Deloitte.

Linking Strategy to Value

Eugene G. Lukac and Don Frazier
Deloitte Consulting LLP

Published in *Journal of Business Strategy*,
Vol. 33 Issue: 4, pp.49-57 (2012)

Linking Strategy to Value

Abstract

Purpose: To provide business executives a practical and systematic way of preparing for Board member questions on the shareholder value of proposed strategic initiatives.

Approach: We observe that previous work has shown how shareholder value is derived from revenue growth, margin improvement, and asset efficiency. While such general value levers are useful they do not guide any particular organization regarding the critical decisions on where and how to compete. We also observe that strategic plans show how strategic initiatives support the overall corporate vision, but apart from ad hoc business cases, do not systematically link to shareholder value. By depicting shareholder value as a vertical tree, and strategic plans as a horizontal tree, we are able to construct a systematic mechanism for explicitly linking strategy to value.

Findings: The approach enables mapping strategic initiatives to their contribution to shareholder value. Furthermore, because the value tree is generic and the strategy tree is specific, linking the two enables identifying the strategic options not taken. The approach has also been extended to show how enabling corporate initiatives (such as those in IT) can be linked to both corporate strategies and shareholder value.

Value: In addition to helping CEOs or CIOs prepare communications to the Board, the article can also help Board members confirm the shareholder impact of proposed corporate strategies. It also provides middle management a practical way of drawing a direct line of sight between their efforts and the concerns of senior management.

Article Type: Conceptual

Key Words: Board of Directors, Board communications, Communications, Strategic Value, Strategic Evaluation, Information Technology, IT value

About the Authors

Eugene G. Lukac, PhD, is a Specialist Leader in Deloitte Consulting LLP. He focuses on the strategic alignment of business and technology. His publications have appeared in journals such as *Optimize*, *CIO*, *Bankers Monthly*, and the *Journal of IT Financial Management*. He can be reached at elukac@deloitte.com or +1 305 978 6332

Don Frazier, PhD, is a Director in Deloitte Consulting LLP. He focuses on the behavioral implications of information systems on the growth and stability of client organizations. His specialty is simulating the potential business implications of IT interventions, giving clients the capability to pre-test their IT strategies. He can be reached at dfrazier@deloitte.com or +1 678 429 9909

Linking Strategy to Value

The Problem

Senior executives are often faced with a dual challenge. On the one hand, they need to demonstrate to the market – in commonly understood terms – that their enterprises are creating value for their shareholders. On the other hand, their effectiveness hinges on identifying and exploiting differentiated ways of serving customers faster, better, and cheaper compared to competitors.

Senior executives face this challenge very much in the public eye. Investors want to see how their investment can pay off. Lenders want to know how their funds will be used and returned. Analysts want to assess one company against others. Customers want a reason to bring their business, and assurances that their needs will be met. Employees want to know they will continue to have interesting work that pays the bills. And, finally, the Board wants to know the enterprise is prudently run while competing aggressively.

With the dual challenge comes a dual risk. If the company cannot differentiate itself from competitors, it may not be able to attract customers, and will cease to be in business. Yet, if it is too different, it may confuse lenders and investors, and not attract the funding necessary to stay in business.

Senior executives, therefore, should to be adept at both developing strategic plans that provide competitive advantage, and at communicating how they will provide shareholder value. They should be able to link strategy to value. The purpose of this article is to help executives understand these connections, and to provide them with a practical, systematic framework for tracing the impact of proposed strategic actions on shareholder value.

There is a significant body of knowledge covering how to indentify value once it has been created or how to identify some of the actions that can create it. These actions apply generally to many organizations – they do not guide any particular organization regarding the critical decisions on where and how they should compete. That's the role of strategy. Existing strategic frameworks can help organizations identify suitable industry segments, and define their competitive positioning, but don't generally identify how shareholder value will be achieved. Although it is commonly recognized – or expected – that effective strategies result in value creation, there is no simple framework for connecting the two. This paper seeks to fill that gap.

