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Seeing your way to better strategy

Viewing strategy choices through four lenses—financial performance, markets, competitive advantage, and operating model—can help companies debias their strategic dialogues and make big, bold changes.

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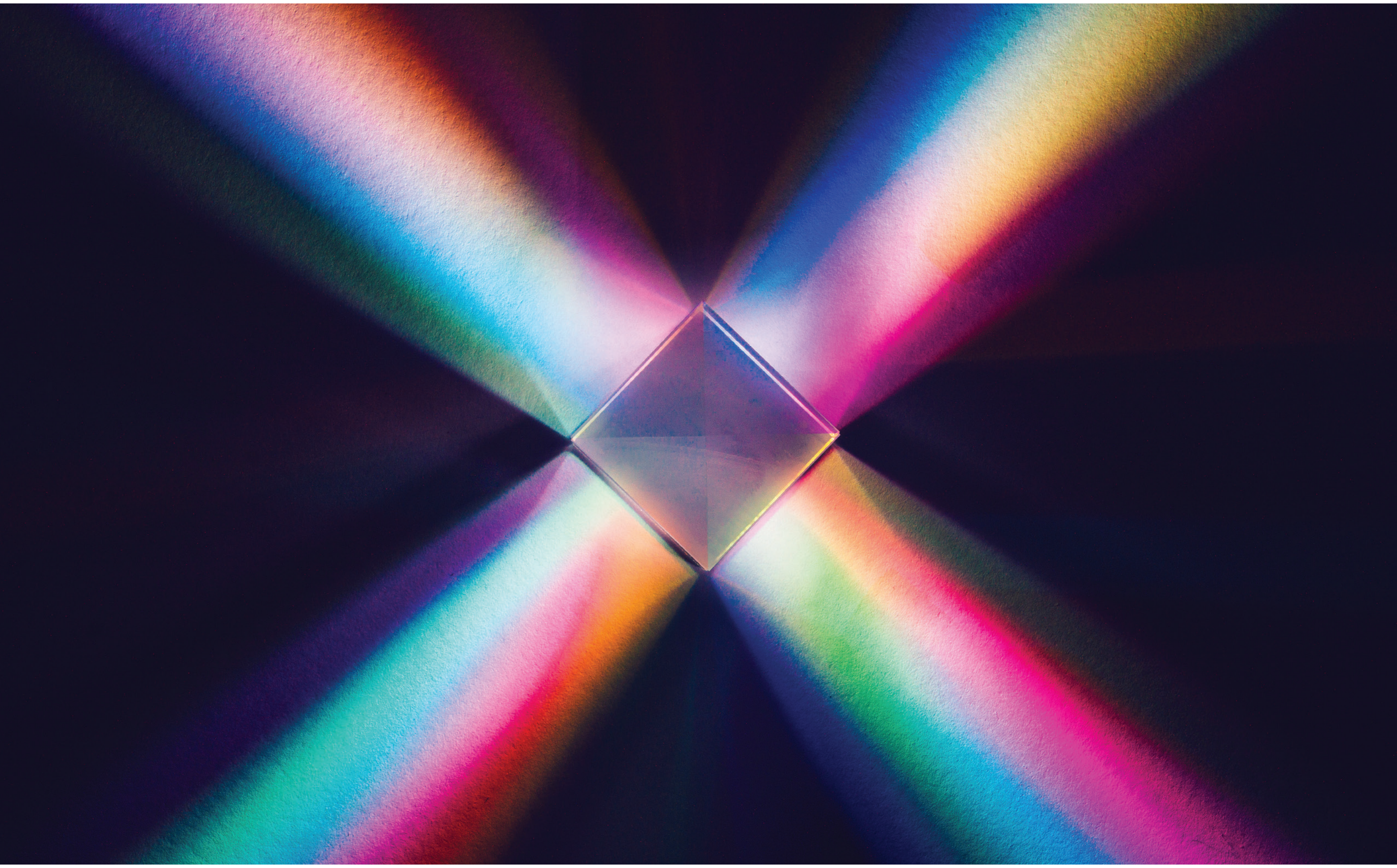


When executives gather in the strategy-planning room, they're aiming to identify and prioritize the big, bold choices that will shape the future of the company. Many times, however, their choices get watered down and waylaid.

Companies that hold no conviction about priorities too often spread resources evenly across multiple projects rather than targeting a few projects with the potential to win big. Those companies seeking to escape slowing growth in their core businesses sabotage themselves by chasing new markets without critically evaluating if or how they can win.

To avoid this fate, companies should examine their strategic choices through four critical, interdependent lenses—the company's financial performance, market opportunities, competitive advantage, and operating model (exhibit).

