other hand, Y company has an additional demand of 300 units, and Z has 200 units more. These are not sufficient for Y or Z to set up new plants with more efficient know-how. So they must continue to produce these additional requirements with the older technology at higher unit cost. Their competitive gap from the market leader would further increase. If Y and Z want to make use of the latest developments in technology they have to resort to installing excess capacity, which may not be always viable to do.

Another option for Y and Z to survive the market competition is to join hands together and merge, so that their total additional market share is sufficient to permit them to set up a new plant with the latest technology. Economics of scale are generally associated with the manufacturing operations, so that the ratio of output to input improves with volume of operations. This gives the company a competitive advantage by gaining an ability to reduce the price to increase market share, or earn higher profits while maintaining a price.

Gaining Managerial Expertise

Sometimes acquisition route is followed because of the unique managerial expertise available with the target company, which when acquired will also help to improve the profitability of the acquirer. This expertise may be embodied in the team of managers and staff, as well as the systems in operation in the target company. In order to ensure managerial effectiveness, a friendly atmosphere of a merger is created.

A short-cut to acquisition of managerial expertise is to lure and hire the key managers only, but this will have some obvious limitations because the atmosphere and the systems in operation would be difficult for them to be fully effective as before.

Market Supremacy

Some of the mergers and acquisitions take place with a view to seek additional power in the market. With the additional combined market share, the company can afford to control the price in a better manner. This will hopefully lead to a better profitability. With Ceat and Dunlop, Goenka has a control on over 40 per cent market share of automotive tyres in India.

We must be aware that in most of the societies, formation of monopolies is restricted by state policies because it reduces competition. As a result long delays may take place on account of regulatory bodies of the Government screening the intentions behind market dominance.

Acquiring a New Product or Brand Name

A company, for strategic reasons, may wish to produce or market a particular product, but may not have the required production, marketing or managerial facilities for completing a product line or for meeting all the needs of a customer segment. Getting the required know-how from other sources installing and commissioning a plant and then launching the new product may take much time and result in loss of advantages for getting into the associated business. Instead, acquisition of the ready-made facilities would provide a quicker entry for encashing the comparative advantage of the new product before the new entrants make the market much more competitive, and much less profitable.

While doing so, the acquirer can give its established brand name to the little known new product or a small company so that a much higher price can be obtained from the market. In the absence of this the little known new product with no brand image has to be introduced at low price to facilitate customers change their consumption preference.

Similarly, if the acquirer has a new product, but no reputed brand image in a particular market segment, then it may seek a company which is the market leader in the desired segment.

Diversifying the Portfolio

Another popular reason for companies to merge or acquire is to diversify their dependence on a number of segments of the economy. All businesses go through cycles and if the fortunes of a company are linked to only one or a few products then in the decline stage of their product life cycles, the company would find it difficult to sustain itself. The company therefore looks for either related or unrelated diversifications, and may decide to do so not internally by setting up new projects, but externally by merging or acquiring companies with desired product profile. Such diversification helps to widen the growth opportunities for the company and smoothen the ups and downs of their life cycles.

Reducing the Risk and Borrowing Costs

Due to diversification of portfolio, the risk of the combined operations and the earnings resulting from the same reduces. This is particularly so if the earnings from different businesses are not correlated. In other words, when one segment is running deficit, the other segment is likely to be surplus or vice versa with a 'co-insurance effect'. Due to this inbuilt safety, the costs associated with the borrowings would reduce.

Sometimes, the companies merge or acquire to utilise unused debt capacity of another company, especially if they have already borrowed in excess, and need to borrow more.

However, this need may not justify the payment of excessive premiums generally involved in mergers and acquisitions.

Taxation or Investment Incentives

A company which has incurred losses in the past can carry such losses forward and offset them against future taxable profits and reduce tax liabilities. Such a company when merged with a company with large taxable profits, would help to absorb the tax liability of the latter.

A similar advantage exists when a company is modernising or investing heavily in plant and machinery which entitles it to substantial investment incentives, but has not much taxable profits to offset them with. Acquiring or merging such a company with a highly profitable company would help make full use of the investment incentives for the latter.

14.5 WHY COMPANIES MERGE OR ACQUIRE: SURVEY FINDINGS

In 1955, a U.S. Federal Trade Commission conducted a survey to find out why companies chose the merger and acquisition route. The report listed seven major benefits of acquisition for the acquiring company:

1. Gaining additional capacity to supply to a market already being serviced by the acquirer,
2. Gaining extended product lines,
3. Achieving diversification of product base,
4. Gaining facilities to produce goods purchased earlier,
5. Gaining facilities to process or distribute goods sold earlier,
6. Gaining access to additional markets,
7. Other advantages such as empty plants, control of patents etc.

In 1974, the Organization For Economic Cooperation and Development (OECD) published a Report of their committee of Experts on Restrictive Business Practices, on 'Mergers and Competition Policy'. The Report listed twelve motives most often cited for mergers, which may be grouped together under the following categories.

	Category		Motive
A	Economies of Scale Related Reasons.	1	Obtain Real Economies of Scale
		2	Acquire Capacity at Reduced Prices,
B	Market share Reasons	3	Increase market power,
		4	Expand production without price reduction
		5	Build an empire
		6	Rationalise production,
C	Financial Synergy Related Reasons	7	Obtain Tax advantages,
		8	Obtain monetary economies of scale,
		9	Use complementary resources,
		10	Gain promotional profits.
D	Diversification of Risk Related Reasons	11	Spread risks by diversification.
		12	Avoid firm's failure.

In 1970 another study of 38 merger moves, the senior managers stated that they initiated these actions so as to retain or increase market shares of their companies because the existing business environment was deteriorating, or because the company had excess cash, or surplus/short capacity.

Many a time, the mergers also occur because a middle man brings a proposal or the targeted company offers itself for merger because of rising competition.

Fear of increasing uncertainty of environment, and the technological, product or managerial obsolescence lie at the back of the minds of the managers propogating merger activity. They

like to reduce or harmonise this uncertainty level by a wider and more diversified product range, more market penetration or bigger size of the company. Companies wish to grow fast so that they are not destroyed by other more powerful firms, and mergers offer them the fastest route to safety.

A previous successful merger by the company also paves way for further mergers by the same management in the near future. On the other hand, earlier indigestion of the acquired units leads to corporate hesitancy and reluctance for further mergers

Activity 2

The reasons behind mergers and acquisitions have been discussed in the above section. Which mergers and acquisitions benefit corporations? They may create problems from the societal point of view. What these problems are likely to be? List them.

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14.6 SCREENING PROCESS

Having understood why companies merge or acquire, we must grasp how they go about it. Once the top management has decided to pursue the route of mergers and acquisitions, the operational managers have to get into action on the look out for suitable candidates.

The process of screening and selecting candidates for mergers and acquisitions should proceed in a systematic manner—from general to the more specific.

The process starts by identifying the general domains of potential industries to the specific selection of candidates to be evaluated and approached for merger or acquisition. From a wider range of potential candidates, successively lesser number of candidates are selected. The process of screening as follows:

Identify Industries

First a set of industries are selected which meet the strategic conditions outlined by the company for merger and acquisition. This may be in terms of size. For instance, a company wanting to acquire a medium scale investment, will leave out the large investment industries such as petrochemical complex, basic electronics/computer business or shipbuilding etc.

Similarly, if the company has its future tied to one industry, it might like to spread its risks by looking at other industries for merger or acquisition. If it is already a diversified company, then it may look at all the possible industries, in certain sectors.

Select Sectors

In this step, a broad group of acceptable sectors are identified. For each of these sectors, data with respect to the sales turnover and growth, return on investment (or sales), market shares, competition and asset turnover etc. is collected for the various participating companies. On the basis of this comparison, the more desirable sectors are chosen.

Choose Companies

Generally the size of companies is characterised by sales turnover and the asset level, which in turn determines the cost level of acquisition. Size of the company is also important because it is invariably quite difficult to acquire companies which are bigger in size than the bidder. Similarly, for the mergers, comparable sizes favourable chances for success. A common rule of thumb followed for acquisition is to consider companies which are 5 to 10 per cent in size of the bidding companies.

Potential companies are also carefully looked at with respect to the competitive environment in which they operate. Specific attention is paid to the competitive strengths of these companies in their sectoral environment. At this stage, the acquiring company also starts considering what new strategic they would pursue to make the acquired company stronger in

their market segments. The acquiring management considers whether it will be possible to make these acquired companies improve their competitive position or is it that their competition is over-powering.

Cost of Acquisition and Returns: Compare Candidates
In this step the financial obligations associated with merger and acquisition are considered, and the potential candidates are reduced further on the basis of their likely return. All the potential candidates are listed and compared with respect to their return on investments for acquisitions. The future expected returns are also developed on the basis of different market scenarios. The risks and uncertainties are incorporated to determine the possible variations in returns. Finally, the various possible candidates are ranked on the basis of their position against each of the identified objectives.

Ranking of Candidates
The ranking has to be done according to common screening criteria identified by the corporate management and related to all the potential candidates. In general, the acquisition or merger should result in returns far in excess of the cost of acquisition. The returns however can also be in the form of access to an additional market segment, ability to maintain a leadership position, distribution of risks across more sectors of economy, development of a new core base over which ventures for further growth can be developed, etc. The company must identify its **Concept of Fit**, and should take into account not only the cost of acquiring, but also the costs of integrating the acquired unit with itself and improving its performance further. Various desirable parameters are weighed to develop a composite index for ranking of the potential candidates.

Identifying Good Candidates
In general, the acquirer is seeking to acquire a company which will increase the overall economic value of the company. To achieve this, some managers seek companies which have :

- High Market share,
- Growing Market,
- Large Sales Volume,
- Good Management Systems,
- Diversified portfolio or its potential,
- A Return on Investment above a bench mark specified for acquisition.

But, following such an approach has a catch. A company with such desirable features may not be available for sale, and if it is available, then every other company in the market may like to bid for it. As a result, the price of such acquisition may rise sky high.

Thus, the strong and perpetual players of the take-over game believe that the acquisition of companies is very similar to buying of shares/stocks in the market. To strike a good deal and make money, one has to look for the inefficiencies and oddities in the take-over trade. With growing interest in mergers and acquisitions, there are more and more companies taking part in this game. And, due to the enormity of deals and large movements of cash, the media picks up the news related to take-overs with added interest. There are now many specialists truly doling out advice on take-overs across the different parts of the globe. Thus there are agents in New York who specialise in following the developments in the chemical firms of Japan, with the sole object of identifying potential take-overs only. Because of these circumstances associated with the trade of take-overs, companies keen on acquiring another company generally have to pay excessive premiums, much beyond the calculated financial value of a company.

The practical guidelines for acquisitions are changing. The focus is on seeking those odd gaps in the overall industrial system, which would provide synergic advantages due to the unique "fit" of the acquisition with the acquirer. For instance, a company must sell its division or the entire existing operations to finance a pending liability, or a more profitable venture in the offing. Or say, one can judge that a particular sector or industry is temporarily going through its low in the business cycle, but is likely to recover in the future. This could be because of secret or selective information available about the forthcoming developments in technology, product or channel of distribution. Thus, the market value for such a company would be low, whereas the bidder may be able to foresee a much higher potential value in the acquisition.

Types of Candidates
Candidates for acquisition can be classified on the basis of how much of the target company can be or will be acquired, and how much of it will be retained.

In principle, a company may acquire the whole or a part of a company, and may retain the whole of acquisition, part of it, or none of it. If the company acquires and retains the whole of it, the acquired company must be carefully re-managed and integrated with the management systems of the acquiring company. This is of crucial importance, otherwise the mismatch of the two can adversely affect the performance of the whole organisation.

If the company acquires the whole of a company and retains only part of it, this is a candidate for Clean-up of portfolio, where the part which does not fit with the acquiring company is disposed off, while retaining the part which blends and balances well with the corporate strategy of the overall portfolio.

If the company acquires only a part of a company and retains whole of it, the acquired part has to 'adapt' to the management style of the acquirer; because of its minority position. When the acquired part is retained, the company is being very selective in its acquisition strategy.

If a company acquires either a part or whole of a company and keeps none of it, the move is mainly for investment purposes. If the whole company is acquired and disposed off, it is because the company finds No-Fit for combined operation. On the other hand, a part of a company may be acquired and disposed off, because it was available at a throw-away price.

Similarly, the candidates can also be classified by other criteria such as distinctiveness or the distance from the present activities or operations of the acquiring company. This is also an indicator of the enormity of the task of integrating the acquired unit with the acquiring company.

14.7 ASSESSING THE SUITABILITY OF A PROPOSAL

After going through the Screening Process, or when a single proposal is brought by the middle man or an agent, the suitability of the proposal is judged by asking certain basic questions listed below:

Funds Availability
The first question is whether the acquirer has requisite surplus funds available for investment. Here one must consider the cost of acquisition as well as the cost of integration of the acquired business.

Likely Positive Synergies
The acquiring company must look at the likely synergies with the acquisition of the proposed company. The resulting synergies are the strengths in support of the acquisition proposal.

Negative Synergies and Weaknesses
The proposal should be viewed also in terms of its limitations and deficiencies. New companies may bring in handicaps also. For example, if the industrial relations are at a poor state in the acquired company, this can also affect the relations between management and workers in the acquiring company. Similarly, if the employees in the proposed acquisition are being paid higher salaries and perquisites, these might spread to the entire enlarged organisation. On the other hand, if the weakness is in terms of technical or marketing skills which the acquirer excels at, then these weaknesses can be easily rectified by acquisition.

Is Timing Appropriate?
The managers of the acquiring company must carefully review if they can afford to spare their time for integrating the acquired company. And, whether in terms of business cycles etc., it is the right time to acquire the proposed company.

Is the Required Management Style Available?
Considering the positive and the negative synergies, the strengths and weaknesses of the acquisition candidate and the availability of funds and time, the acquirer must also consider whether the requisite management culture and approach is available to run the acquired company more efficiently. Will the managers in the acquired company cooperate in running their company differently, or would they have to leave to do so. One must also consider how the key managers can be retained to run the organisation while supplementing some additional controls.

Activity 3

For a business segment with which you are familiar, consider the various possibilities for mergers and acquisitions, and report how you would go about screening the candidates.

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14.8 VALUATION FOR MERGERS AND ACQUISITIONS

So far we have discussed how the various potential candidates for mergers/acquisitions are viewed in the context of the corporate strategy of the acquirer. By systematically going through the screening process and after checking the suitability of the candidates for acquisition, a desirable company is identified. Then the next question is: How much is it worth, or what is its value?

Mergers and acquisitions involve share stocks of different companies, and their exchange for suitable consideration. Acquiring the shares of another company entitles one to get the dividend accruing on the same, or the capital gains by selling the shares when the prices are higher than what was paid for. Value of the shares/stocks of a company is determined by factors such as:

- Present Dividend Returns,
- Likely Future Returns,
- Risk of these future returns,
- Present profitability,
- Potential growth rate.

Thus, the valuation for merger and acquisition involves evaluation of the associated risks and the potential growth rate of the firm and its earnings. The valuation procedure follows a rigorous analysis similar to the one followed for other capital budgeting decisions.

Valuation by P/E Ratio

The P/E ratio is defined as:

$$\frac{\text{Market Price Per Share}}{\text{Net Earnings after tax per share}}$$

Thus, if the market price of a share is Rs. 40/- and Earnings per share is Rs. 2.00, then

the P/E Ratio = 40/2 = 20

In other words, this company would have to sustain profit at this level for 20 years to pay back its current share price. Of course, generally an investor would not wait this long to recover his cost. The investment is made either with the hope that the company would grow faster, or that when the price of the share rises beyond Rs. 40, the investor would sell the shares for some capital gains. When the P/E Ratio is reversed, it gives the Earnings Yield. In the above example, the earnings yield is 5 per cent after tax. This is how considering the risk of investment in shares, and the risk-free returns available from bank deposits.

The different values of P/E Ratio for different companies is attributed to the differences in:

- Growth rate of company.
- Risk associated with the investment.
- Competition and environment of the industry.

The industrial sector to which a company belongs plays an important role in the value of a company and its shares. Certain sectors have shorter business cycles and more uniform earnings compared to other sectors. The essential consumer commodities such as soaps, detergents, oil, bread etc. have steady returns on investments compared to the heavy engineering equipment manufacturer. The fortunes of the latter are intimately linked to the upswing growth phases of the economy only.

Thus, the P/E Ratio for a company is a simplified tool for assigning value to a company. This must be viewed along with other underlying factors such as the growth prospects, risks associated with the company and the business sector, and the present earning position of the company.

Earning Per Share

Another way of looking at the potential acquisitions is to compare the earnings per share of the acquirer, the company to be acquired and the two together.

If the market price of a share is Rs. 100 and its P/E Ratio is approximately 25, then its Earnings Per Share is Rs.4.

However, this value is a static measure of the performance of the acquisition. The earnings of the company can move upward or downward depending on the actions taken by the company. To grasp this, one needs to look at the major sources and uses of funds given in the Balance Sheet and Profit and Loss Accounts. P/E ratio or earnings per share alone indicate very little and must be checked side by side with the Balance Sheet and Profit and Loss Accounts of the firm. These together should be viewed to develop a scenario on how the company is running at present and how it can be run better after the acquisition.

A typical financial analysis to facilitate such building up of scenario, would involve the following steps:

Divest Loss Making Operations

The first action that the acquirer considers while acquiring another company is to see if there is any loss making operation within the organisation. By divesting the loss making subsidiary, the acquirer reduces the cash drain in the form of losses, and generates some liquid funds for running the profitable part of the organisation. The additional funds so generated help to reduce the bank borrowings or may be invested in good marketable securities for additional income. One hopes that these unwanted assets can be disposed off at their book value at least.