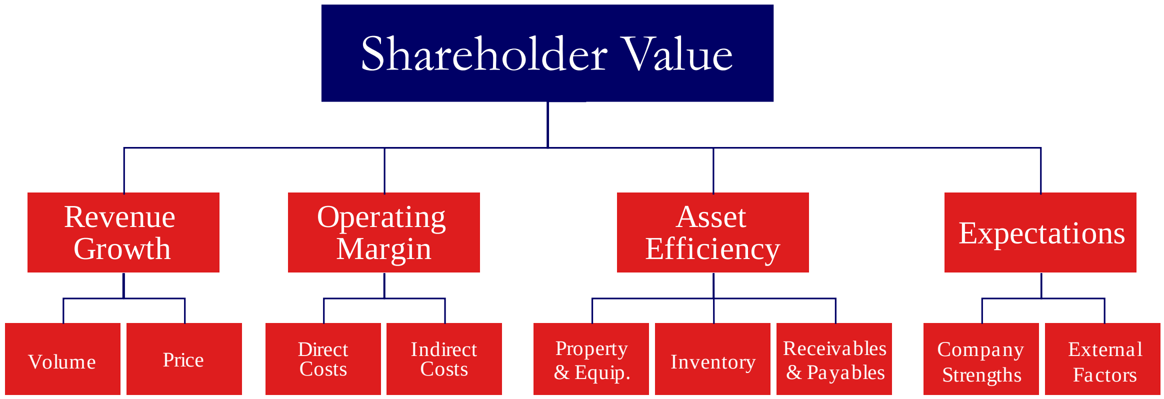
Identifying Value

In discussing "value" we need to keep in mind one of its main characteristics: value is relative. As an example, take earnings per share. By itself, it's just a number. It becomes meaningful – can reflect value – when we compare this period against last period, current against expected, earnings against price, and so forth. A $300k house may or may not be a valuable investment. But a $300k house in an attractive neighborhood is clearly more valuable than a similar house in a less desirable neighborhood.

Regardless of the business, shareholders value a company that can grow revenue while delivering a healthy margin and efficiently using its assets. Since value is relative, more revenue growth is valued over less growth, larger margins are valued over smaller ones, and greater asset efficiency is favored over lower efficiency. Furthermore, shareholders value the ability of management to sustain the continuing improvement of revenue, margin, and asset efficiency. Clearly, more management ability is valued over less.

These commonly recognized value drivers can be depicted as the starting point for a full shareholder value map. See Figure 1.

Figure 1. High-level Shareholder Value Map (Deloitte Methods)



Each of the value drivers can be affected by specific actions, such as the ones shown on Table 1. These actions can affect the drivers of shareholder value by either changing what an organization does, or improving the way it does it.

Table 1. Some Potential Ways of Affecting the Drivers of Shareholder Value

Revenue Growth		Operating Margin		Asset Efficiency			Expectations
Volume	Price	Direct Cost	Indirect Cost	Property & Equipment	Inventory	Receivables & Payables	Company Strengths
Innovate products and services	Manage supply and demand	Improve product development efficiency	Improve marketing and advertising	Improve real estate efficiency	Improve finished goods inventory efficiency	Improve accounts, notes, and interest receivables	Improve managerial and governance effectiveness
Strengthen sales and marketing	Improve pricing	Reduce cost of materials	Improve sales process	Improve infrastructure efficiency	Improve work in process efficiency	Improve accounts, notes, and interest payables	Improve partnerships and collaboration
Improve account mgmt		Improve production efficiency	Improve customer service	Improve systems and equipment	Improve raw materials efficiency		Improve agility and flexibility
Focus on customer retention		Improve logistics and distribution	Improve order fulfillment and billing				Enhance strategic assets
Cross-sell		Improve merchan-dising	Improve corporate services				
Leverage income-generating assets		Improve service delivery	Improve tax efficiency				

Table 1 can be used either top-down to identify possible ways of affecting the value drivers, or bottom-up to trace how particular actions contribute to shareholder value. Although broader lists of value actions are available [1], the abbreviated list in Table 1 is sufficient for this discussion.

In addition to being relative, value has another important characteristic: value is purposeful. What we find to be valuable depends on what we're trying to achieve, what our goals are. It is not always obvious whether revenue growth is to be favored over margin improvement or vice versa. It may depend, for example, on whether we're trying to achieve long-term growth or short-term returns.

In that regard, the Shareholder Value Map depicted in Figure 1, and extended in Table 1, is completely silent: it does not provide any indication on what a particular company should try to achieve. It applies to many companies, and is completely agnostic about what market segments to play in, or how to compete. That guidance is provided by the organization's business strategy.