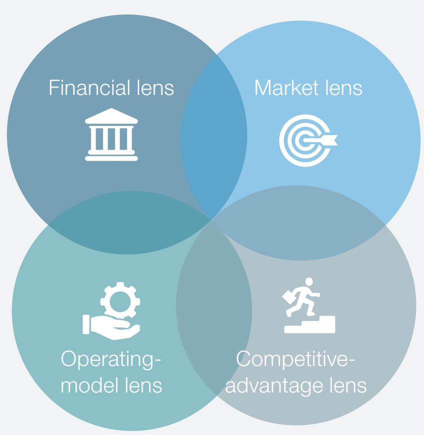
Executives tend to overemphasize the first two—viewing choices strictly in the context of financial and market opportunities—because those lenses represent critical inputs into the business case. But knowing what it will take to meet or beat financial expectations and which markets are profitable won't do much good if the company doesn't have the assets or capabilities required to win in those markets. Nor will it do much good if the company lacks the people, processes, and organizational structure to implement the proposed strategy successfully.

By viewing strategy choices through *all four lenses*, executives can identify and prioritize the big moves that will lead companies to new markets and growth opportunities, or the steps they can take to consolidate the core. When combined, the lenses provide a clear, balanced, holistic view of not just

Exhibit

Companies should view strategy through four interdependent lenses.

Value-creating strategy choices



What is required to create value in the business?
- A benchmark of financial performance against peers
- An assessment of impact on value from growth and ROIC[1] improvement
- A momentum case

Am I playing in profitable markets that will deliver growth over time?
- Structural attractiveness of markets
- Profit pools and pockets of growth
- Impact of trends and disruptions
- Adjacent markets in existing value chains or new ones

Do I have an organization that can deliver?
- Resource allocation
- Funding sources
- Capabilities and talent
- Performance management

What does it take to win in these markets?
- Market position and trajectory relative to competitors and potential disruptors
- Requirements to shape industry conduct
- Ownership advantages in the portfolio
- Ability to compete in adjacent markets

[1] Return on invested capital.

the opportunities in play but also what it will take to capture them. This kind of objective strategy diligence can improve conversations in the strategy room—and, ultimately, kick corporate performance into a higher gear.[1]

The financial lens

Most companies necessarily initiate their strategy processes with a look at their financial performance. The financial lens can help them incorporate an outside view into these discussions and develop an objective baseline for assessing the feasibility of long-term targets.[2]

A company can use standard valuation methods to estimate what performance levels it must achieve in the long term to justify today's value. If the company performs at these expectations, shareholder returns would roughly equal the cost of equity, compensating investors for their opportunity cost of capital.[3] This, however, is not value creation—it's simply the lowest threshold by which leaders can say their strategy was successful.

To create value, companies must deliver returns above and beyond the cost of capital, or they must deliver returns that exceed those of peers. Thus, executives should also use benchmarks to figure out how the company must perform to move well beyond that threshold—delivering top-quintile returns to shareholders, for instance. An objective look at peers' performance will help companies develop a meaningful three- to five-year plan for how to earn excess returns. Companies can learn a lot from this benchmarking exercise: perhaps high returns in the past were the result of a run-up in multiples in the market and, hence, expectations, but not actual performance.

To anchor those perspectives in current company performance and market position, it is critical for teams to develop a market-momentum case (MMC).[4] Using external market data and peer-performance benchmarks, the MMC gives the company a holistic view of how financial performance will be affected if the company follows its current trajectory relative to market growth, cost evolution, and pricing dynamics without taking any countervailing actions. The end result is an objective baseline for performance that allows executives to conduct an unbiased assessment of how to prioritize new initiatives (and big moves) without counting on them in the base plan.

By assessing implied performance, aspirations for performance, and the MMC, strategy and finance professionals can arm themselves with the information required to start meaningful, objective discussions on value creation: How does the company need to perform to achieve superior returns, and how would the company perform if it remained in steady state?

The market lens

Most companies are seeing slow growth in core businesses and wishing they were in higher-growth, higher-margin businesses. In some cases, the slowing core business may even be under attack. For instance, a low-cost entrant might destroy incumbents' economic profit in a certain segment, as happened in markets as diverse as those for aluminum wheels and children's electronic toys. In today's fast-moving business environments, many companies start from a baseline of deteriorating profit, not slightly increasing earnings. This creates urgency to make big moves into new markets or to block attackers.

The market lens provides a means by which companies can identify pockets of growth within existing segments and beyond, and assess them against strategic options.[5] The critical factor here is granularity; executives should quantify and validate shifts in profit pools in relevant markets given trends that are visible now. One consumer-

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apparel company, for instance, examined absolute dollar growth in the product markets it operated in. It assessed growth by channel and by region. The differences were striking. In some geographies, demand was expected to continue to grow mostly in brick-and-mortar stores for at least five years, with a significant price premium for high-end products. In other geographies, online channels were capturing profits much more rapidly than expected. Using the market lens, the strategy team recognized the need to allocate resources in product development and marketing for high-end products in brick-and-mortar stores in certain regions, as well as more localized, lower-cost production in others. By running the analysis in this granular way, it could capture better profit in all regions, leading to above-average growth.