Use Ratio Analyses

The performance of the company and efficiency of its various operations can be judged by calculating various key ratios.

$$\text{For example, the Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The Current Ratio for the company should be compared with the industry average to check if it is on the higher side. A high current ratio should lead one to go through the individual components of current assets and current liabilities.

Reduce Current Assets

Under current assets, often there is a high level of stocks and excess money blocked with the debtors.

$$\underset{\text{(in months)}}{\text{Level of stock}} = \frac{\text{Stocks}}{\text{Cost of Goods sold}} \times 12 \text{ months}$$

This stock level should be compared with the industry average, and then it should be estimated how much of it can be reduced, for instance, a high level of 8 months of stocks can be reduced to a 6 months level. Funds corresponding to stock level of 2 months would be released for better deployment of funds elsewhere.

Similarly,

$$\underset{\text{(in days)}}{\text{Average Age of Debtors}} = \frac{\text{Debtors}}{\text{Sales}} \times 365$$

This should be compared with the average age of debtors for the acquiring company. If the acquirer's debtor's age is lower, consider how the acquirer's credit controls can be used to reduce the average age of debtors. For instance, if the average age can be reduced by 25%, then this would give additional funds for current use.

Reduce Current Liability

The funds released from stocks and debtors are then ploughed back into the firm, and

correspondingly some current liabilities in the form of bank overdraft or working capital loans can be reduced to save on their respective interest charges.

Revise Balance Sheet and Profit and Loss Account

On the basis of the actions outlined above, revised Balance Sheet and Profit & Loss Accounts are developed. The new net earnings per share is calculated, which will be far better than the earlier value of earnings per share, of the target company.

Thus, the acquirer is able to derive savings and higher profits which presumably the target company had not foreseen.

Incorporate Growth and Expectation Rates

In the context of P/E ratio we presumed that it would stay constant before and after acquisition. On the other hand, the reality speaks otherwise. The very fact that the P/E ratio of different companies varies, implies that the investors associate their investments in different companies with different risks. Thus, the mergers and acquisitions must be valued on the basis of the likely growth rates of the different companies when run independently. and compared with their combined performance.

Acquisition involves generally paying a premium over and above their current market prices to the shareholders of the acquired company. Thus the number of shares in the combined company would be different from (and less than) the simple sum of the number of shares in the two companies.

Furthermore, the growth rate of a high-growth company is bound to fall with the acquisition of the low growth company. Thus, initially for the acquirer, the earnings per share may seem to improve over their earlier operations with the acquisitions. Similarly, the shareholders of the acquired company also gain by their over-capitalisation of shares (which were paid for at a premium). But it is generally seen that because of the difference in the growth rates of the acquirer and the acquired companies, the growth rate of the combined company is lower than that of the acquiring company. At some stage in future, the earnings per share of the combined operations fall below what would have been the earnings per share of the acquirer's operations alone. As the investment is that of the acquirer, a merger or acquisition is considered profitable if the returns on investment for the acquirer company are higher than their investment. The two streams are compared in terms of their present values.

The above method has been criticised for the fact that it is based on reported earnings rather than actual cash streams in the form of actual dividends paid to the shareholders. To that extent the market can be deceived by manipulating the reported earnings.

Market Value of Assets

This is another way of judging an acquisition. The current market values of the used assets of the target company if traded in the market are a good measure of their worth. However, the market may perceive an asset to be in a different use than the one for which the company is using it.

Land and buildings are the fixed assets of the company which provide productive industrial operations, but they may have a much higher market value especially if they are located conveniently near a growing urban centre. In such a situation, the company must also incorporate the cost of conversion of the asset to the proposed new use, and check whether the concerned governing agencies would allow such conversion.

Replacement Value of Assets

Another way of evaluating the worth of the assets of a company is by evaluating the written down replacement value of the assets. This takes into account the usage of the assets and their remaining useful economic life.

The written Down Replacement value of an asset is calculated as:

$$= 1 - \frac{\text{Age of Assets}}{\text{Total Economic Life of Asset}} \times \text{Current cost of asset.}$$

Here, the current cost of an asset is determined by the market price of the asset if replaced now.

Replacement cost is better than the historical cost, particularly in an inflationary economy, where the price of assets is rising steadily. Furthermore, the price of the assets also increases if these assets are in general being used more profitably. On the other hand, if these assets are not so profitable in use, their prices get depressed or else the asset replacement will not take place.

However in this analysis, the economic life of the asset has to be estimated, and sometimes due to the technological advancements the assets available in the market are markedly different from the ones originally installed by the company a few years ago. Most of the currently available assets incorporate computers in them and more automatic/with flexible manufacturing features. The replacement value of assets is compared with the other option for the firm to invest in new assets.

Thus, a merger or acquisition can be valued in different ways to compare the cost with the potential benefit. The benefit accruing with the future earnings is discounted to the present values, while the costs are determined by market value or the written down value on the concerned assets.

14.9 MANAGING AFTER ACQUISITION OR MERGER

The performance of companies after mergers vary from case to case and place to place. A number of studies have reported on what happens after the merger or acquisition.

In terms of profitability (as percentage return on net assets), there should be improvements after the merger due to enhanced economies of scale and other functional advantages such as in the area of financing and marketing. The firm would also acquire better control of the markets, so the profitability should improve. But many companies end up getting lower profitabilities after the merger, not only during the turbulent year of acquisition, but sometimes much later as well. The measurements here have to be standardised with respect to companies operating in different industrial sectors with different average profitabilities. Profitabilities before mergers should also be averages over a three-year period.

The study must be carried out for extended period after the merger, to see how the profitability moves two years or five years after the merger. In some cases, despite higher market power, the acquired operations deteriorate or even fail. In a U.S. study in the 1960s, about 75 per cent of the mergers were reported to be failures. In a U.K. study, eight out of nine mergers were rated as failures. Here, one can argue that the future events are always unpredictable, or that worse could have happened to the company if they had not gone for merger.

Many problems of compatibility occur: Will the managers in the acquired company follow the practices of the acquirer willingly? Will the operations of the merged company be run as efficiently and effectively as the individual operations? In many cases the mergers only lead to a change in ownership and control, while the operations of the old and the acquired one continue to run as before.

Due to fear of uncertainty and redundancy, the executives on both the sides resort to excessive manipulation. Such efforts then have very adverse effects on the acquired company, causing disillusionment, disappointment, and excessive loss of personnel. The psychology of employees across the merged company are likely to clash and cancel each other out, if not carefully harmonised well in advance.

The acquiring company must also carefully consider and evaluate which skills of theirs can be more easily transmitted from their organisation to the acquired organisation. It is felt that financial management skills are easily transferable whereas the technical management skills on Research & Development, design and production innovations are much more difficult to transfer. The managers who spearhead the merger must not insist on transferring all their methods and practices to the other side, with their 'big brother' attitudes.

A sincere and sensitive management is the key to the success of the mergers and acquisitions. The understanding and 'putting oneself in the other's shoes' go a much longer way than pushing people for immediate results. The combination of two different cultures may cause upheaval of human emotions. Invariably the managers of the acquiring and the acquired firms take the roles of the victors and the victims. It is, therefore, not rare that the managers of the acquired firm especially the ones who resisted the take-over bid, lose their jobs on the day the deal is signed.

Mergers and acquisitions are costly affairs as they take time and involve premiums of over 100 per cent which the acquirers have to pay to the shareholders of the acquired firm. During the stalemate period when the fate of the ownership of a firm is not decided, most of the employees on either side are not fully concentrating on their jobs, resulting in many lost

opportunities. Many of the deals are also disputed and contested in courts, causing additional cost in legal fees, commission charges, printing of stationery etc.

14.10 MERGER POLICIES: INTERNATIONAL TRENDS

We will now consider the role of external agencies in mergers and acquisitions. The policies governing and controlling mergers and acquisitions vary from country to country. These are invariably related to their influence on competitive environment of the economy. The arguments against free uncontrolled amalgamations are that they lead to the concentration of commercial and industrial power in the hands of few. Such monopolistic power bases may lead to price collusion and create barriers to entry in market for new smaller firms.

Let us now consider how merger policies have evolved in different economies.

USA

In the USA the general objective of the Government policies is to promote free competition and curb activities which restrict such competition and free market forces to operate. A series of Acts, for about hundred years now have been in operation. For example, Sherman Act of 1890, restricts moves towards building up monopoly, which is defined at or beyond a market share level of 75 per cent. The enforcement is done by the Anti-Trust Division of the Department of Justice and the Federal Trade Commission. The US law strictly prohibits horizontal mergers, if they would lessen market competition. The vertical and conglomerate mergers (with dissimilar operations) are also discouraged but not effectively. Generally, the enforcement agencies consider the potential benefits of the mergers, but competition is not allowed to be restricted, and mere economies of scale are not strong enough reasons for permission.

In USA the mergers and acquisitions, though quite frequent, involve a series of legal battles. For instance, the shareholders of the firm targeted for acquisition, would sue their own directors and senior executives, if they have not taken any action to resist the bid from the raiders. The targeted firm files a suit against the bidder to gain time, to develop alternate strategy for defence. Huge costs are often incurred by both the sides in mergers and acquisitions in USA.

Japan

Japan's merger policy has been developed from the American policy, and after revision in 1977, has acquired powers to break up companies with a majority market share of more than 50 per cent. As a typical Japanese practice, these drastic powers have been never used. Otherwise, their law also draws heavily from the US legal framework, though the extent of litigation in Japan is much less than in the USA.

Europe

In Europe, the EEC policy is to control the abuse of the dominant market share, rather than to place restrictions on market domination per se. Article 86 of the Treaty of Rome considers market domination at a market share of 40 per cent and beyond. In U.K., the limit is set on 25 per cent and in West Germany, it is at 33 per cent.

In West Germany, the merger controls are in operation since 1973, under their Federal Cartel Office. The proposed mergers are to be notified in detail to this office, which must be shown the potential benefits of the merger. If the merger is above a certain size or it leads to market domination, it is less likely to be approved. A discouraging feature is that the merger may be classified as liquidation in some cases, resulting in levy of tax on the premium if the merger value is more than the book value. Generally there is less interference, and the merger can proceed while it is still under investigation by the Federal Cartel Office. On the other hand, this office can within one year of merger, decide against it and ask the parties to separate.

In the U.K., the mergers are much more frequent than in other European countries. As a result the Monopolies and Mergers Commission tends to delay and restrict creation of Monopolies. Since 1948, the U.K. had a competition policy, formulated with Monopolies Commission. The Restrictive Trade Practices Act of 1956 and 1960 followed, and subsequently there the Fair Trading Act of 1975 and the 1976 Consolidating Act, whereas the U.K. has statutory monopolies in the form of nationalised industries, the concentration of power with private companies is controlled.

In 1978, in a review of their monopolies and mergers policy, it was recognised that to achieve greater efficiency with respect to increasing international trade, concentration of economic strength may be necessary, but not if it reduces competition.

France started control of merger activity in 1977. As a result of this, it permitted horizontal merger causing a market share of 40 per cent or more, and mergers of companies with market share of over 25 per cent. only by proving that they would have more advantages than disadvantages. The take-over bids are generally less, and these proposals have to be submitted by the bankers of the bidders to the Chambre Syndicate des Agents de Change (CSAC). a committee of stockbrokers and agents appointed by the Minister of Economy and Finance. The banks have to guarantee the offer with cash or securities. The proposals for the mergers are also to be published in the newspapers, and must undergo extended legal formalities. All shareholders are to be fully informed about the terms of the bid, and the progress is closely regulated.

14.11 INDIAN SCENE

India's corporate activities are highly regulated by government policies and regulations.

The Managing Agency System prevalent in India, and heavily misused since the British Rule, was brought to an end by the Companies Act in 1956. The government also controls the appointment and remunerations of Managing Directors, wholetime Directors etc. The Companies Act also restricts loans made or guarantees given by one company to another. To avoid interlocking of funds and multiple mutual directorships.

Two of the major control policies governing the conduct of the companies, especially their expansion and ownership, are Monopolies and Restrictive Trade Practices (MRTP) Act of 1970, and Foreign Exchange Regulation Act (FERA) of 1973. The latter Act was in existence in some other form since 1931, and was subjected to successive changes over the years. MRTP Act is to restrict concentration of economic power in a few hands and market dominance which restrict free trade practices. The asset limit for MRTP Act has been raised to Rs. 1000 million.

The FERA has guidelines for ownership by foreign business in India. For certain limited items permissible foreign shareholding limit is 74 per cent, whereas for companies engaged in 'other manufacturing items', construction and consultancy trading companies, non-tea plantation etc., the limit is 40 per cent.

According to Indian corporate laws, company shares are freely transferable except under very special circumstances (section III) when the directors can refuse their transfer and registration. But while doing so, the directors have to give reasons behind such a move.

The management analysts and watchers believe that corporate take-over activity, though presently in infancy, is likely to grow in the next few years. Several banks, particularly foreign banks like Citibank, Hong Kong Bank and Standard Chartered Bank, have enlarged their merchant banking activities to include the management of mergers and acquisitions. The financial institutions, which have enormous shareholdings in public limited companies, have so far been using their veto on take-overs. However, they have lately tended to take a more realistic and benign view of such activity. Some ambitious industrialists, it has been reported, are opting to become Non-Resident Indians (NRIs) to get out of the clutches of FERA (Foreign Exchange Regulation Act) which hampers offshore take-over deals.

The Chhabaria and Hindujas have an edge over others because of their NRI status which helps them in acquiring the foreign component of the equity consequent upon the dilution of the foreign collaborators' holdings in the Indian companies.

The changing economic environment is creating its own compulsions for a consolidation of capacity through take-over and output rationalisation. With growing competition and economic liberalisation it has become essential to build viable production sizes. Take-overs achieve this end by letting the strong buy out the weak.

Backward and forward integration are two other reasons for seeking growth by acquisition. The R.P. G's bids to acquire running enterprises fall into this pattern. With the country's largest tyre manufacturer (CEAT) under its belt, the RPG group's strategic alliance with the overseas's shareholders of Harrison Malayalam gives it control over a major tyre input, viz., rubber. Since the group already owns a carbon black company (Phillips Carbon Black), the

Harrison Malayalam link gives CEAT a stronger backward integration than most other tyre companies. This brings into play the synergistic effects that we talked in a previous section.

Some major take-overs in recent years are given in table 14.1

Table 14.1: Major Take-overs In Recent Years

Company	Purchaser/Partner	Price	Year of Purchase
Warren Tea	G.S. Ruia, UK	£ 6 m	1983
Shaw Wallace	M.R. Chhabria	$ 26 m	1985
Metal Box	B.M. Khaitan (1)	N.A.	1985
T.N.Chemicals	R.Udayar Ross Deas	N.A.	1986
Chloride India	S.K. Birla (2)	N.A.	1987
Holman Climax	Nat Puri	£ 2 m	1987
Ashok Leyland	Hindujas	£ 26 m(3)	1987
Mather & Platt	M.R. Chhabria	£ 14 m	1987
Hind Dorr Oliver	M.R. Chhabria	$ 9 m	1987
Berger Paints	Vijay Mallya	£ 12 m	1988
Shalimar Paints	M.R.Chhabria	Rs 72 per share	1988
Neivelli Ceramics	Spartek Ceramics	Rs.1.69 crores	1988
Harrisons Malayalam	R.P. Goenka	N.A.	1988
ICIM	R.P. Goenka	N.A.	1988
Dunlop	M.R.Chhabria	N.A.	1988
Allwyn Nissan	Mahindras	Rs.4.32 crores	1988
IEL Rishra Unit	Abhey Oswal	Rs. 14 crores	1988
UCIL Chembur Unit	Abhey Oswal	Rs. 58.5 crores	1988
West India Engg.	Vijay Mallya	N.A.	1988
West India Enter	Vijay Mallya	N.A.	1988
L&T	D.H.Ambani	Rs 80 crores(4)	1988
ACC	Darban Seth	N.A.	1988
Universal Luggage(5)	Dilip Piramal	Rs.4.17 crores	1988
Swastio Surfactants	Nitin Jabanputra(6)	Rs. 1 crore	1988
Nicholas Labs	Ajay Piramal	$ 2 m	1988

Notes (1) 7% stake bought through rights issue (2) Strategic alliance no equity stake (3) includes 59% stake in Ennore Foundries (4) 12.4% stake bought from market for approximately Rs. 80 crores (5) includes three ancillary units (6) 97% of equity bought together with Satish Bhanagar.

Source: Business World, December 7-20, 1988, p. 52.

14.12 SUMMARY

The strategic alternatives of growth based on mergers and acquisitions involves a series of interrelated decisions. Beginning with identifying potential candidates based on take-over objectives, a firm wanting to grow through the take-over route will proceed to identify the financial flows in a take-over. It will have to foresee the new challenges, that it will have to face in managing the acquired business. Compliance with legal framework is an important dimension in any take-over exercise. Effective negotiation and a complete understanding of the take-over are important on the part of both the acquiring and the acquired companies for smooth functioning of the business. Mergers and large scale acquisitions in India are recent phenomena, though such activities are likely to grow in future due to changed environment and softening of attitudes on the part of powers that be toward this activity.

14.13 KEY CONCEPTS/TERMS

Acquisition

Bear Hug

Merger

Poison pill

Target

White Knight

14.14 SELF-ASSESSMENT QUESTIONS

1 Define the following :

   a) Merger
   b) Acquisition or Take-over

2 Do you know of any mergers or take-overs which have taken place recently? What were the motivations behind such mergers or take-overs?