Defining Strategy

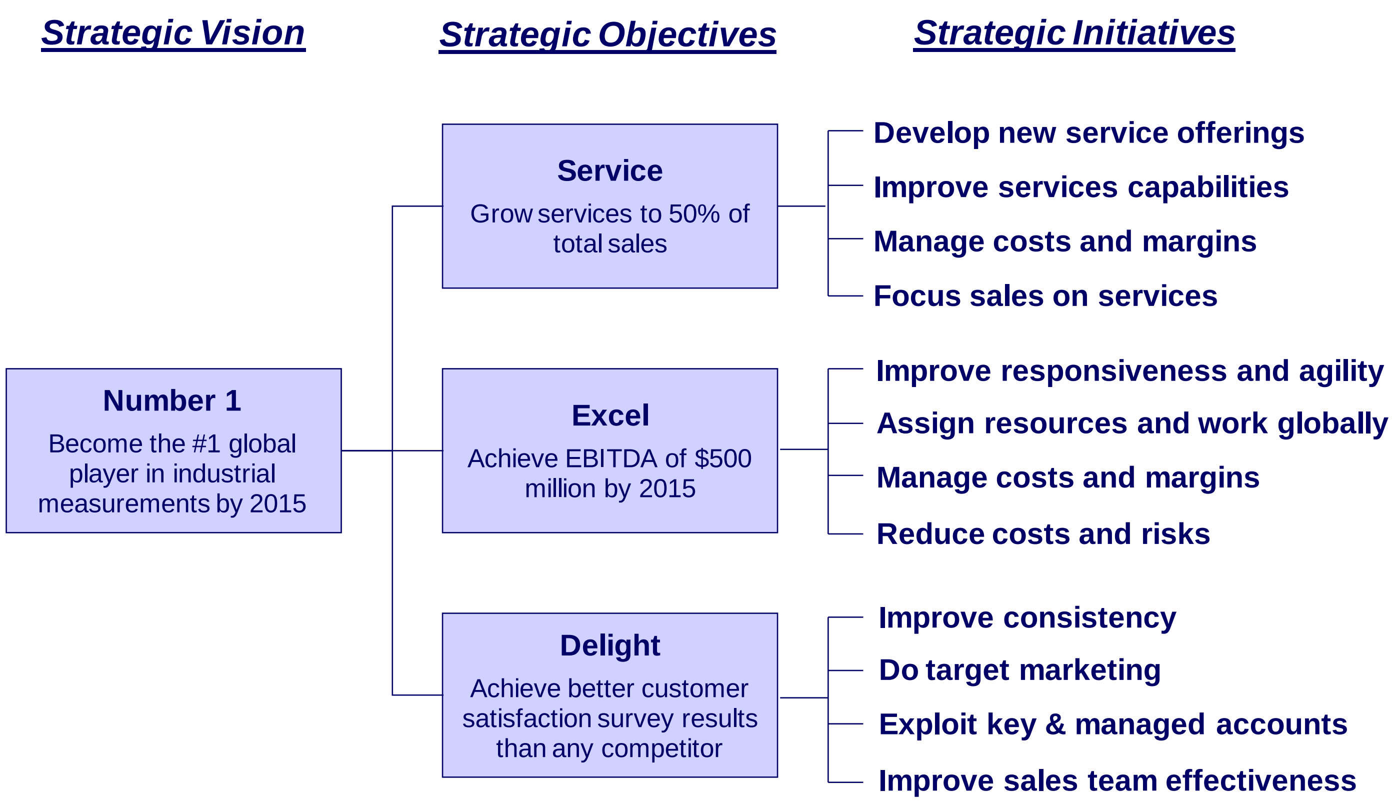
Strategy often starts with a vision of how the company wants to be seen, or, indeed, how it wants to see itself. For example, “Be the preferred provider of consumer financial information globally,” or “Be the leading US manufacturer of furniture.” But this vision is barren without further definition. What does “leading” mean? The most revenue? The largest catalog? The most readily recognized name? Highly recommended by analysts and critics?

A company must give concrete meaning to its overall vision. It must articulate strategic objectives that will help it determine the extent to which it is achieving its vision. Its strategic objectives specify something that can be objectively ascertained. For example, “Achieve $800 million in sales by 2012,” or “Maintain a larger market share than any competitor,” or “Book 20% of sales from new products introduced in the last X months.”