Additionally, strategy and finance leaders should always examine adjacent markets, which may be not only attractive segments for growth but also breeding grounds for potential future competitors. Many times, the adjacencies are obvious, as in online retailers' continued push into industrial distribution for small and medium-size businesses, or technology companies' moves into software-as-a-service businesses. Other times, they are not as obvious—for instance, raw-materials companies selling consumer goods.

After conducting the requisite analyses of markets, strategy teams should be able to address two key questions: In which market segments will we be able to grow profitably over time? What additional attractive markets should be considered?

The competitive-advantage lens

Most companies face a critical strategic choice in the planning room: Are we better off consolidating the core, where growth is slower, or can we realistically enter new high-growth, high-profit markets and win? But given time pressures, innate biases, and other factors, executives typically fall short in their consideration of assets, capabilities, and the investments required to compete more effectively against rivals. As a result, companies end up chasing unattainable growth and underinvesting relative to what it would take to win.

The competitive-advantage lens can help executives identify whether the company has what it will take to win in current markets and those going forward, or whether a big change is required to capture value. An honest assessment of current capabilities should inform how the company chooses to play in its markets, as well as partnerships or acquisitions that may be necessary.

In the wake of new realities such as digitization and the fact that many industries are reaching the limits of consolidation, the competitive-advantage lens is more important than ever. Take as an example the notion of building a digital platform, a goal shared by many executives these days: What competitive advantage will the platform provide? What sort of market share does it need to capture to be considered a "winner" and not just "average"? Is an ecosystem of third-party players required for the digital platform to succeed, or can this be done organically—and will we be able to do it quickly enough to become the preferred platform for our customers?

The analyses and insights here are typically based more on firsthand "case load" expertise than on industry databases or reports. Interviews with sales teams and postmortems on deals that went awry can be very insightful, as can customer and supplier surveys. There is a lot at stake in gaining these perspectives. The apparel company mentioned earlier discovered that competitors still owned brick-and-mortar stores in certain markets in which the apparel company worked only through online partners. The competitors' sales representatives in these markets had special training and a structured sales approach that allowed them to collect information on customer preferences—for instance, the shapes, colors, and sizes customers wanted to see in the next season's designs. This gave competitors a leg up in product development that the apparel company no longer had. The essential competitive advantage in these high-growth markets was real-time customer insights fed back into a rapid product-development cycle. The apparel company learned, therefore, that it had to continue to invest in brick-and-mortar stores to recapture this advantage, even in markets driven by online sales.

The operating-model lens

Companies routinely take for granted the impact of their operating models on their strategy choices. They maintain the status quo rather than asking whether they have the people, processes, technologies, and other critical components required to make big moves. The operating-model lens, then, is essential for understanding whether the company is set up for future success. Indeed, a company's approach to resource allocation, talent management, organizational design, and performance management can either reinforce or defeat strategic objectives. Consider the following talent- and performance-management-related examples.

A pharmaceutical company estimated that more than one-third of its cash flow would come from Asia within five to seven years. That outcome never materialized, however: senior management had stationed fewer than 10 percent of the company's sales representatives in Asia—all of whom were focused on maintaining current sales and profit, not on expanding sales according to the strategic plan. An analysis of the growth opportunity at stake (in dollars) versus the number of full-time employees allocated to the regions over the past five years revealed the degree of underinvestment. Senior management decided to hire heavily in Asia.

Rather than prescribe performance metrics from the top down—ordering, for instance, that no one can have more than a 1 percent increase in cost in the next fiscal year—a retail company picks two or three "growth cells" each year that get twice the relative marketing budget (among other investments) compared with other areas of the business. As a result, strategy discussions are now focused solely on which cells should be designated for accelerated growth, rather than minutiae about the budget.

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Companies need to look at more than just financial opportunities when embarking on a new strategy or implementing a transformation program. They need to follow a due-diligence process for strategy, in the same way they would dispassionately and holistically vet critical mergers and acquisitions. Such a process can counter innate biases that lead to indecision or incremental rather than bold moves. The four interrelated lenses we've described provide a road map for ensuring that a strategy plan is supported by the right investments and change in operating model. ■

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[1] Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 2018, McKinsey.com.

[2] *Strategy & Corporate Finance blog*, "When doing strategy, make yourself an outsider," blog entry by Chris Bradley, February 13, 2018, McKinsey.com.

[3] If a company produces exactly the expected cash flows, the return to shareholders (including dividend payouts) will be the discount rate used to value the company.

[4] Werner Rehm and Anurag Srivastava, "Are your strategy discussions stuck in an echo chamber?," *McKinsey on Finance*, April 2018, McKinsey.com.

[5] Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie, "The granularity of growth," *McKinsey Quarterly*, May 2007, McKinsey.com.

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