3 Explain the screening process for merger or acquisition.

4 What would be your five most important recommendations for managing a merged or an acquired enterprise.

5 Briefly describe the policy regarding mergers and acquisitions in India.

6 Look at Table 14.1 carefully. What appear to be the main strategic motives behind take- overs? Discuss.

7 Whether take-overs should be freely permitted or should curbs be placed on such activity? In your view what should be the important elements of a policy on take-overs?

14.15 FURTHER READINGS

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NOTES

NOTES

Uttar Pradesh
Rajarshi Tandon Open University

MBA-3.1

Corporate Policies and Practices

Block

6

IMPLEMENTATION AND EVALUATION OF STRATEGY

UNIT 15

Implementation of Strategy **5**

UNIT 16

Evaluation and Control of Strategy **21**

UNIT 17

Turnaround Management **31**

BLOCK 6 IMPLEMENTATION AND EVALUATION OF STRATEGY

In the previous block we discussed various strategic alternatives. After a particular strategy has been selected, it has to be implemented. Implementation embraces all those actions that are necessary to put the strategy in practice. The test of effectiveness of implementation lies in the extent of matching of the actual performance with the performance envisaged in the strategy. In the very first unit of this course, we had mentioned that it was not in the formulation but in the implementation of the strategy that most of the organisations meet their waterloo. No other statement probably would speak about the importance of implementation so eloquently as this one. There could be many slippages between the strategy as formulated and strategy as implemented. Implementation is a difficult and relatively neglected area. While a strategy is being implemented it has to be continuously evaluated during and after the implementation.

Many of the business enterprises run into trouble not because they fail to formulate or have a strategy, they fail because they are unable to implement the strategy effectively. That is why we have included Turnaround Management as part of this Block.

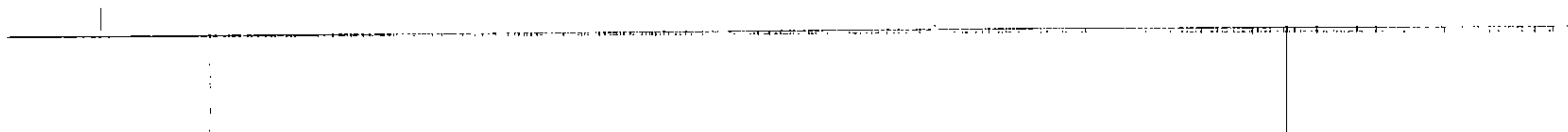
This block is divided into three units.

Unit 15 deals with Implementation of Strategy. The process of resource allocation and budgeting is explained. The need for appropriate structure for implementation is highlighted. The relevance of different types of structures and their linkage with external and internal environment are examined. The appropriateness of leadership styles is stressed and their relationship with environment is discussed. The need for appropriate functional policies to translate the strategy into reality is emphasised. What possible policies could be followed in functional areas are discussed. Lastly, the need for communication of strategy and the challenge of change are discussed.

Unit 16 discusses about Evaluation and Control of Strategy. For implementation to be effective, it needs to be constantly evaluated. The process of evaluation and control, identification of key variables and performance standards are discussed. Then, the structure for evaluation and control, follow up action needed for control, and problems of control system are dealt with.

Unit 17 is concerned with Turnaround Management. The incidence of industrial sickness in India is first taken up. What are the danger signals of corporate sickness, how business failure can be predicted, and what are the causes of corporate decline are examined. The later part of this unit deals with the turnaround process and the various types of strategies that can be used for bringing about the turnaround. Some turnaround cases drawn from the Indian public sector are also discussed toward the end of this unit.

After a corporate body finds that its strategic goals have not been achieved, it must recommence the strategic planning process of considering its objectives, analysing its environment of resources, choosing again among new strategic possibilities and implementing improved strategies. Thus corporate strategy is an on-going process.



UNIT 15 IMPLEMENTATION OF STRATEGY

Objectives

After studying this unit, you should be able to appreciate the:

- importance of implementing a chosen strategy
- process of resource allocation and budgeting
- relationship of strategy with organisation structure, leadership, and systems
- role, nature and development of functional strategies
- task and process of change implied in implementation
- issues related to communication of strategy

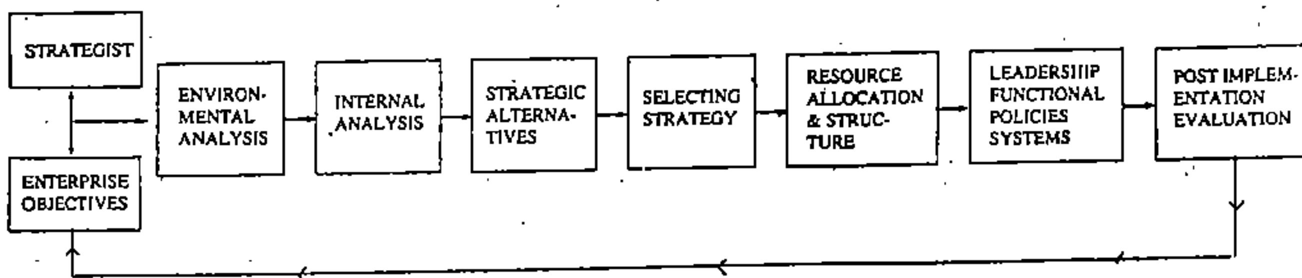
Structure

15.1 Introduction
15.2 Resource Allocation
15.3 Organisation Structure
15.4 Leadership
15.5 Functional Strategies
15.6 Challenge of Change
15.7 Communication of Strategy
15.8 Pre-implementation Evaluation of Strategy
15.9 Summary
15.10 Key Concepts/Terms
15.11 Self-assessment Questions
15.12 Further Readings

15.1 INTRODUCTION

In one of the units of the previous block, we discussed the process of selection of strategy. Once a strategy has been chosen, it has to be put into action. This process is known as implementation of strategy. The process of implementation is also called **corporate development**. Strategy implementation or corporate development covers a wide range of issues, involving a number of decisions and actions which are often critical for the success of a strategy (see Figure 15.1). The resources of the organisation have to be allocated/ reallocated in a manner that reinforces the choice of strategy. The search for technology has to be made (unless it has already been considered while analysing and selecting the strategy). Besides, various tasks related to organisational development (i.e gearing the enterprise in its entirety to meet the demands of future business) have to be undertaken. The success of a strategy, to a large extent, depends on the way the task of corporate development is carried out. The McKinsey's 7-S Model (refer to Unit 2 of Block 1) captures the essence of the task of corporate development. A strategy is usually successful when the other Ss in the 7-S Framework fit into or support the strategy. The task of corporate development is to achieve this good fit among the seven Ss by making necessary alterations.

Figure 15.1: Strategic Management Process



Source : Glueck.W.F. (1984), p. 6.

The corporate development is a complex task due to the fact that the elements of the 7-S Framework have intricate relationships among themselves, thus, defying any band-aid approach to success. The elements have to be fitted with each other. Even a single "bad-fit" has a potential to jeopardise a well thought out business strategy.

The task of corporate development is also quite difficult because it involves the process of change for managing transition from the present structure, systems, styles, skills and staff to the desired ones.

It may be noted that although the discussion on strategy formulation and implementation may give the impression that one leads to the other in a sequence, it may not be so. The implementation flows both from and into the determination of strategy. In an on going organisation, structure, policies, and systems are already in place and the choice of strategy is constrained by the firm's ability to alter them. The task of managing transition implies that the strategy be "workable". A good strategy is not synonymous with "doable" one, nor is "doable" one synonymous with good strategy. There is a need for "doable", good strategy[1].

Activity 1

Which one, in your view, is a more difficult task : strategy formulation or strategy implementation? Why?

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15.2 RESOURCE ALLOCATION

Resource allocation is the process of allocating organisational resources to various divisions, departments and Strategic Business Units (SBUs). The resources could already be existing in the organisation or may have to be acquired. Resource allocation becomes a critically important exercise when there are major shifts proposed from the past strategies in terms of product/market scope. For instance if the official strategy is expansion in one line, withdrawal from another and stability in the rest, then greater resources would flow to the first and lesser to the second to reinforce the strategy. Similarly, if the strategy is to develop competitive edge through product development, greater resources will have to be committed to R&D. Resource allocation is a powerful means of communicating the strategy of the organisation as it gives the desired signals to all concerned. It will demonstrate what strategy is really in operation. If the resource shift is not in line with the official or announced strategy, the latter will remain only as a paper strategy.

The resource allocation decisions are important. "The use of a formula approach (for instance as a percentage of sales or profits), in allocating resources to advertising or research and development, may be inappropriate and counter-productive, as the resources may be inefficiently spent when or where they were not required and may not be available when or where they may be critically required". Care should also be taken to see that the resources are not allocated or withdrawn because of easy availability or paucity. For instance, cutting down R&D budget in view of sudden fall in profitability should be avoided as such expenditure may be most critical for developing future competitive advantage. This may be in spite of the fact that R&D activities use resources without producing any benefit in the short- run. The resource allocation decisions are linked to the objectives. Decisions about dividend, for example, are important in relation to objectives and long-term ability of the company to attract capital. How to distribute the expected profits among investors, employees and the company's own needs is an important resource allocation decision from the viewpoint of long-term implications of the strategy[2].

Methods of Resource Allocation

In profit oriented organisations, the BCG Matrix (see Figure 15.2), which we had earlier discussed in Unit 10, provides a convenient tool for resource allocation.

Cash Cows are the business which are in the saturation phase of the product life cycle. They generate enough of surplus cash. The surplus resources may be reallocated to "Stars" and "Question Marks" (in case the company strategy gives a further thrust to them). "Dogs" with low growth and market share do not need any thrust, hence resources may be gradually withdrawn from such businesses.

Figure 15.2: BCG Matrix

Relative Market Share

Business Growth Rate		
HIGH	STAR	QUESTION MARK
LOW	CASH COW	DOG
	HIGH	LOW

Relative Market Share

Source: Hedley, B., "Strategy and Business Portfolio", *Long Range Planning*, Feb. 1977, p. 10.

The BCG matrix is a useful tool in that it impresses upon a portfolio approach to resource allocation. It helps in averting over-investment in any particular type of business. In the absence of such a tool, an enterprise may commit resources to all high growth businesses which may not necessarily be "Stars". This may undo the very advantage of the strategy. The enterprise may land up in serious resource crisis. The approach also averts sustained commitments to "Dogs" which are non-promising propositions from the long-term point of view.

Despite the utility of BCG matrix, as discussed above, it should be used with care and only as a guideline. It does not provide a concrete measure for making a finer choice particularly among the businesses of the same nature, for example, businesses which are Stars or which are Cash Cows.

The common approach to resource allocation in the implementation phase is through the budgeting system. It is possible to incorporate some basic features of the BCG matrix approach in the budgeting system by considering the stages of the product life cycle of various businesses. The cashflows, departmental expenses, revenues and demand for capital expenditure would be different at different points of the product life cycle, and so will be the balance sheet and income statements. Extreme care has to be taken with regard to any incremental capital expenditure from one period to another. Further capital expenditure may not be incurred where withdrawal of investment may be advisable. Zero base budgeting is an important tool for analysing capital expenditure, particularly where retrenchment strategies are used.

For long-term commitment of resources in mergers or acquisitions, setting up of a new plant or factory taking up new product lines, capital budgeting techniques may be employed. Plans for securing and allocating capital for large-scale investments are needed to accomplish strategy. The techniques of project appraisal like Internal Rate of Return (IRR), Payback Period, Net Present Value (NPV), etc. may be used in decision making. In simple situations, Return of Investment (ROI) or Residual Income (RI) criteria can also be used. Due care should be taken in multi-business enterprises where there may be several divisions/ SUBs competing for resources. If an SBU's performance is measured on ROI criterion, a situation may arise where a high performing SBU may reject a reasonable investment proposal because it will reduce its existing high level of ROI. On the other hand, SBU with a current low ROI may like to invest in a product line which promotes a lower ROI compared to the one dropped by the SBU, because it is likely to boost its overall ROI. As a consequence, the enterprise as a whole may commit resources to less attractive proposals while neglecting more promising proposals. In such cases it is advisable to use Residual Income approach which guards against such ironical situations. The RI method stipulates a minimum desired ROI level for SBUs or for the enterprise as a whole. The proposals that are expected to give high residual income after charging off the stipulated return on capital are accepted[3].

The capital budgets are helpful in creating the necessary infrastructure to carry out the business. On the other hand, annual budgets are necessary for more routine resource allocation for conducting operations.

The operating budgets may be fixed or flexible. Both of these have their own advantages and disadvantages. The fixed budget commits resources based on activity levels. If frequent changes are necessary, the resources in a fixed budget situation may be committed based on false assumptions in the analysis, unreliable forecasts and unrealistic estimates of future activity levels. It is always possible to give post facto justifications for non-achievement of activity levels. There may be a tendency to retain the committed resources even if the activity levels are not being achieved, thus depriving other divisions of the resources which have a better potential. This leads to non-efficient utilisation of resources. Even at the end of the period when accounts are closed, the surplus resources arising from lower activity levels may not be transferred back. As a result, additional resources may be claimed in the next period, when the allocation process starts again, for any increase in activity levels beyond what was actually achieved in the last period. Thus resource allocation may get linked with inefficient operations.

Flexible budgeting system overcomes this problem but it has the disadvantage of encouraging non-seriousness about the targets. It is, however, better to follow flexible budgeting to ensure transfer of funds from one organisational unit to another if a fall is expected in actual activity level in the former, thus ensuring better resource utilisation. The fall in activity levels may be separately taken up by monitoring and controlling the performance of the organisational units.

It may be mentioned that resource allocation may not necessarily be a purely "rational" decision making process involving techno-economic considerations only. It is also "behavioural" process involving people who may be motivated by different objectives. All these influence the funding of projects. It is also as much a "political" process affected both by formal as well as informal structure of the organisation.

As the "behavioural" and "political" considerations are inevitable, one must ensure that they do not dominate the rational considerations; otherwise ineffective implementation of strategy may lead to failures. Integration of budgeting process with the overall planning process is important. Failure to do so may lead to problems in achieving the desired strategic change.

Activity 2

What considerations influence the allocation of monetary, human and other resources to different divisions/departments in your organisation? Does the process of allocation, in your view, reinforce the strategy of the organisation? If it does not, what are the reasons?

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15.3 ORGANISATION STRUCTURE

Once the strategy is decided, the entire organisational set up in terms of six Ss (of the 7-S Framework) have to be geared to match the strategy; organisation structure being one of the most critical of them. Organisational structure is the network of durable and formally sanctioned organisational arrangements and relationships. Among other things, it involves the development of mechanisms to ensure that the parts are linked and work together effectively[4]

There are two different aspects of organisation structure, the highly visible **super-structure** or departmentalisation (i.e., how people are grouped in different departments/divisions/ sections and how they are related to each other) and the less visible **Infrastructure** (i.e., authority relationships, specialisation, communication, etc.)

Super-structure

Super-structure is generally depicted pictorially in what is known as organisational chart. It shows at a glance how the organisation is geared to meet its tasks, and how differentiated the

organisation is (i.e how elaboratory specialised are its activities, etc.). The super-structure also indicates the principal ways in which the organisational operations are integrated (or coordinated). By showing their levels it indicates which groups have relatively more strategic importance[5].

There are several other factors that determine the grouping of people in the organisation. One of the most important factors for determining the grouping is the interdependence. There are three types of interdependence namely, *reciprocal* (when the output of one group/ individual becomes input for another and vice versa), *sequential* (when the output of one is dependent on the input of another but not vice versa), and *pooled* (where the groups are only indirectly dependent on one another). Organisations generally group together people having reciprocal interdependence. Next, they group together those having sequential interdependence and then those having pooled interdependence[6]. The grouping of course is limited by the span of control or supervision. This may, however, vary depending upon the nature of task performed by individuals and the intensity of interactions between superior and subordinates. Similarly the nature of function being performed by two individuals/ groups is also a factor that influences grouping of people. There is little gain in putting market researchers and accountants together. Therefore clubbing together people performing similar functions makes it easier to have access to their pooled specialised skills.

Infrastructure

The comparatively less visible part of the organisation structure — the infrastructure — deals with issues like delegation of authority, information systems, procedure, etc. The infrastructure enables the organisation to engage in a number of disparate activities and still keep them coordinated[7]. As the performance-related behaviour of individuals and groups is made possible through the infrastructure, one does not feel difficulty even in the mammoth task of coordinating the activities of several thousand people. For example, a simple money order form and standard operating procedure can reduce the total work involved. Infrastructure not only makes behaviour more predictable but also more efficient. It also constrains behaviour, sometimes quite painfully, though more often it facilitates the satisfaction of needs.

Decentralisation i.e., delegation of authority to lower levels is necessary to make the organisation more responsive to the demands of dynamic environment. It allows the people/ departments who are closest to the situation to take decisions. There are several determinants of delegation of authority. Larger organisations with greater competitive pressures need more decentralisation. Similarly, the more sophisticated and comprehensive the control and information system, the more is the decentralisation[8].

Decentralisation is more than just a management philosophy and is not easy to achieve. It is in fact a part of the organisation culture. It requires that the people at higher level be willing to delegate authority and people at lower levels be prepared to accept the responsibility. In the absence of either, there cannot be effective decentralisation. People at various levels should, therefore, be continuously groomed to assume more responsible roles. The decentralisation with all good intentions may remain only on paper if organisation fails to ensure human resources development.