Stating strategic objectives obviously raises the question of how they will be achieved. What needs to be done to reach the desired level of sales, or to obtain the coveted quality rating? How the objectives will be achieved are critical strategic decisions. There may be many ways of improving product quality from more stringent specifications for raw materials to improved testing. A company needs to decide which of the many possible initiatives are the most significant for achieving its strategic objectives. In other words, strategy is about what a company intends to do, and – perhaps more importantly – what it intends not to do.

To help visualize the connection between strategic vision, strategic objectives, and strategic initiatives, some organizations use a “strategy tree.” In a strategy tree, a single vision is supported by multiple objectives, and each objective by multiple initiatives. Figure 2 shows an example of such a strategy tree.

Figure 2. Strategy Tree from an Electronics Instrument Manufacture (Deloitte Methods)

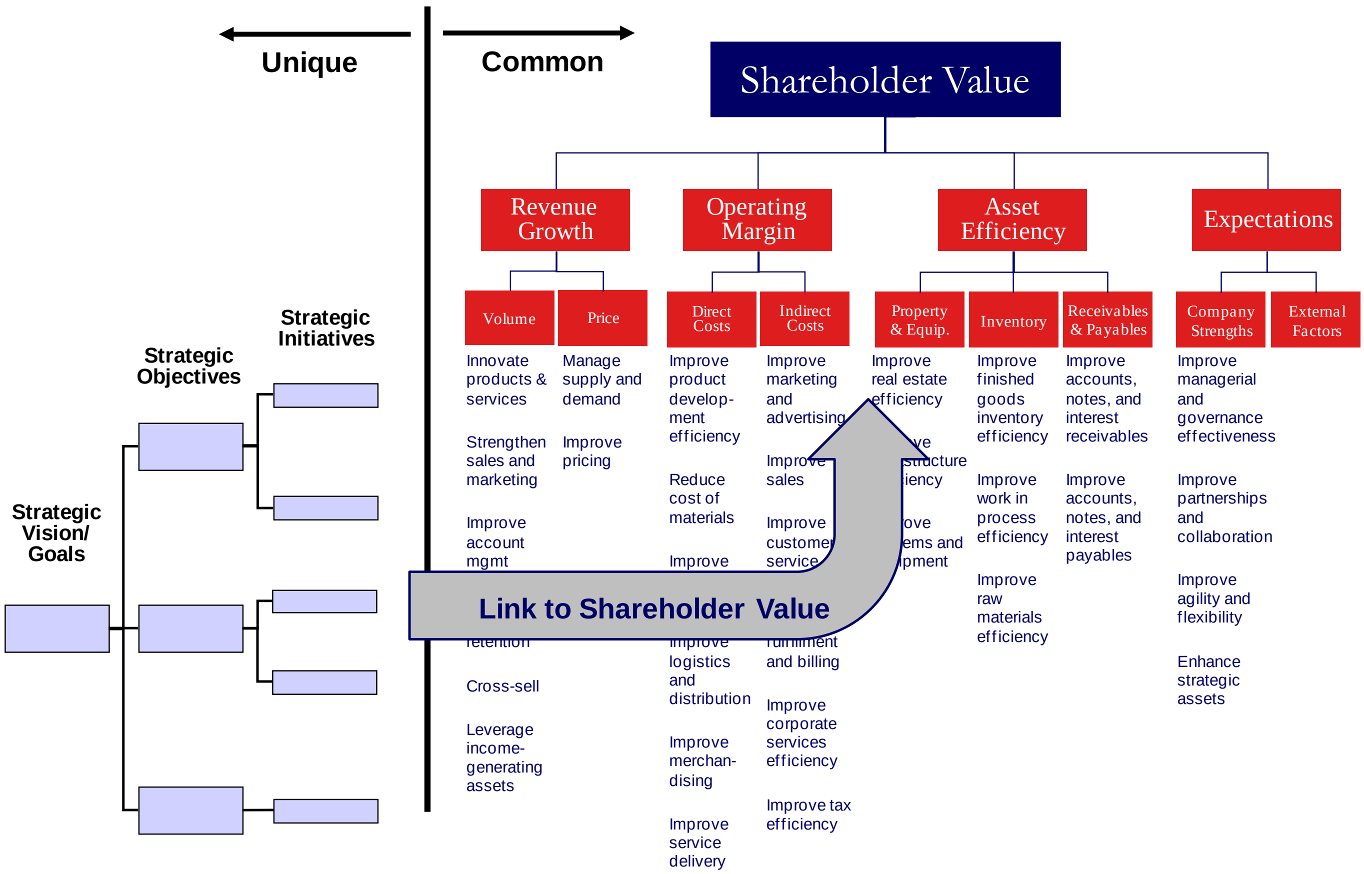


Mapping Strategic Initiatives to Value