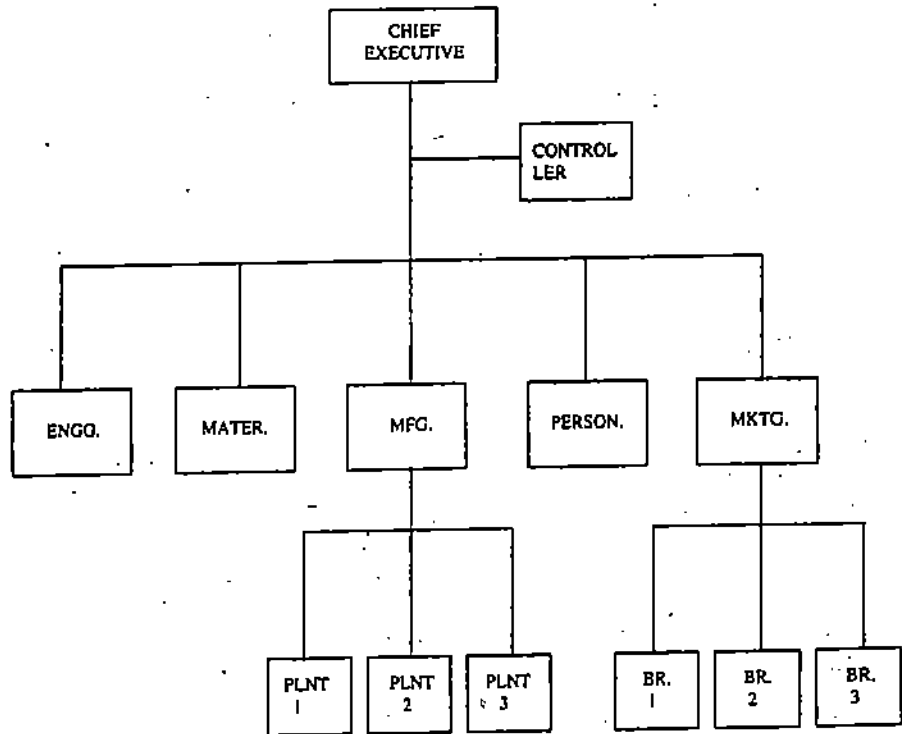
There are important links between decentralisation and information system, and between the task of human resources development and demands of environment. The environmental demands are in terms of speed of decision making. Since information is a critical element in a decision, the response-time-demands of environment get translated into speed of information flow. With rapid strides in the field of communications, the pressure for decentralisation at least in certain areas has been reduced.

Varieties of Organisation Super-structure

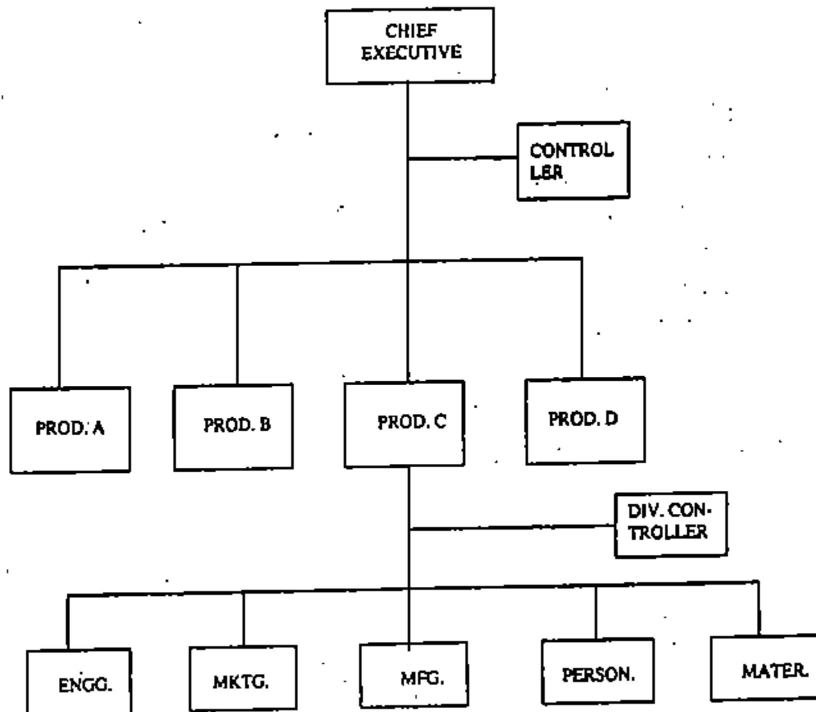
The researchers have indicated that a firm is more effective in implementing its strategy if it has the right organisation structure[9]. The question then arises : What structure is appropriate for a particular strategy? In a very small enterprise, the structure is only the employer and the employee. As the organisation grows, it usually develops into functional type i.e., the employees are grouped by the nature of the work they do (e.g. marketing, production, accounting and finance, etc). This structure facilitates specialisation and brings economies of scale. However, when the size becomes large and operations complex, the coordination and integration or various functional units becomes difficult. Further, undue attention may be paid to existing dominant businesses at the cost of promising new ones. If the organisation

grows by diversifying into variety of activities (products/markets/services), then another level of management above the functional levels is generally created and thus a multi-divisional structure develops (see Figure 15.3). A divisional structure results in improved coordination among (internal) functional units and increased response to changes in environmental demands (through decentralisation). The divisional structure could be product-oriented or (geographical) area-oriented or at times client-oriented. There could also be a combination of functional and product/geographical division

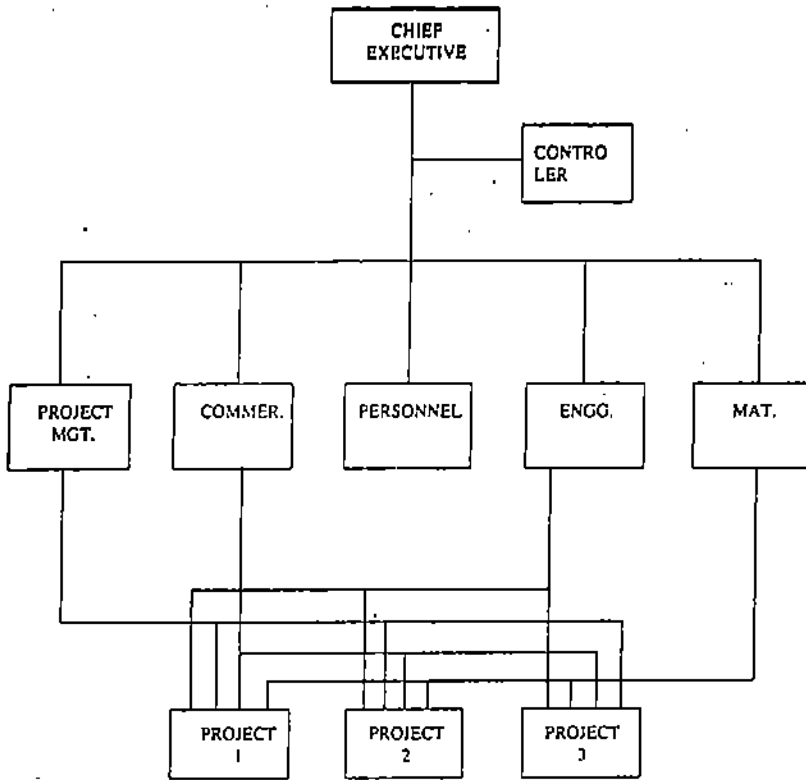
Fig. 15.3 : Varieties of Organisational Structure



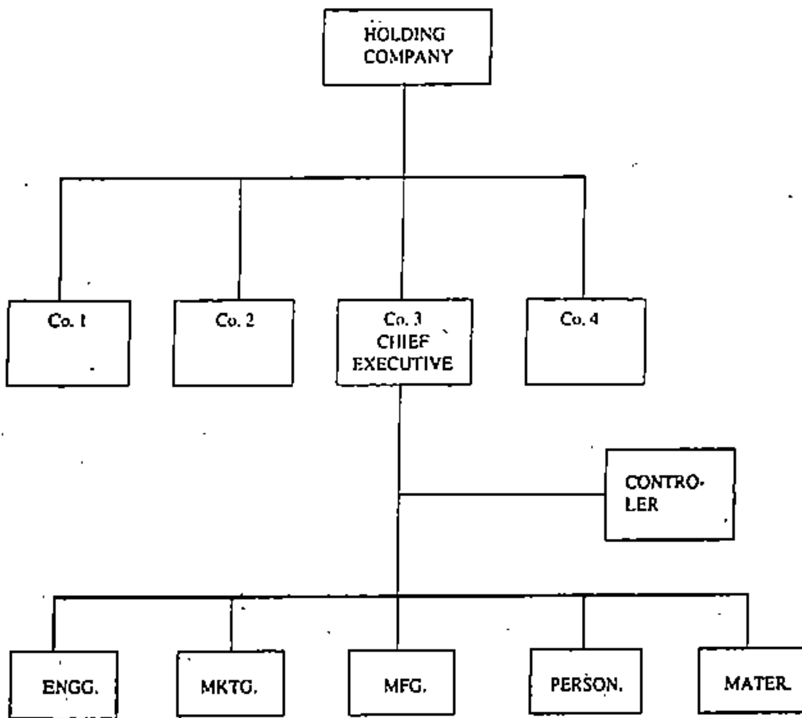
A. Functional Structure



B. Product Division Structure



C. Matrix Structure



D. Holding Company-Subsidiary Structure

tructure in an organisation. Moreover, in enterprises where products change frequently, still another layer may be inserted between divisional and functional levels, consisting of project development and project implementation. Such groups are temporary and are terminated at the end of the project.

There is another type of organisation structure, known as "holding company-subsidiary structure". It can be taken as similar to divisional structure where the divisions are legally

autonomous units (as companies), but the main company holds 50% or more of its equity (see Figure 15.3-D). Though legally autonomous, the subsidiary companies may not necessarily be fully independent in taking decisions. The decision making is influenced by the holding company as it holds key to the board membership through its controlling interest in equity shareholding. With wider spread of equity shareholding, the control of a subsidiary company could be exercised even with less than 50% equity. Though such a company does not legally qualify as a subsidiary, there is little difference in practice. The parent and all the "controlled companies" together are collectively known as business house.

This structure has certain advantages over divisional and functional structure[10]. It provides flexibility in keeping financial, personnel and other policies among different business lines while keeping uniformity in some other businesses. It keeps the control over each company easy by virtues of smaller size, and helps top management in controlling various businesses through financial tools. It provides ease and speed of acquisition, divestments and expansion through unrelated diversifications, and reduces the hostility of the general public towards large companies expanding through divisional structure. Such a structure also facilitates quick response to exploit incentives offered to selected industries.

Which Organisation Structure Is the Best?

There is no particular type or form of organisation which can be said to be right or best for all the enterprises. The "best" form is the one which fits the organisation's environment and its internal characteristics in terms of culture, styles, skills and strategy. Structure follows strategy, and strategy determines the future environment of the enterprises. At times it also determines which one of the basically different forms, e.g., holding company-subsidiary, divisional, or functional structure is the right choice. For instance, there may be no visible advantages of using divisional structure if the company has decided in favour of unrelated diversification. Holding subsidiary company structure may perhaps be a better form. Similarly, no definite advantages would be derived from divisional structure over functional one is the company plans to grow by backward or forward integration.

The impact of environment and internal characteristics on the form of organisation structure is shown in Figure 15.4.

Figure 15.4: Factors that Influence form of Organisational Structure

	Functional	Divisional
Environment		
Rate of change	Slow	Rapid
Degree of competition	Little	Much
Dependence on stakeholders	Low	High
Internal Characteristics		
Organisation size	Small	Large
Diversity of Product/Markets	Low	High
Technology used	Small Batch or job work	Mass Production or routine
Management Style	Authoritarian	Participative

Source : Glueck W.F., p. 322.

When the environment is steady, the need for innovation and inter-departmental coordination is less, the product lines are few and markets are narrow, the functional structure works well. It enables the benefits of specialisation and economies of scale. In contrast, the divisional structure becomes imperative when the product lines and markets are diverse and the environment is dynamic, requiring faster and intensive inter-departmental coordination, faster communication and more innovation.

In terms of division of labour and integration of different groups, the research findings indicate that organisations which have more differentiation (i.e., have created specialist groups to meet the demands of environment) are more successful than those which have less[11]. For instance, an organisation that has separate R&D, market research and sales activities is likely to be more successful than the one that has put all of them in one department. There is however, a caveat rider to it. The organisation has to develop integrating mechanisms commensurate with the degree of differentiation. The requirements of integration (i.e., coordination/conflict resolution mechanisms) increase with differentiation. The research studies have shown that organisations which had differentiated

more but are not integrated appropriately are poorer in performance than those which had not differentiated as much[12].

It may be added here that except in a few simple organisations, organisation structure may rarely be found in pure form. In a large complex organisation the mixed structure is more a rule than an exception.

The style and skill dimensions put constraints on the creation of an appropriate structure. For instance, if the style cannot be changed to help decentralisation, little advantage will be gained by divisionalisation. Similarly, if a functionally organised enterprise cannot develop the functional specialists to be the general managers, little can be gained by changing to profit-oriented divisional structure at the cost of economies of scale and specialisation. Indeed, if the style and skills cannot be changed, the structure may not meet the demands of environment and strategy. Structure itself, thus, at times, affects the strategy.

Activity 3

Identify the main features of the environment of your organisation. To what extent, do you think, the structure of your organisation meets/does not meet the demands of the environment?

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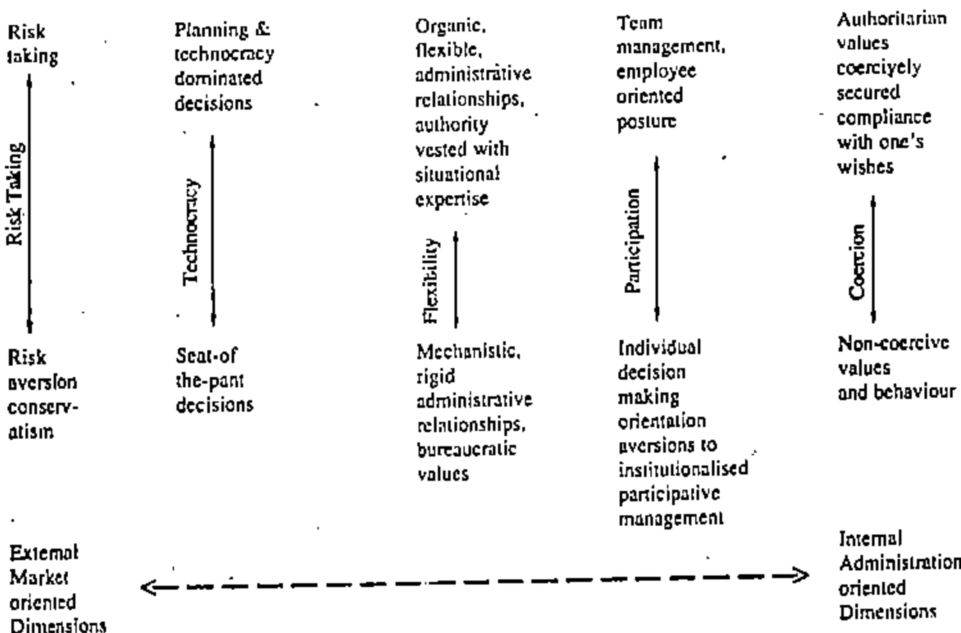
15.4 LEADERSHIP

Developing appropriate leadership is one of the most important elements in the implementation of a strategy. This is important because leaders are key organic elements who help an organisation cope with changes. Appropriate leadership is necessary, though not a sufficient condition, for mobilising people, and for developing effective structure and systems for the success of strategy. Failure of leadership may lead to difficulties in achieving goal congruence, communication breakdown, ambiguity with regard to roles of sub-units, and difficulty in obtaining commitment to a plan e.g., staff conflicts and lack of strategic thinking. Leadership is the key factor for developing and maintaining the right culture and climate.

Figure 15.5 : Dimensions of Leadership Styles



Source: Khandwalla, P.N. (1977) p. 399.

There are several aspects of leadership styles and skills, some of them are more appropriate to the context/content of a strategy, while others are desirable attributes in general for the success of an organisation.

Leadership styles are manifested through the orientations, Khandwalla has identified five orientations (dimensions of style) namely, the *risk taking* (willingness to make high risk, high return decisions), *optimisation* (degree of commitment to the use of planning, and management science techniques in decision making by technically qualified people vis-a-vi. seat-or-the pant decisions), *flexibility* (degree of looseness and flexibility in organisation structuring), *participation* (of those other than the ones holding key positions) and coercion (use of fear and domination)[13] (see Figure 15.5). For superior performance on key organisation goals he proposes that if

- the orientation of top management is risk taking, then it should be at least moderately organic and coercive in proportion to internal resistance to change.
- the orientation is risk aversive, then it should be moderately mechanistic and non-coercive.
- the orientation is of highly optimisation type, then it should be strongly participative.
- the orientation is highly seat-or-the-pant and non-technocratic, then it should be at least moderately risk taking and non-participative.

Figure 15.6 : Seven Styles of Top Management

Leadership Style	Risk Taking	Technocracy (Optimisation)	Flexibility Organicity	Participation	Coercion
1 Entrepreneurial	High	Moderate to low	Moderate to high	Moderate to low	Variable
2 Neoscientific	Variable	High	Moderate to low	High	Moderate to low
3 Quasi-scientific	Variable	High	Moderate to low	Moderate to low	Moderate to high
4 Muddling through	Moderate to low	Low	Moderate to high	Moderate to low	Moderate to high
5 Conservative	Low	Moderate to low	Moderate to low	Moderate to low	Variable
6 Democratic	Moderate to low	Moderate to low	Moderate to high	High	Variable
7 Middle of the Road	Moderate	Moderate	Moderate	Moderate to low	Moderate to low

Source: Khandwalla, P.N., "Some Top Management Styles : Their Context and Performance", *Organisation and Administrative Sciences*, Vol. 7, No.4, Winter 1976. p. 27.

Different leadership styles have "good fit" with different environments. Since the strategy determines the product/market scope, and also the environment in which the organisation is going to operate in future, it has a bearing on leadership style. Khandwalla has further categorised leadership styles into seven types to relate them to environment, each reflecting different mix of the five orientations, as shown in Figure 15.6.

Like leadership, there are several dimensions of environment also, namely, the degree of turbulence/volatality (high degree of changeability/unpredictability), hostility (hostile environment are highly risky and overwhelming), heterogeneity (diversity of markets/ consumers), restrictiveness (economic, social, legal & political constraints) and the degree of technological sophistication. The leadership styles which are more appropriate to different types of environment are shown in Figure 15.7.

It should be noted that while the above discussion gives a good idea of orientations and the styles of leadership to respond effectively to the environmental demands, it does not cover the leadership skills required for "revitalisation" or "transformation" of the organisation[14]. The above discussion gives the attributes of a manager who is a "transactional" leader, and not a "transformational" leader. The task of a "transformation" or "revitalisation" leader is to take the organisation to a dominant position. This involves managing change or transition. It has three distinctive phases.

- Recognising the need for revitalisation
- Creating a new vision
- Institutionalising change.

Figure 15.7 Environment-Style Fit

Environment		Styles
Turbulence	High	Entrepreneurial, neo scientific
	Medium	Neo scientific, middle of the road
	Low	Conservative
Hostility	High	Entrepreneurial
	Medium	Neo scientific
	Low	Neo scientific, Conservative
Diversity	High	Entrepreneurial, Neoscientific
	Medium	Muddling through, middle of the road
	Low	Neoscientific, conservative, entrepreneurial, quasi-scientific
Restrictive-ness	High	Neo scientific, entrepreneurial
	Medium	Entrepreneurial, conservative
	Low	
Technological Complexity	High	Entrepreneurial, Neoscientific,
	Medium	quasi-scientific
	Low	Democratic

Source : Khandwalla, P.N. "Some Top Management Styles : Their Context and Performance", *Organisation and Administrative Sciences*, Vol. 7. No.4, Winter 1976, p. 27.

The leadership task in the first phase requires the ability to sense the need for change (often there is a low threshold to catch trigger events in the environment). The second phase requires communication skills to create a vision for future that excites people to move, and also the interpersonal skills and creativity to mobilise commitment of at least a critical mass in the organisation. To perform the task in the third phase of the transformation process the leader should have the ability to understand and manage powerful conflicting forces in people. The negative emotions and threats to power and authority have to be transformed into positive emotions and reconciliation. New ways of working, new styles, new culture, and new norms have to be developed. The shock of change has to be reduced.

The challenges of leadership in implementation are the gravest as leadership is the most scarce resource. Organisations cope with it in several ways, by changing the current leadership and by developing appropriate leadership styles. The change of current leadership may not be easy to achieve even though it might be inevitable for effecting "transformation" in the situation. The existing leadership might have been cast in a particular mold which may be inappropriate to the demands of the organisation. The "casting" effect can be overcome if changes are introduced gradually in the leadership styles and skills, to avoid accumulated lags or mismatches between existing leadership styles/skills and company's changed requirements. This would require a blueprint to indicate the kinds of styles and skills, and the number of persons of different styles and skills required in future, current talent available and a plan of recruitment and grooming. The task of human resources development is thus very closely related and determined by strategy of the organisation.

Activity 4

Describe basic features of the top management styles in your organisation. Compare them with the styles necessary to match the demands of your organisation.

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15.5 FUNCTIONAL STRATEGIES

The strategies have to be ultimately translated into business operations. The operating decisions are taken by middle and junior level managers. Functional policies provide

guidelines to operating managers so that (a) the strategies are implemented, (b) executive time in decision making is reduced, (c) similar situations are handled consistently and (d) coordination across functional units takes place. Once the strategy of the company is decided, modification in functional policies may become necessary to meet the demands of new business or new business philosophy, particularly if a major deviation in product/ market scope is contemplated. This becomes all the more necessary in the Indian context where unrelated diversification is not uncommon and where large-scale sickness of business exists. Depending upon the changes in the present business and the method of its management, the magnitude of modifications may range from a few minor ones to total revamping of functional policies. For instance, a company might plan an expansion in sales by introducing instalment schemes. This may need some alteration in the financial policies. On the other hand, if a company growing only at a 5% rate wants to be the leader in the industry and has the ambition of appearing on world scene, major changes may be imperative not only in financial but also in technology production, marketing, personnel and R&D policies. The functional policies should be comprehensive; they should not leave so much choice to operating managers that they work suboptimally or at cross purposes. At the same time, the policies should be flexible enough to leave room to managers for responding quickly to situations and make exceptions for good reasons. The firm should have policies in every major aspect of business, at least in key functional areas.

In the financial management area, the major policies relate to the arrangement and deployment of funds. Major issues involved are the sources from where the funds will come, from owners (equity) or by borrowing. How much of the borrowing will be short-term and how much long-term? In terms of usage of funds, the policy decisions would relate to whether and to what extent funds have to be deployed in long-term (fixed) and short-term (current) assets. The long-term or capital investment decisions relate to buying or leasing the fixed assets. A retrenchment strategy or paucity of funds may compel the organisation to lease rather than buy. In case of an organisation where capital investment decisions are decentralised, a "hurdle rate" may be fixed so as to avoid investment in weaker projects by one division and non-investment by another division, as discussed in section 15.2 (Resource Allocation).

Apart from capital budgeting, another consideration in financial management which influences other functional areas is the cashflow. A company may frame bonus and dividend policies based on availability of cash. In case a company proposes expansion through internally generated funds, it may reduce bonus and dividend. This is particularly so when it has formulated ambitious growth policies which require huge cash. Similarly, if the firm has high risk business, it should have a conservative debt/equity ratio to guard against falling in red due to heavy interest burden.

The funds position and optimisation orientation of top management also determine the accounts receivable and payable policies. Financial policies may even determine the account keeping (e.g. LIFO or FIFO) as these affect the profitability, balance sheet and hence cashflow through tax, dividend, bonus, etc.

Functional policies in marketing area are required for marketing- mix decisions, namely, the four Ps (Product design, Product distribution, Pricing, and Promotion) of marketing. In terms of specifics, the product decisions relate to such issues as the variety of product/ service (shape, size, models, etc.), completeness of the line, quality requirements, introduction/withdrawal of products, nature of customers, etc. Specific policies are also necessary regarding distribution channels, i.e., through retailers or direct selling? What will be the spread of distribution network? Whether new dealers will be established or old ones developed? What will be the terms of contract with dealers and the nature/extent of after-sales service (wherever necessary). The promotion policies will relate to mode of promotion, coverage and nature (corporate/product or brand promotion). Very clear and specific policies will have to be made about pricing, e.g., full cost or standard cost based pricing. In the case of latter, at what sales levels? Offensive vs. defensive postures also influence pricing policies.

The functions relating to production will need policies relating to quality assurance, machine utilisation, location of facilities, balancing the line, scheduling of production, and materials management. The strategy for entering into export market will dictate a different policy regarding quality of products and maintenance. In case of common facilities policies of prioritisation will have to be made for scheduling production. Location of facilities may be determined by closeness to market or input supply points. Policies must be made to

determine whether and how much to make or buy, on the basis of cost differential, certainty regarding availability, criticality of the item, ability to follow up procurement action for production, capacity utilisation of the existing plant & facility and alternative uses of expanded capacity if expansion becomes necessary. In case of bought out items, policies regarding the number of suppliers and the criteria for selecting them are necessary.

In the area of research and development, functional policies regarding nature of research are necessary. In case of expansion through new product development, heavy emphasis has to be laid on basic and applied research. On the other hand, for expansion in the same line, research emphasis has to be on product/process improvement to cut cost and on added value. It may be noted that in case of basic research the firm should be prepared to commit resources and wait for outcome for several years. It cannot have basic research unless it is prepared to commit resources on long-term basis.

Lastly, functional policies will be necessary in the area of personnel management: what will be the compensation/ incentive system to get the best out of the people and to make them fit for desired positions in the organisation? What compensation/incentive system will be able to attract people of the desired type to join the organisation so as to meet the task requirements demanded by the strategy? What policies will be necessary for grooming internal people for new positions? The problem becomes acute in the context of turnaround strategies. On the one hand, the most competent people leave and the firm finds it difficult to attract suitable replacements. On the other hand, it faces problem of surplus staff. Retrenchment policies, though painful, are quite necessary but difficult to develop.

The functional policies have a lot of interlinkages between themselves and, therefore, cannot be developed independent of each other. Attempts to do so, for whatever reason, may lead to chaos and serious mismatches, resulting in failure of the strategy.

Activity 5

List the main functional policies in your organisation. What mismatch, if any, do you notice among them?

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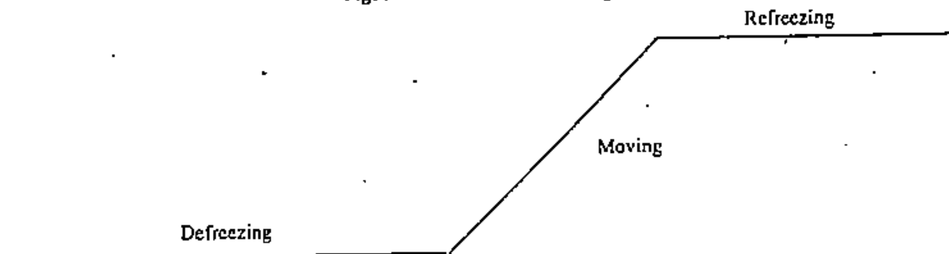
15.6 CHALLENGE OF CHANGE

The strategy implementation process generally involves a change. The change can be minor or major. If it affects a large number of people, cuts into deeper issues like beliefs, values etc., it is major change. The process of change becomes more difficult because it involves "unlearning" and them "relearning". The process of change has three stages namely unfreezing, moving and refreezing as shown in Figure 15.8

Figure 15.8 : Process of Change



Challenge of change comes in implementation in all the six Ss of the 7-S model. Adjustment means adjustment in the people. The change in strategy may mean acquiring new skills, change in power structure, change in style, change in values, norms, etc. The more the number of Ss affected by strategy, the more the challenge of change.

The problem is compounded if the degree of freezing is very high. For instance, poor quality products might have been tolerated for too long. If the company decides to enter in a big way in the international market which demands very high quality standards, the company may find it difficult to enforce quality standards.

Similarly, if the organisation is in serious trouble because it has been failing consistently for quite sometime, the morale may be low and people may start leaving. Holding staff members and enthusing them to work may not be easy. Indeed it is the challenge of managing change that determines the acceptable level of plan and performance. The tentative strategy and aspiration levels for desired performance are tested on the anvil of challenge of change to decide whether they are okay or ought to be modified.

15.7 COMMUNICATION OF STRATEGY

Communication of strategy, covering the mission, objectives, product/market scope, technology and all the issues relating to implementation, to different levels in the organisation is very important for its success. This is so because strategy is implemented through people who ought to be clear about the roles they have to play in relation to each other. This should be done as clearly and directly as possible to avoid doubts and confusion which are quite likely to arise if people have to interpret the roles from the behaviour and oblique references. The confusion may lead to people working without direction and at times even at cross purposes. The clarity of communication may assume critical proportions if there are major shifts in product/market scope, structure, system, etc. It is also necessary to overcome resistance to change arising out of anxiety and lack of participation in the strategy development process. The challenges of communication are really great in a turnaround strategy when morale is low and a vision is to be created promising a brighter future. Formal corporate plan is a good instrument for communicating strategy, although in many cases it does not cover the significant issues of implementation.

While there is a strong need for communicating strategy, there may be several difficulties in announcing it loud and clear. The strategy may include an approach for meeting competition. It may be necessary to keep this as a closely guarded secret lest the competitors come to know and sabotage it by counter strategies.

Formal announcement of strategy may also lead to reactions from regulatory agencies and others. This is particularly so in case of large business houses covered under MRTP/FERA, etc. where announcement of high profile aggressive growth strategies may lead to hostile reactions. Such announcements may also be quite embarrassing if deficiency in formulation or implementation of the strategy are found later.

Implementation of strategy, more often than not, implies a change. If the change is a major one like restructuring bringing major reforms in work norms, etc., it may lead to strong reactions. The political process involved may lead to serious difficulties if the strategy is announced in unrestricted way. The situation may be really grave if there are factions and cliques in the organisation particularly at top management levels.

Strategies have motivational aspects too. Growth strategies are popular because they promise incentives in terms of financial benefits as also career growth. Retrenchment strategies on the other hand are unpleasant and those affected are likely to have low morale and may actively oppose it, making the task of implementation difficult.

Given the above difficulties and risks associated with unrestricted announcement of strategy, it is necessary to understand that the communication has to be restricted. The announcement should not be premature.

15.8 PRE-IMPLEMENTATION EVALUATION OF STRATEGY

Before you effect the implementation of strategy, it is advisable for you to subject it to a final scrutiny so as to avoid failures due to weaknesses in the analysis, if any, and to ensure that strategy decided for the organisation is optimal. It is something like checking all the electrical connections before switching on the circuit. There are several checkpoints that may be used for evaluation as given below[15]:

- Is the strategy easily identifiable and can it be easily communicated?
- Is the strategy unique for the organisation? If so, can it be easily imitated by the competing organisations?
- Does the strategy exploit the opportunities and corporate resources to the maximum?
- Is it consistent with the corporate resources and competencies, both the present and the future?
- Are the major provisions of the strategy and the resultant programmes and policies internally consistent?
- Is the chosen level of risk commensurate with the organisations capacity to sustain the shocks associated with the risk?
- Does the strategy meet the aspiration levels and personal values of the key executives?
- Does the strategy fulfil the minimum expectations of the society?
- Will the strategy provide clear stimulus to organisational efforts and commitment?
- Are the key executives confident of effecting the change associated with the implementation?

15.9 SUMMARY

The success of strategy depends to a large extent on the efficacy of implementation. Indeed, the limits to the size and scope of workable strategic plans are set by the associated challenges of implementation. The complexities in the task of implementation arise from the number of organisational adjustments relating to structure, systems, skills, culture, resources, etc. needed and the demands of matching them all. The difficulties in effecting the organisational adjustments arise from the tasks associated with managing change. Poor appreciation of the tasks of implementation and issues involved in it, many a time, lead to selection of inappropriate strategies. Before finally deciding the strategy and effecting implementation it is imperative to have an evaluation. The final corporate strategy is thus a package covering the mission, objectives and product/market scope on the one hand and policies, programmes etc. relating to the implementation on the other.

15.10 KEY CONCEPTS/TERMS

BCG Matrix
Differentiation
Human Resource Development
Integration
Internal Rate of Return
Net Present Value
Payback Period
Pooled Interdependence
Portfolio Approach
Product Life Cycle
Product/Market Scope
Reciprocal Interdependence
Residual Income
Return on Investment
Sequential Interdependence
Strategic Business Units (SBUs)
Transformational Leader
Zero-base Budgeting

15.11 SELF-ASSESSMENT QUESTIONS

1 What is strategy implementation? Why is the task of implementation complex and difficult?

2 Discuss various methods of resource allocation. Would you recommend Return on Investment (ROI) or Residual Income method for capital investment in a multi-business divisionally structured company?

3 Discuss the advantages and disadvantages of different types of organisation structures.

4 What is the need for formulating functional policies? What care should be taken while developing them?

5 What is the importance of communicating strategy? What are the difficulties involved in communicating strategy?

6 Why pre-implementation evaluation of strategy is important? What checkpoints would you like to use in pre-implementation evaluation?

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UNIT 16 EVALUATION AND CONTROL OF STRATEGY

Objectives

After studying this unit, you should be able to appreciate

- why enterprises must evaluate strategy after implementing it
- what the evaluation process is
- how one decides the measures for evaluation
- what types of standards are used for evaluation
- how performance deviations are controlled from the set standards.

Structure

16.1 Introduction
16.2 Evaluation and Control Process
16.3 Key Variables
16.4 Performance Standards
16.5 Structure for Evaluation and Control
16.6 Evaluation System in a Multi-business Company
16.7 Analysis and Follow up action for Control
16.8 Problems of Control Systems
16.9 Summary
16.10 Key Concepts/Terms
16.11 Self-assessment Questions
16.12 Further Readings.

16.1 INTRODUCTION

With the completion of the strategy implementation, the organisation looks forward to achieving the desired goals and objectives. It is necessary, however, to introduce the process of strategy evaluation and control in the early stages of implementation, to see whether the strategy is successful or not and to carry out mid-course corrections wherever necessary. There are several reasons why a strategy may not lead to desired results. The external environment may not actually follow a trend as was expected at the time of planning the strategy. The internal changes within the organisation such as the organisational systems consisting of structure, policies and procedures may not reflect harmony with the strategy. After a while, the top management or even middle-level managers may find it difficult to exercise a substantial degree of control over operating systems. The unexpected moves of the competitors might create major gaps in the strategy. Thus the list of such factors will require a continuous evaluation and control of strategy. In this unit we will describe the process of evaluating a strategy while it is being implemented.