Given a vision and a set of strategic objectives, the strategic initiatives that a company decides to focus on may or may not be the most effective ones; they may or may not be the most valuable ones. Management needs to be deliberate about the initiatives chosen – as well as those not chosen. Furthermore, as noted above, customers, employees, and shareholders want to be able to see the connection between the selected initiatives and the effectiveness and value of the enterprise. Corporate management therefore requires a practical way of connecting the dots between the strategic vision and initiatives on the one hand, and the value expectations of stakeholders on the other.

Having drawn the Shareholder Value Map as a vertical flow, and the Strategy Tree as horizontal flow, we can now link strategy to value by connecting the two flows. By mapping the Strategy Tree to the Shareholder Value Map as in Figure 3, we are able to link the company-specific strategic initiatives with the company-agnostic – and commonly recognized – shareholder value map.

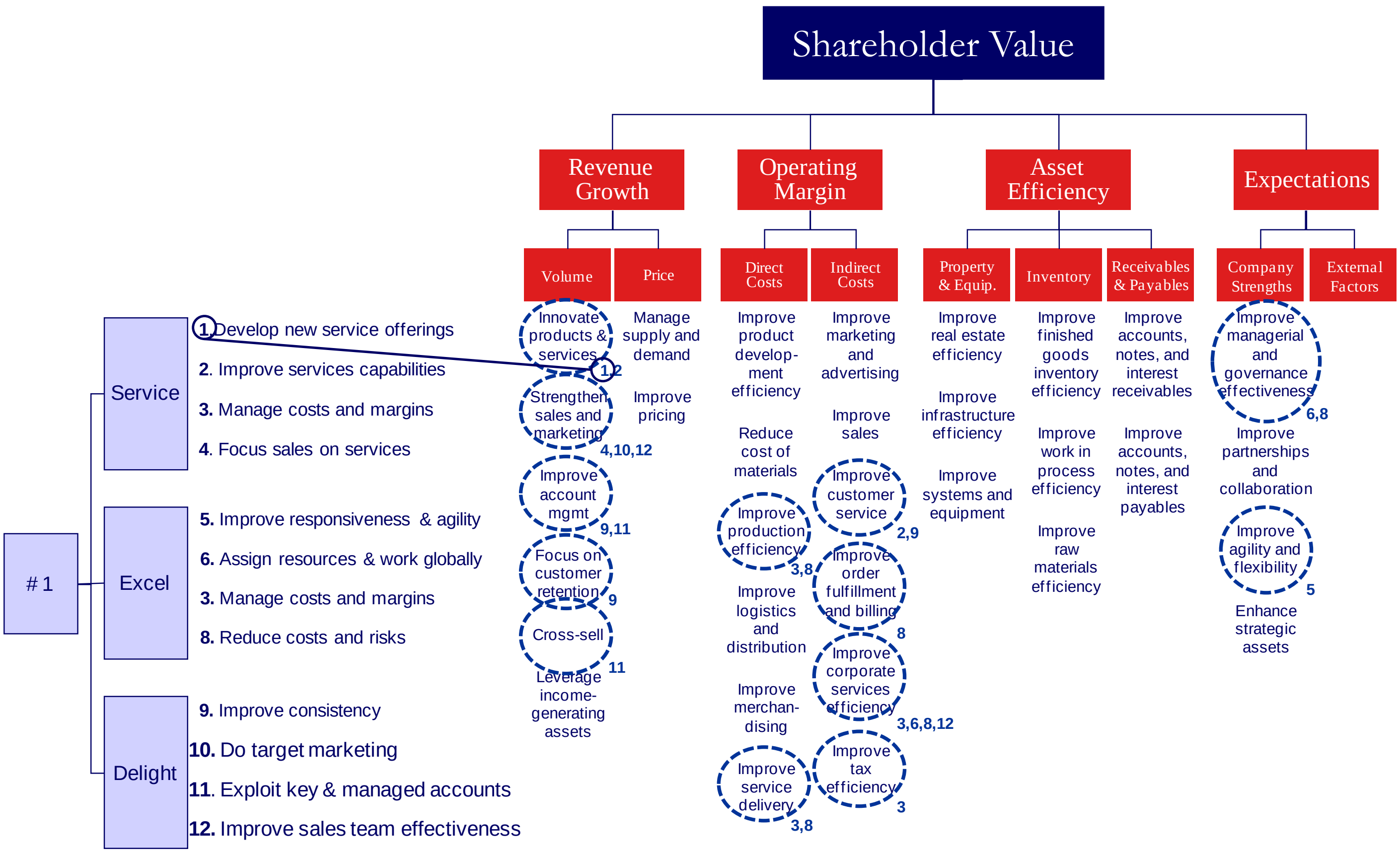
Figure 3. Mapping the Strategy Tree to Shareholder Value (Deloitte Methods)