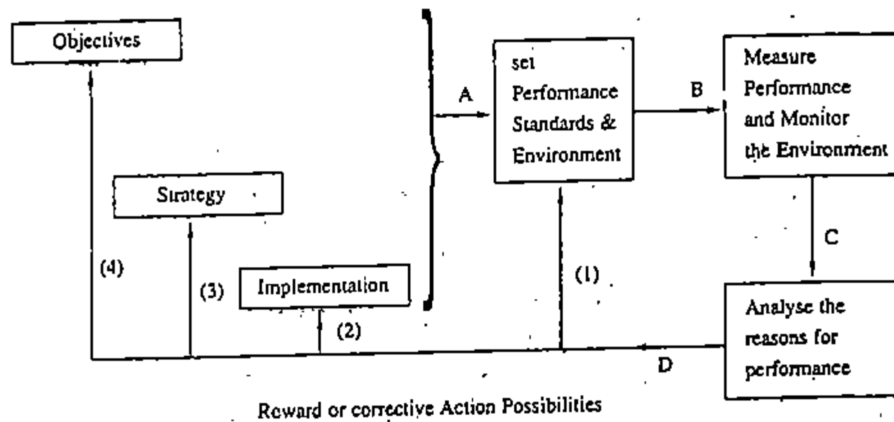
16.2 EVALUATION AND CONTROL PROCESS

The design aspect of a strategy evaluation system follows from the following considerations[1]:

a) Where are the unexpected changes? Are these external or internal to organisation? If external, are they in terms of policy changes or at the market level? If internal, are they in the form of resource constraints or failure of operating systems?
b) There is a natural tendency in all organisations to go out of control on account of quality of leadership and the cultural profile of employees.
c) The availability of techniques within the organisation for undertaking the evaluation of strategy.

The evaluation of a corporate strategy can be done qualitatively as well as quantitatively. The quantitative evaluation is based on data and is possible through post facto analysis to detect whether the content of strategy is working or has worked. However qualitative

Figure 16.1: Evaluation and Control of Strategy



Source : Glueck W.F., p. 393.

evaluation can also be done by addressing the question : Will it work? The qualitative evaluation can thus be done before activating plans of change. As already discussed in an earlier unit, the qualitative evaluation of strategy after implementation is based on following criteria[2]:

- Does each area of policy form part of an integrated pattern?
- Does each policy area meet the current demands of the environment?
- Does the strategy involve deploying all the critical resources?
- Given the values of management towards risk, does the strategy meet its preferences?
- Are the appropriate time-related goals laid down or not?
- Does the strategy achieve the enterprise objectives or not?

The quantitative evaluation and control of strategy is a real time process. The performance of strategy is monitored and corrective actions are taken to make alteration as and where necessary. The process of evaluation and control of strategy has been shown in Figure 16.1. The first phase of this process consists of selecting the key success factors, developing measures and setting standards for the same, and collecting information about actual state (performance on these measures). The second phase consists of comparison with the standards laid down and initiating action to alter performance, wherever necessary. The follow up action could relate to people/business or both and could be tactical or strategic. For instance, if the business has not picked up as expected, it may be necessary to increase promotional efforts, or revise the product policy, or as a last resort, the firm may pull out of a particular business.

It is necessary to maintain a distinction between the follow up action towards business/ people and evaluation/control process. If major changes in environment have taken place or if major assumptions about environment have gone wrong, it may be improper to give credit or discredit to the people for the deviation in performance from standards set. At the same time good performance of a strategy may not be due to good performance of the people as there may be windfall gains due to changes in the environment not imagined at the time of setting the standards of performance or targets.

From Figure 16.1 you would realise that the process of evaluation is quite complex and there are several pitfalls in proper evaluation and control. The success of an organisation is gauged by its effectiveness and efficiency. Effectiveness is measured by the degree to which the organisation has achieved its objectives while efficiency refers to the manner of resource utilisation for achieving the output. The two can thus be represented as below :

a) $\text{Effectiveness} = \dfrac{\text{Output}}{\text{Objectives}}$ b) $\text{Efficiency} = \dfrac{\text{Output}}{\text{Input}}$

It is easy to evaluate efficiency by comparing output/input of various organisations or organisation units with one another. Inputs, by and large, are always quantifiable. An organisation is more efficient than the other if it uses less resources (inputs) than another for

the same output or if for the same input it gives more output. The latter case requires output to be measured in quantitative terms and hence is more difficult to assess.

Measurement of effectiveness has both numerator and denominator which are comparatively more difficult to quanti. . Hence assessment of effectiveness is more difficult than the assessment of efficiency of the organisation.

The success of corporate strategy should be evaluated both in terms of efficiency and effectiveness. It is, however, not common to find an efficient but in effective organisation or vice versa.

In a profit oriented organisation, profit becomes a surrogate measure for both efficiency as well as effectiveness[3]. Profit, is the difference between revenue and expense, and thus is a measure of efficiency. Being the objective itself, profit also becomes a measure of effectiveness. In organisations with multiple objectives, the situation is different if the surrogate measures like profit are not available/not sufficient for evaluating the strategy. In such cases the major problem in evaluating the strategy is to develop measures for evaluating the strategy. The problem is solved by identifying the key variables or key success factors which are measures of performance of certain key activities of the organisation.

Activity 1

Analyse the periodical evaluation and control reports in your organisation. Do they emphasise effectiveness or efficiency?

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16.3 KEY VARIABLES

Key variables, key success factors or critical success factors are most important for a successful strategy. A typical list of such factors for a business organisation is shown below:

Marketing	Production	Assets Management	Personnel
Sales, Orderbook Position Market share Gross Margin or Repeat orders	Capacity Utilisation, Cost of Production Timely deliveries	Inventory Turnover Sundry Debtors Returns on Investment	Employee Turnover, Absentee-ism Man-days lost in strikes

It must be noted that the key variables for designing the system of evaluation and control differ from business (and thus organisation) to business (organisation). Also in a large multi-business organisation, they may vary from one organisation unit/level to another.

This is particularly true in the Indian context where unrelated business strategies are not necessarily unsuccessful or uncommon. A company may be in textile and pharmaceutical businesses simultaneously as also in vegetable oils and computers. The environment permits that it is therefore all the more necessary to avoid getting bogged down with a standard or uniform set of key variables for all the organisations. Knowledge of key characteristics of industry in which the business falls is thus imperative and useful for identifying key success factors. Some of the key variables on the other hand will emerge from the company's functional strategies. For instance, if a company has proposed aggressive strategies, the number of new products introduced in a period will be a key success factor. The guideline for identifying key variables has been provided by Anthony[4] as below :

- Is it **Important** in explaining the success or failure of the organisation?
- Is it **volatile** and can change quickly, often for reasons not controllable by the managers?
- Is it **significant** enough to require prompt action when a change occurs?
- Is it not easy to **predict** changes in key variables?
- **Can the variable be measured, either directly or via a surrogate?** For instance, customer satisfaction cannot be measured, but its surrogate, number of sales returns can be a key variable.

Activity 2

For the following businesses, identify the key success factors for evaluating the success of their respective strategies :

	Business	Key Success Factors		
a)	Bank	(1)	(2)	(3)
		(4)	(5)	(6)
b)	TV Manufacturer	(1)	(2)	(3)
		(4)	(5)	(6)
c)	A National University	(1)	(2)	(3)
		(4)	(5)	(6)
d)	A Large Retail Outlet	(1)	(2)	(3)
		(4)	(5)	(6)
e)	Police Department	(1)	(2)	(3)
		(4)	(5)	(6)
f)	Life Insurance Co.	(1)	(2)	(3)
		(4)	(5)	(6)
g)	Exporter	(1)	(2)	(3)
		(4)	(5)	(6)

16.4 PERFORMANCE STANDARDS

Having identified the measures relevant for assessing the success of the strategy, the next important issue is to set the standards against which actual performance is to be measured. The standards of performance could be any of the following three types.

a) Historical Standards

In this type of standards, comparison of present performance is made with the past performance. Though simplest, this type does not take into account the changes in environmental conditions between the two periods. Moreover the prior-period performance itself may not have been acceptable. It also could be misleading in the formative years when the numerator (previous years figures) is small.

b) Industry Standards

In this type of standards, the comparison of a firms' performance is made against similar other firms in the industry. The difficulty here is that all the firms may not be exactly the same for purposes of comparison.

c) Present Standards

The goals/targets are decided by the firm's management to be achieved in a particular period. Present standards convey the aspiration levels and take into account environmental conditions if properly derived. These are more realistic and also consider the organisations' capacity to achieve them. These, however, require tremendous analysis. Absence of such analysis may lead to shocking results. However, for a company developing a conscious strategy, present standards provide the best alternative.

Activity 3

What kinds of standards are being used in your organisation? What, in your view, are the problems arising out of it?

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16.5 STRUCTURE FOR EVALUATION AND CONTROL

For effective implementation of strategy, it is necessary that someone is made exclusively responsible for carrying out the operations. Responsibility centres, therefore, may be created for achieving the objective of the organisation following the selected strategy. The responsibility centres should have full freedom to take operational decisions relevant to their businesses. To an extent the responsibility centres will be restricted in taking decisions relating to functional policies as those decisions will not be within the jurisdiction of them.

Responsibility centres may be of several types. In a profit oriented organisation, there could be profit centres, there could be revenue centres or there could be expense or cost centres.

Profit centre managers are responsible for profits. They have full freedom to decide their level of sales, margins and production, what to make and what to buy, etc. At times, however, they do not have jurisdiction over financial policies (sources of financing) and basic personnel policies. The revenue centre heads are held responsible for generating the revenue (within the approved costs) and cost centre heads are responsible for costs for a certain level of production or activities.

In the functional structure the only person who can be held responsible for profits is the chief executive, since the very next level below (i.e., the functional heads) does not have operational jurisdiction over issues related to other functional areas (but which influence profits all the same). Functional structure of the organisation can thus have revenue and expense centres. In divisional structure the divisions will have most of the key operational decisions under their jurisdiction. Hence they can have profit centres for the success of strategy. The structure, thus, facilitates keeping of records for managerial accounting (so crucial for strategic decisions and strategy evaluation), and taking up/divesting a new product/business. The most appropriate structure for strategy of growth through diversification or expansion is to create profit centres in the form of divisional structure. Divisional structure also facilitates grooming of functional executives as general managers, although it dilutes the functional specialisation to some extent. The holding company-subsidiary structure also provides similar advantages from evaluation and control point of view, though it limits the scope of business portfolio management as different companies may be catering to different businesses.

The product divisional structure does not provide any significant advantage for growth through expansion in the same business or through (backward/forward) vertical integration. It is so because little flexibility is available to the divisions involved in the intermediate stages of production and all of them stand or fall together with changes in environment. Indeed it may be more appropriate in such cases to make the marketing division as revenue centres and production divisions as expense centres. The situation may be different if the intermediate product lines too have a significant market of their own. In such cases, making all such divisions as profit centres may be advisable.

Activity 4

What kind of responsibility centres exist in your organisation? If you were given a free hand, what responsibility centres you would have created? Why?

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16.6 EVALUATION SYSTEM IN A MULTI-BUSINESS COMPANY

The identification of key success factors and their exact trend values is a complex process because of inter-business unit transfers of goods and services. Often these transfers take place at price levels which might suppress the true profitability of the supplying division. In

such cases transfer price adjustments are carried out for the purpose of fair evaluation of each unit.

In a multi-product/multi-business company, having several divisions as profit centres, there may be several products/components which are manufactured and sold by one division and at the same time required by others for their product/business. In such case a system of transfer pricing needs to be developed for transfer of products/components from one division to another, otherwise a situation may arise when two divisions may take decisions which may be against the overall interest of the company. For instance, take two divisions A & B as profit centres. Division A produces a component which is a monopoly

Division A		Division B: Situation I		Division B: Situation II	
Cost of component A	70	Cost of other Com.B	185	Cost of other Comp. B	185
Profit Margin	30	Cost of component A	100	Cost of Component A	85
Price	100	Profit margin	15	Profit margin	30
		Sale Price	300	Sale Price	300
Profit / Sale	30%	Profit / Sale	5%	Profit / Sale	10%

	If A does not reduce price	If A reduce price
Division A gets	30	15
Division B gets	—	30
Company gets	30	45

item and can fetch a margin as high as Rs. 30. The component price is say Rs. 100. Division B needs this component for one of its products. However, if it gets it at a price of Rs. 100, it cannot earn any profit on its product. Division A is not prepared to reduce its price to Rs. 85 as it cuts into its margin by Rs. 15 to give 10% return on sales to Division B. Division B is left with two options to ensure 10% cut off return for its operations, either to drop the product or invest in facilities. The minimum size of facilities is far in excess of the requirements of the product in Division B, hence it will have to sell in open market. The prices in that case are likely to fall to Rs. 75 a piece. Division B may also not like to divert its energies to sell the component separately. It will, therefore, decide to drop the product. The actions of Divisions A & B in maintaining profitability of their respective division thus lead to loss to the company as a whole on the margin that was available to it on product B, if only Division A had reduced the price a bit.

Similar would be the case if Division A has created capacity to meet the requirements of Division B. However, at a later stage, a situation of glut appears and the other suppliers resort to heavy price cutting, and B decides to purchase from open market at a price which A cannot afford to supply without running into losses. The situation may be even more damaging to the company, if the price reduction by the other supplier was to force some of the manufactures (like Division A) to close the manufacturing facilities for the component and to rise prices again after the closures. Not only the company as a whole but even Division B will be a loser.

It would be realised that there are two issues involved in situations of transfer pricing, Firstly, the sourcing decision, i.e., whether the product is to bought/sold by a division internally or externally. In view of profit centres as independent responsibility centres, normally the divisions should be allowed to decide it themselves. But a situation may arise when the intervention of top management may be necessary to give sourcing decisions to ensure that buying/selling by divisions is in the interest of the company. The second question is what should be the (transfer) price for the transfer of goods from one division to another.

It should be remembered that the purpose of transfer pricing is not to encourage inefficient operation by dictating a transfer price that will fetch a profit, but to ensure a fair price to the concerned divisions in the absence of an open and free competitive market price. That unifies the interests of the divisions with the interest of the company. Thus, whenever market place prices are available and when the divisions can meet all their requirements of buying and selling there may be no need of intervention. Indeed even when these conditions

do not prevail, the level of inter-division transfer may not be significant. Or no intervention may be necessary/advisable.

Activity 5

Is transfer pricing used in your organisation? If so, which method is being followed and what problems, if any, are arising due to it? If not, which method you would like to suggest for your organisation?

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16.7 ANALYSIS AND FOLLOW UP ACTION FOR CONTROL

Once the actual operations start, information about the actual performance has to be collected periodically and compared with the standards set. If the objectives or major components of strategy include such factors as market leadership, information about market share will also have to be collected. Information may also be collected regarding performance of the other key factors. If the performance on key success factors is unsatisfactory, the long-term success of the strategy may be endangered. This may be despite the current success which may be due to favourable current environment, for example, boom in the industry, scarcity etc.

If the performance is unsatisfactory, two courses of action are possible. The responsibility centre manager may be asked to improve performance, or if it is not possible, target or standards of performance may be revised.

The evaluation and control reports may be of two types namely the motivational and the economic reports[5]. The motivational reports relate to the performance of the people in the responsibility centres. Economic reports are concerned with the economic performance of the responsibility centres. The basic difference in the two is that while the latter gives actual economic performance covering all factors, the former reports the performance of a responsibility centre. For instance, while an economic report will include all costs, the motivational report will include only those items of cost over which he has control.

For example, the division may not have any control over purchase price of materials, but it may have control over material consumption. Similarly, the responsibility centre has control over market share while it may not have control over industry volume. It is advisable to keep the two reports separate. For instance, if the economic performance is going down despite best efforts of the responsibility centre, there may be need to make a shift in the strategy. Similarly, strategic performance based on economic reports may be satisfactory but still there may be need for modification of the strategy if the good performance is due to unexpected favourable developments.

From the control point of view the reports must be timely, otherwise corrective action may not be possible. The frequency of reports is determined by the lead time required for corrective action and is constrained by the lead time for processing the transactional data and its transmittal to retrieve data in the form of reports. If on the other hand, the evaluations are made too early kneejerk reactions are likely which may hurt the plan.

A strategy need not be changed or abandoned just because evaluation has revealed the causes of poor performance over a short period. It should be tested for a sufficiently long period of time because certain assumptions might have gone wrong and there was no contingency plan to take care of such situations. If even after reasonable period of time the performance is not coming up to expectations, it may be due to serious deficiencies in the business strategy. However, before changing the strategy, it would be advisable to check its

implementation on the test of adequacy. It is quite possible that some of the Ss of the 7-S model may be grossly out of line with the strategy. And, if corrected, the strategy may still be quite useful. However, there might have been serious errors in assessing the external and internal environments even though the evaluation of implementation reveals no major mismatches. The assessment may also reveal that it is impossible for the management to make other 6-Ss matching with the strategy. In such cases it may be imperative to modify or change the strategy.

Activity 6

How are the targets fixed for various divisions/departments in your organisation? How and why are the targets revised? Give comments on the duration of target fixing and revising.

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16.8 PROBLEMS OF CONTROL SYSTEMS

There are a large number of problems associated with control systems for strategy evaluation. An efficient system may collect a lot of irrelevant data whereas a sophisticated system might ignore crucial information. Some of the typical problems encountered in designing and managing control system are :

- These may not be a consensus on the criteria for measuring the effectiveness and efficiency of the strategy.
- The reporting data may be invalid.
- The performance norms may be based on outputs on which the relevant business may not have a control.
- Often performance standards may be set with inherent contradictions. For example, an increase in market share may be expected in conjunction with an absolute decrease in marketing expenditure.
- Employees may consider the system to be unfair and therefore may not accept it.
- Overemphasis on measuring short-term performance may make managers forget about the strategy which inherently has long connotations.
- It is very difficult to set "good", "average" and "poor" levels of performance in situations where the outputs are not very tangible.

16.9 SUMMARY

An effective system of evaluation and control is important for the success of corporate strategy. It is also necessary for taking decisions on whether strategy should be continued or modified. The success of a strategy should be considered both in terms of effectiveness and efficiency. While it is easy to measure efficiency, it is relatively more difficult to measure effectiveness.

The problem in evaluation and control is that of developing appropriate measures. The key variables of the organisation may guide the duration of measures for evaluation and control. Structure also plays an important role in evaluation and control of strategy. Defective structures may lead to inadequate evaluation and control. The economic performance of an organisation unit must be distinguished from the performance of people of the unit from the viewpoint of follow-up action. Factors which are not under the control of a responsibility centre must be excluded from the reports in evaluating the performance of the responsibility centre people. For evaluation of a strategy for concrete action, all factors of cost and environment must be included. On the basis of evaluation the corrective action may be taken. if the performance is not up to the planned levels. If it is found that the performance of the responsibility centre is not improving or is unlikely to improve, the targets may be revised.

If there are successive failures, the strategy may have to be abandoned. Before abandoning the strategy, however, an examination should be made as to whether implementation has been adequate.

16.10 KEY CONCEPTS/TERMS

Economic Reports
Effectiveness
Efficiency
Expense Centre
Key Variables
Motivational Reports
Profit Centre
Responsibility Centres
Revenue Centre
Transfer Pricing

16.11 SELF-ASSESSMENT QUESTIONS

1 What are the 'key success factors' in the organisational context? How would you determine them?
2 Compare and contrast different types of standards which can be used for evaluation and control of strategy?
3 What is the importance of structure for the evaluation and control of strategy? What are the advantages of profit centres? In what situations is it advisable to set up revenue and expense centres?
4 What is the purpose of transfer pricing? What are the merits and demerits of different methods of transfer pricing?
5 Analyse the case "Punjab Tractors Ltd". What are the other important points which you think the questions given at the end of the case do not cover?

16.12 FURTHER READINGS

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2 Tilles, Seymour. "How to Evaluate Corporate Strategy", Harvard Business Review, July-August 1963, pp. 111-121.
3 Anthony, op. cit., p. 197
4 Ibid.
5 Ibid, p. 127.

NOTES

UNIT 17 TURNAROUND MANAGEMENT

Objectives

After going through this unit, you should be able to appreciate the

- extent of industrial sickness in Indian economy
- symptoms of corporate sickness and its causes
- process and strategies for turning around sick companies
- experiences of turnaround management in public sector undertakings.

Structure

17.1 Introduction
17.2 Incidence of Industrial Sickness in India
17.3 Danger Signals for Corporate Sickness
17.4 Predicting Company Failures
17.5 Causes of Corporate Decline
17.6 Types of Turnaround Strategies
17.7 Turnaround Process
17.8 Turnaround Management in Public Sector Undertakings
17.9 Summary
17.10 Key Concepts/Terms
17.11 Self-assessment Questions
17.12 Further Readings

17.1 INTRODUCTION

A firm is said to be sick when it faces a severe cash crisis or a consistent downtrend in its operating profits. Such firms become insolvent unless appropriate internal and external actions are initiated to change the financial picture of the firm. This process of recovery is called turnaround management. Any successful turnaround management can be broadly classified into three distinct but inter-related phases. The first phase is the diagnosis of impending trouble. Many authors and research studies have isolated distinct early warning signals of corporate sickness. The second phase of turnaround management involves analysing the causes of sickness and choosing appropriate turnaround measures to restore the firm on its profit track. These turnaround measures are of both short-term and long-term nature and have been successfully implemented in companies both in private and public sector. The third and final phase of turnaround management involves implementation of change process and its monitoring. In the case of public sector units, the turnaround management acquires a special character because of restrictions imposed by the controlling institutions. In this unit, we will look into all these aspects of turnaround management.

17.2 INCIDENCE OF INDUSTRIAL SICKNESS IN INDIA

One parameter for measuring the incidence of sickness in an industrial unit is its inability to pay back bank loans. Using this parameter, we have figures for the number of sick units in India from 1980 to 1986 in Table 17.1. This table gives the number of sick units in all industries and the amount of outstanding bank loans. The percentage increase in the number of sick units and their outstanding loan amounts is also presented in the table. This will give you an idea of the increasing dimension of the problem from year to year.

As presented in Table 17.1 there were 24,450 sick units in all industries in India in 1980 which swelled over the years to 1,47,740 in 1986. Their corresponding outstanding loan amounts increased from Rs. 1,809 crores in 1980 to Rs. 4,874 crores in 1986.

Table 17.2 presents an industry-wise picture of industrial sickness in India from 1978 to 1986. As revealed in the Table, the maximum number of sick units are in engineering and textile industries. At the end of June 1986, out of a total of 689 sick units, as many as 213

Table 17.1 : Incidence of Industrial Sickness in India

As at the end of the year	Total units	Outstanding bank loans (Rs. crores)	Percentage increase over the preceding years: No. of units	Percentage increase over the preceding years: Outstanding bank loans
1980	24,550	1,809	—	—
1981	26,758	2,026	8.98	12.00
1982	60,173	2,585	124.87	27.59
1983	80,110	3,101	33.13	19.96
1984	93,282	3,638	16.44	17.32
1985	1,19,606	4,271	28.22	17.40
1986	1,47,740	4,874	23.52	14.11

Source: Economic Survey, 1987 - 88.

belonged to the engineering industry and owed the banks Rs. 954.5 crore. Another 186 units out of a total of 689 belonged to the textile industry and owed the largest amount to banks, aggregating to a figure of Rs. 1,118.4 crore. Engineering and textile units together comprise 57 per cent of all sick units. The total outstanding amount owed by all the 689 sick units belonging to various industries amounted to Rs. 3,238.6 crore in 1986. The other sick units belonged largely to the sugar and jute textile industries. 47 sugar units and 43 jute textile units were sick in 1986 and owed to the banks a total of Rs. 177 crore and Rs. 199.6 crore respectively.

Table 17.2: Industry-wise Industrial Sickness
(Large and Medium Units)

Industry	End of June 1978: No. of units	End of June 1978: Amount of bank credit outstanding (Rs. crores)	End of June 1983: No. of units	End of June 1983: Amount of bank credit outstanding (Rs. crores)	End of June 1986: No. of units	End of June 1986: Amount of bank credit outstanding (Rs. crores)
Engineering*	112	286.2	139	508.2	213	954.5
Textile	78	263.6	119	579.8	186	1,118.4
Chemicals	21	117.9	27	209.2	39	240.1
Sugar	31	79.5	44	180.1	47	177.0
Jute textiles	31	76.6	37	120.5	43	199.6
Rubber	5	25.2	16	108.3	16	127.2
Cement	4	13.7	3	9.2	5	41.3
Miscellaneous	43	93.4	78	197.6	140	480.6
Total	325	956.1	463	1,913.1	689	3,238.6

* Including electrical, iron and steel.

Source: RBI, Report on Currency & Finance, 1979-80 & 1986-87.

Activity 1

Visit a commercial bank and find out how banks deal with sick industrial units?

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17.3 DANGER SIGNALS FOR CORPORATE SICKNESS

Do companies suddenly turn sick overnight and qualify as potential candidates for turnaround or do they become sick slowly which can be stopped by timely corrective action?

Obviously the latter is possible. But the reality also is that companies becoming sick often do not themselves recognise this fact, and fail to take timely remedial action to remedy the situation.

Despite the fact that the factors that lead to sickness in one particular industry or company may be very different from the causal factors in another industry or company, there are some universally common signals which herald the onset of sickness.

Companies becoming sick would exhibit one or more of the following characteristics:

1 **Decreasing market share:** This is the most significant symptom of a major sickness. A company which is losing its market share to competition needs to sit up and take careful note. Regular monitoring of market share helps companies to keep a tab on their performance in the market vis-a-vis their competitors. Any indication of declining market share should trigger-off immediate corrective action.

2 **Decreasing constant rupee sales:** Sales figures, to be meaningful, should be adjusted for inflation. If constant rupee sales figures are showing a declining trend, then this is a danger signal to watch out.

3 **Decreasing profitability:** Profit figures are a good indication of a company's health. Care must be taken to interpret the profit figures correctly, so as to avoid any misjudgments. Decreasing profitability can show up as smaller profits in absolute terms or lower profits per rupee of sale or decreasing return on investment or smaller profit margins.

4 **Increasing dependence on debt:** A company overlay reliant on debts soon gets into a tight corner with very few options left. A substantial rise in the amount of debt, a lopsided debt to equity ratio and a lowered corporate credit rating may cause banks and other financial institutions to apply restrictions and become reluctant to lend more. Once financial institutions are hesitant to lend money, the company's rating on the stock market also slides and it becomes very difficult for the company to raise funds from the public too.

5 **Restricted dividend policies:** Dividends frequently missed or restricted dividends signal danger. Often such companies may have earlier paid substantially higher proportion of earnings as dividends — when in fact they should have been reinvesting in the business. Current inability to pay dividends is an indication of the gravity of the situation.

6 **Failure to reinvest sufficiently in the business:** For a company to stay competitive and keep on the fast growth track, it is essential to reinvest adequate amounts in plant, equipment and maintenance. When a business is growing, the combination of new investments and reinvestments often warrants borrowing. Companies which fail to recognise this fact and try to finance growth with only their internal funds are applying brakes in the path of growth.

7 **Diversification at the expense of the core business:** It is a well-observed fact that once companies reach a particular level of maturity in the existing business they start looking for diversifications. Often this is done at the cost of the core business, which then starts to deteriorate and decline. Diversification in new ventures should be sought as a supplement and not as a substitute for the primary core business.

8 **Lack of planning:** In many companies, particularly those built by individual entrepreneurs, the concept of planning is generally lacking. This can often result in major setbacks as limited thought or planning go into the actions and their consequences.

9 **Inflexible chief executives:** A chief executive who is unwilling to listen to fresh ideas from others is a signal of impending bad news. Even if the CEO recognises the danger signals, his unwillingness to accept any proposal from his subordinates further blocks the path towards recovery.

10 **Management succession problems:** When nearly all the top managers are in their mid-fifties there may be a serious vacuum at the second line of command. As these older managers retire or leave because of perception of decreasing opportunities there is bound to be serious management crisis.

11 **Unquestioning board of directors:** Directors who have family, social or business ties with the chief executive or have served very long on the board, may no longer be objective in their judgment. Thus these directors serve limited purpose in terms of questioning or cautioning the CEO about his actions.

12 **A management team unwilling to learn from its competitors:** Companies in decline often adopt a closed attitude and are not willing to learn anything from their

competitors. Companies which have survived tough competitive times continuously analyse their competitors' moves.

17.4 PREDICTING COMPANY FAILURES

Using financial ratios, many attempts have been made to predict company failures. However, it is well recognised that any analysis of financial data can at best serve only as a warning system. Also, inter-industry and inter-firm differences may sometimes render the analysis meaningless in one situation whereas it may prove quite useful in another.

One of the well known efforts in this area is that of Altman. He used five financial ratios and linear discreminant analysis to classify firms as solvent or insolvent to calculate an index called a Z-score. This is calculated as follows :

$Z = x_1 + x_2 + x_3 + x_4 + x_5$

where Z = index
x_1 = working capital/total assets
x_2 = retained earnings/total assets
x_3 = earnings before interest & tax/total assets
x_4 = market value of equity & preferred stock/total liabilities
x_5 = sales/total assets.

Where the Z-score is below 1.81 the firm is considered to be failing, and where it is above 2.99 it is considered healthy. Altman's scores turn out to be 82-95% accurate one year prior to bankruptcy and 72% accurate two years prior to bankruptcy. The Z-score has been found to be a poor predictor if the period before bankruptcy is longer than two years.

Z-score will differ from industry to industry and will change over time as economic conditions change. It is therefore important to be careful in using these or any other predictive scores.

Activity 2

In the unit on *Strategic Financial Analysis*, we have presented the financial highlights of **Burroughs Welcome Ltd**. Study the various ratios and comment on the corporate health of this company.

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17.5 CAUSES OF CORPORATE DECLINE

A great deal of research has been conducted into the causes of corporate decline. Many books have been written on this subject. Table 17.3 presents in a summary form the most commonly occurring causes of corporate decline as put forward by different people.

At the top of the table in the topmost row are the names of various researchers/authors such as Stuart Slatter, J. Argenti, Schendel, Patton and Riggs, and S. Sigoloff. Listed under each name in the table are the primary causes of decline as propounded by each author.

Table 17.3 : Causes of Corporate Decline

Slatter	Argenti	Schendel, Patton & Riggs	Sigoloff
Lack of financial control	Accounting information	Lack of control	
Inadequate management	Management	Management problems	Peter Principle Management without guts Interpersonal conflict at decision-making level
Competition	Firm unresponsive to change	Increased competitive pressure Lower revenues	Change in technology Firm hostage to current product-markets
High cost structure relative to competitors		Higher costs	Development of locational disadvantages
Changes in market demand		Demand declines	Change in marketplace Increasing cost of debt
Adverse movement in commodity markets (including interest rates)	Normal business hazards		
Operational marketing problems		Marketing problems	Poor distribution
Big projects	Big project		Dependence on single customer
Acquisitions			
Financial policy	Gearing		Limited financial resources
Overtrading	Overtrading	Strikes	Sales growth faster than working capital

Source: Slatter, Stuart, Corporate Recovery : A guide to Turnaround Management, Penguin, 1984.

As revealed by the Table 17.3, the major causes for corporate decline are :

1 **Lack of or inadequate financial controls:** This is often a major cause of decline. Weak control means that management is unable to find out on which products or markets it is making or losing money. Week financial control is often reflected in the absence of any cash-flow forecasts, and inadequate costing systems and budgetary controls.

  The firm may be having an accounting system which is not geared towards management decision making. What it probably has is financial accounting information as derived from the statutory requirements.

2 **Inadequate management:** In analysing the poor quality of management there are five typical situations where this problem may occur.

   i) **One-man rule:** The presence of single, domineering chief executive unwilling to adapt to new ideas, characterises many declining companies. Often the early reasons for success become the later day causes of decline as the CEO invariably tends to repeat his past policies unmindful of the changed or changing environment.

   ii) **Combined chairman and chief executive:** In such a situation there is no effective "watchdog" in the system.

iii) **Ineffective board of directors:** A board may be ineffective for a number of reasons such as directors who are mere rubber stamps, or who have no real interest or knowledge of the business, or because they may all be drawn from one particular functional area or industry thus representing a lop-sided view.

iv) **Management of core business:** Diversification becomes a substitute and not a supplement to the core business resulting in eventual financial losses.

v) **Lack of management depth:** Managers just below the CEO level often lack adequate management skills and this may be a contributory reason for the decline of a firm.

3 **Competition:** Competition as a reason of corporate decline occurs in the form of product and/or price competition. All products after a certain period of time become obsolete and are replaced with newer substitutes. A firm which fails to introduce new products at the right time is likely to face a declining fortune.

4 **High cost structure:** A company that has a higher cost structure than its competitors is likely to be at a competitive disadvantage. The high cost structure may be due to :

- relative cost disadvantages because of the firm's inability to take advantage of scale economies,
- absolute cost disadvantages arising out of lack of control of strategic variables,
- cost disadvantages due to diversification,
- cost disadvantages due to management style and organisation structure,
- operating inefficiencies, and
- unfavourable government policies.

5 **Changes in market demand:** This may be due to secular decline in demand in which case the firm either has to find a new use for its existing product or diversify into a new product line. In case the changes in market demand are due to cyclical market decline then the firm has to find ways and means to boost up sales during the low sales period.

6 **Lack of marketing effort.** Firms that are going through a phase of declining profits are characterised by management and employee complacency. This is most visibly exhibited in a lack of marketing effort on the part of the firm.

7 **Big projects and acquisitions:** Often a cause of corporate decline is the starting of new big projects or large acquisitions. The new projects may lead to decline because of under-estimation of capital requirement, start up difficulties or high market entry costs. A firm acquiring new firms may end up in trouble in case the acquired firm has a weak competitive position in its market, or due to the inadequacy of the management in the post-acquisition period leading to corporate decline.

8 **Financial policy:** The three types of financial policies that directly lead to corporate decline are:

- high debt—equity ratio,
- conservative financial policy, and
- use of inappropriate financing sources.

9 **Overtrading:** When a firm's sales grow faster than it is able to finance from internal sources and borrowings.

Activity 3

Identify a sick industrial unit and interview its managers and employees to identify the causes for its sickness.

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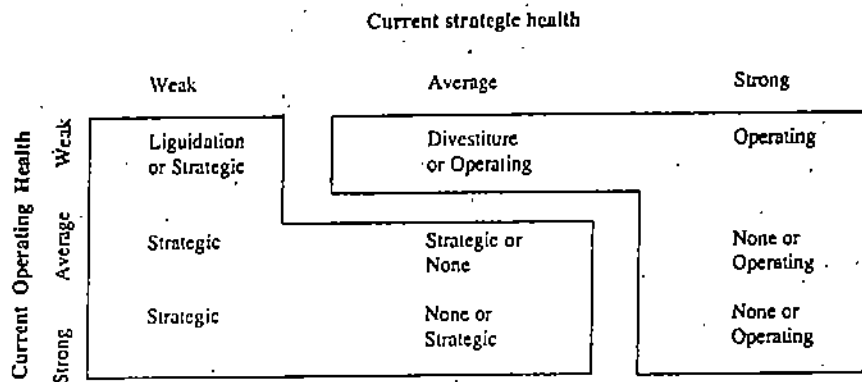
17.6 TYPES OF TURNAROUND STRATEGIES

Hoffer[2] has classified the turnaround strategies in two broad categories. These are strategic turnarounds and operating turnarounds. Whether a sick business needs strategic or operating turnaround choice can be ascertained by analysing the current strategic and operating health of the business as shown in Figure 17.1. The operating turnarounds are easier to carry out and can be applied only when there are average to strong strategic strengths (product-market relationship) in the business.

Figure 17.1: Selecting the Optimal Turnaround Strategy



The strategic turnaround choices may involve either a new way to compete in the existing business or entering an altogether new business. Entering a new business as a turnaround strategy can be approached through the process of product portfolio management. This has been discussed in details in Unit 10. The strategic turnarounds around existing business focus either on increasing the market share in a given product-market framework or by shifting the product-market relationship in a new direction by repositioning. The increase in market share can be achieved by improving product quality perception, through dealer push or even by consumer pull. However, strategic turnarounds seeking no change in the market share almost always involve a change in the product-market segment focus.

The operating turnaround strategies are of four types. These are:

- Revenue — increasing strategies
- Cost — cutting strategies
- Asset — reduction strategies
- Combination Strategies

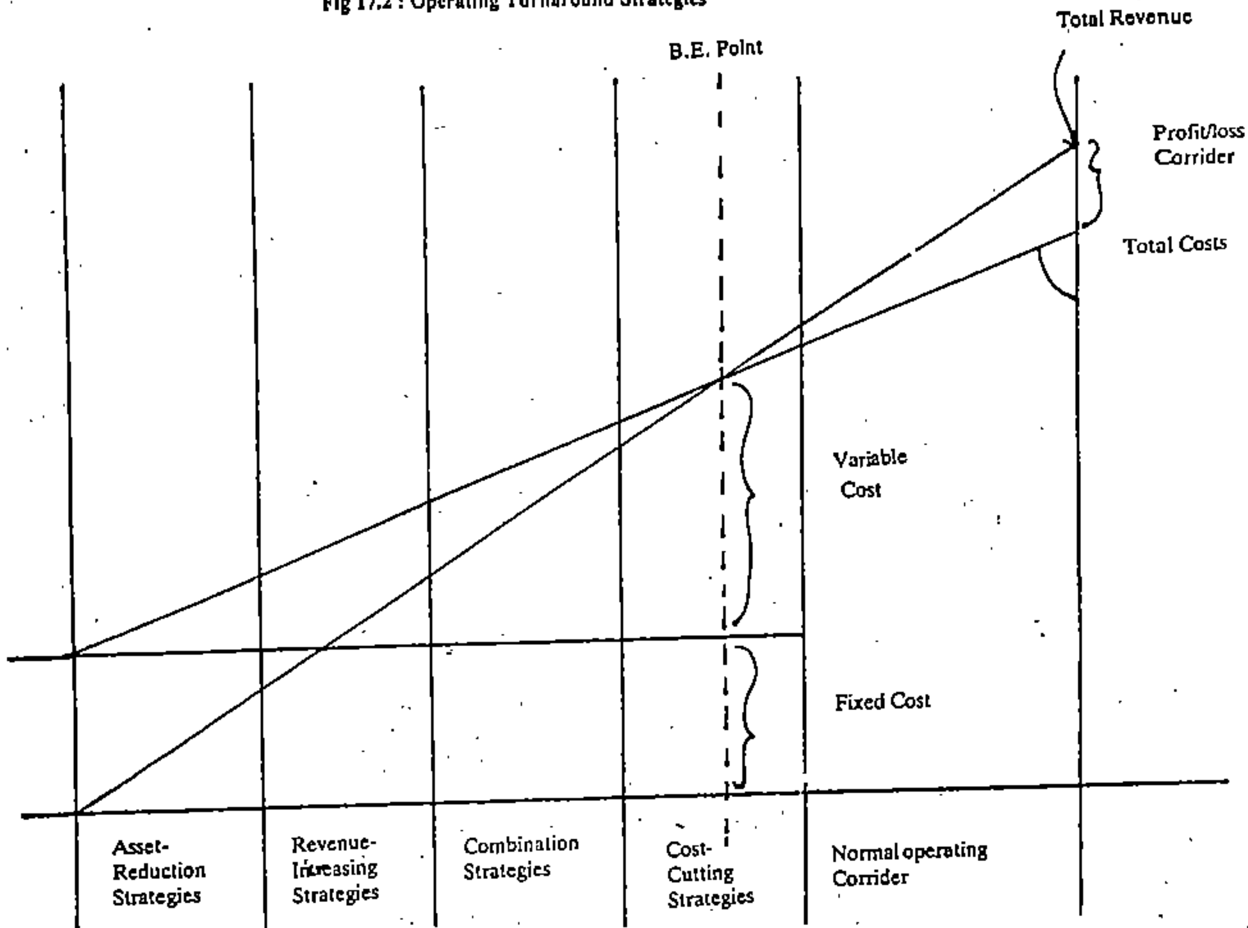
Figure 17.2 presents the choice of operating turnarounds with reference to the firm's capacity utilisation. The focus of all these choices is on short-term profit effect. Thus if a sick firm is operating much below its break-even, it must take steps to reduce its assets. This will reduce the levels of fixed cost and help in reducing the total costs of the firm. In real life it is always a difficult choice to identify the assets which can be sold without affecting the productivity of the business. To identify saleable assets, the firm may have to keep in mind its strategic move in the next 2 to 3 years.

"f the sick firm is operating substantially but not extremely below its break-even point, then the most appropriate turnaround strategy is the one which generates extra revenues. These may be in the form of price reduction to increase sales, stimulating product demand through promotional efforts or sometimes by introducing scaled down versions of the main products of the firm. The increased quantities of product sales not only result in higher sales but also reduce the per unit cost, this leading to higher operating profits.

Operating closer but below break-even point calls for application of combination strategies. Under combination strategies cost-reducing, revenue generating and asset-reduction actions are pursued simultaneously in an integrated and balanced manner. The combination strategies have a direct favourable impact on cashflows as well as on profits.

Operating around break-even point, a sick business usually needs cost-reduction strategies, since cost-reduction actions are easily carried out as compared to revenue generating actions, the former is usually preferred for quick short-term profit increases.

Fig 17.2 : Operating Turnaround Strategies



Slatter[3], has, however, linked the choice of turnaround strategies to the causes of decline. Figure 17.3, presents the causes of decline and the appropriate turnaround strategies. The recommended choice of strategies include change in management and organisational processes, improved financial controls, growth via acquisition and new financial strategies in addition to four choices suggested by Hoffer[4].

Closely associated to the choice of turnaround strategy is the concept of turnaround process. In the next section we will focus on this aspect.

Activity 4

In activity 3, you have identified the causes of sickness in an industrial unit. Find out what turnaround measures can this unit initiate to make it profitable or viable.

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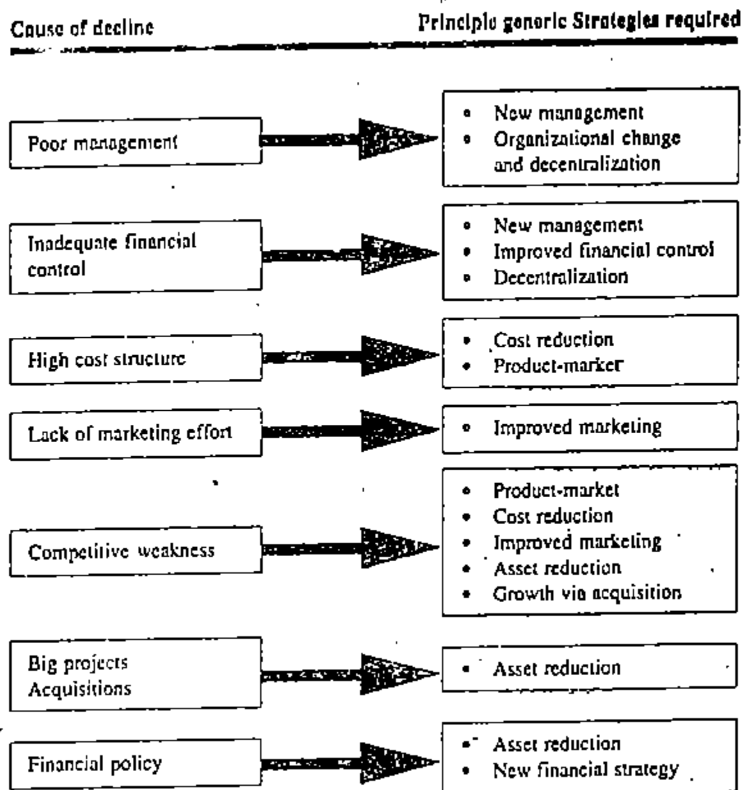
17.7 TURNAROUND PROCESS

The process of turning a sick company into a profitable one is rather complex and difficult. It is complex because a successful turnaround strategy demands corrective actions in many deficient areas of the firm. It is necessary that all these actions are integrated and do not contradict each other. The turnaround process is difficult because it involves perceptual and attitudinal changes at all the levels as far as employees are concerned. These human change

Figure 17.3 : Influence of Causes of Decline on Generic Strategic



Source: Slatter, Stuart: Corporate Recovery — A Guide to Turnaround Management, Penguin Books, 1984

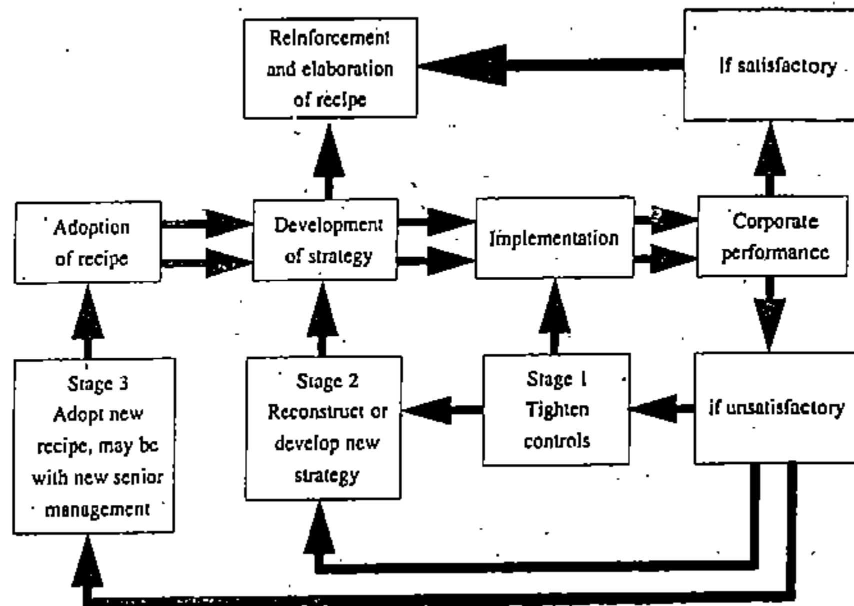
processes tend to become very sensitive when the firm is in a crisis situation. Therefore, many a time, a change in the leadership or even an active intervention from outside is suggested for bringing about such changes in the organisation.

Figure 17.4 shows the model for a turnaround process as suggested by Grinyer and Spender. As soon as the parameters of corporate performance are indicative of unsatisfactory corporate performance, it becomes necessary to immediately tighten the controls within the organisation. Effective controls have a positive impact on cost-reduction, that is, profit improvement and also on the net cash-flows of the firm. But this tightening of the financial and administrative control do not guarantee a stable turnaround process. In fact controls coupled with poor quality image of the product may hasten the process of corporate failure. So while the controls are being affected, it is necessary that the strategic posture of the company may also be overhauled. This involves major changes in the product-mix, customer-mix and the patterns of resources deployment in the company. These two stages of change further need to be complemented by changes in top management and many organisational processes. If these changes produce early results which are satisfactory, then for long-term effects it is necessary to reinforce these changes.

Prahlad and Thomas[5] have analysed the turnaround strategy and processes adopted by Hindustan Photo Films, a public sector company, during 1972 to 1976. Based on their research they have presented ten propositions for turning around sick units. These propositions are:

i) Revival of a sick unit requires the formulation and implementation of a new strategy
ii) Localising problems and sequencing the corrective actions helps in the revival of the sick unit;
iii) The successful implementation of the turnaround strategy requires appropriate organisation structure, a participative type of decision making environment, effective administrative and budgetary controls, training, performance evaluation, career progression and rewards.
iv) The turnaround strategy must focus on profit generation and profits must be regarded as a legitimate goal.

Figure 17.4 : A Model of Turnaround Process



Source: P.H. Grinyer and J.C. Spender, "Recipes, Crises and Adaptation in Mature Businesses", *International Studies of Management and Organisation*, Vol. IX, No. 3.

v) The acceptance and the commitment of managers and employees of the organisation towards revival measures must be high if not total. Openness in management processes helps in gaining commitment and thus facilitates the implementation process.

vi) Openness in the change process leads to confidence in the top management and its strategy.

vii) Understanding of technical processes and problem-solving attitude in overcoming technical snags is essential for turning around sick companies.

viii) Consultants can play a vital role in objective analysis of problems as well as in implementing innovative changes.

ix) The active support given to the chief executive by the appointing authorities is critical for the implementation of turnaround strategy.

x) Leadership provides the focus for action in sick units.

Thus, from these propositions, it is evident that in any turnaround process, the important issues are strategy, the management process, the technical competence and the leadership.

17.8 TURNAROUND MANAGEMENT IN PUBLIC SECTOR UNDERTAKINGS

Public Sector Enterprises (PSEs) in India represent the 'commanding heights', in terms of investment and turnover. However, a large number of PSEs are still in the red and there is great pressure on them to stage a turnaround.

Different PSEs have adopted different strategies for managing a turnaround. One commonly adopted strategy has been of diversification where the PSEs have ventured into related areas, such as airlines diversifying into hotels, milk procurement and supply organisation venturing into marketing of fruits and vegetables. Another strategy that is sought to be used for turnaround is that of re-organisation and amalgamation of sick units into viable ones and changing the product-mix.

Hindustan Machine Tools (HMT) and Bharat Heavy Electricals Limited (BHEL) are two public-sector units which have successfully used the diversification strategy to turnaround. HMT's strategy of diversification has been based on the use of surpluses from old ventures to diversify into allied profitable products and gradually expanding.

HMT was incorporated in 1953 with the objective of manufacturing machine tools with Swiss collaboration. In 1961 the company decided to diversify into the watch industry. The impact of this decision was felt only in 1967-68 when capacity utilisation in the major production units dropped to 50 per cent and the company incurred a loss for the first time. It was then that the decision to diversify started to give good results. The watch factory generated cash income every month and showed profits at the end of every year. It were these profits that were used to meet the running expenses of other loss-incurring plants. In the mid-seventies and again in 1980-81 the watch division once again rescued the company from a tight spot. Apart from ensuring the economic viability of the company as a whole, these diversifications have also led to a more balanced organisation structure. The heavily production-oriented organisation has to develop some marketing skills which would stand in good stead in the future too.

BHEL is one of the larger public sector organisations. It has monopoly in the area of power generating equipment. Its customers are mainly the government owned State Electricity Boards (SEBs). In recent years due to the inability of the SEBs to tone up their efficiency coupled with monetary resource crunch of the government and a demand recession for power generating equipment in the developed countries. BHEL has been facing a dwindling order position. The situation is no grim that the capacity utilisation which was 89 per cent in 1987 could drop to as low as 18 per cent in 1989-90.

To overcome this situation, BHEL has decided to reduce its dependence on power generating equipment which accounted for 70 per cent of sales turnover in 1985-86. The company has decided to venture into telecommunications, metropolitan transportation and defence production. The diversification plans entail a major change in management thinking and shifting from an area of monopoly to one which is highly competitive, and also internal re-organisation revolving around the concept of product managers. The success of BHEL's diversification plan would unfold with time.

National Textile Corporation (NTC) embarked on a turnaround programme in 1988. The main planks of this turnaround strategy are:

- restructuring and amalgamation of non-viable units with viable ones,
- upgradation and change in product-mix,
- shedding-off surplus labour, and
- re-structuring of the capital structure.

NTC has clearly spelled out short and long-term objectives.

17.9 SUMMARY

The incidence of industrial sickness is on the increase in Indian economy. This may be due to increasing competition, obsolete technology, poor product quality, lack of financial and administrative discipline and poor management. Whatever may be the reason, sick units cannot be left unattended. The process of turning these sick units into profitable ones involves proper diagnosis, choosing of appropriate turnaround options and implementation of the same. In case of public sector companies, we have several cases of successful turnaround management. A recent case is that of Engineering Project (India) Ltd. (EPI), which set out aggressive and competitive tendering contracts in the domestic market. This increased activity has resulted into EPI turning the corner.

17.10 KEY CONCEPTS/TERMS

Sick unit
Turnaround Process
Turnaround Strategy

17.11 SELF-ASSESSMENT QUESTIONS

1 What are the various indicators of Industrial Sickness?

2 What could be the various types of Turnaround Management?
3 Explain the process of turnaround management and also explain, briefly, how it was carried out in certain public sector companies in India?
4 Explain major causes of industrial sickness in general. What specific measures will you recommend to overcome industrial sickness?

17.12 FURTHER READINGS

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3 Slatter, Stuart, 1984, Corporate Recovery, A Guide to Turnaround Management, Penguin, England.
4 Hoffer, op. cit.
5 Prahlad and Thomas, 1977, 'Turnaround Strategies : Lessons from HPF's experience' Vikalpa, Vol. 2, No. 2.

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