For example, a specialty pharmaceutical company wants to be seen as having "significant presence in selected world markets," by which it means achieving 12% market penetration by 20XX in Latin America, which, in turn, requires a strategic initiative for creating sales channels in the region. From a Shareholder Value Map perspective, targeting new geographies is a way of extending marketing and sales to acquire new customers to increase volumes, which contributes to revenue growth. The linked framework thus helps us make a direct line connection from the vision of having a significant presence to the revenue growth contribution to shareholder value. To say that this is obvious is to overlook the power of the framework – helping us avoid errors of omission. The link from strategy to value enables us to see which potential ways of increasing volume were <u>not</u> chosen. For example, other than creating sales channels, the company did not choose to, say, develop products specifically for the Latin market.

The framework, therefore, not only shows how strategic choices lead to shareholder value, but – equally important – other potential strategic alternatives not pursued. It thus provides management with a richer context for strategy and value discussions than would be the case without the link. In Figure 4, for example, the strategic initiatives of Figure 2 are mapped to the Shareholder Value Map showing that the company's strategies are deliberately focused on the growth, margin, and expectations value drivers rather than on asset efficiency. At a more detailed level, it shows that revenue growth is being driven primarily through volume-increasing actions rather than through pricing initiatives.

Figure 4. Mapping the Strategic Initiatives of Figure 2 to the Shareholder Value Map (Deloitte Methods)



We see in Figure 4 that the initiative "Develop new service offerings" is mapped to "Innovate products & services," which is a specific way of affecting the Volume driver of Revenue Growth. Clearly, however, a strategy requires operational plans before it can be carried out. If new service offerings are to be developed, the organization must still select which ones to develop and in what sequence. Furthermore, it should make sure it has the process capabilities required to carry out its strategic initiatives. In other words, it should be able to support its strategies.

Strategic Support

To execute the strategic initiatives aimed at achieving an organization's strategic objectives requires having certain business capabilities. A business capability is typically something an organization has in terms of either knowledge or know-how. For example it may need to have readily available customer information, or a process for prioritizing investments, or the skills to manage a refinery.

There are a number of corporate functions, such as Finance, Human Resources (HR) or Information Technology (IT), whose mission it is to provide or enable the required business capabilities. Since often one of the only reasons these functions exist is to provide those capabilities, it is clearly important for the managers of these functions to be able to trace their activities and expenditures to both the corporate strategy and the creation of shareholder value.

Managers of the Finance, HR, or IT functions frequently develop stand alone business cases to justify investments such as improving accounts receivable processes, providing increased training, or implementing a new system. It is now possible, however, to extend the strategy tree framework described above to include strategic support activities, and thus provide a systematic approach to their justification. By way of example, we discuss how this may be done for IT, and how doing so helps the IT executive create a direct line of sight between IT initiatives and the strategy and value concerns of senior management.

We start by observing that the connection between business and IT strategy takes place – becomes concrete – at the point where IT capabilities are used to enable the strategically required business capabilities. Table 2 shows how each of the five types of IT capability contributes to an organization's business capabilities.

Table 2. The Contribution of IT Capabilities to Business Capabilities (Deloitte Methods)

IT Capability Type	Selected Examples	Impact on Business Capability
Automation	Automated replenishment, workflow management, web shopping	Reduces time, labor, and error rates
Connection	Email, video conferencing, social networking, mobility	Reduces distance, enabling work to reach across dispersed locations
Coordination	Reservation systems, meeting schedulers, electronic dispatchers	Reduces conflict, enabling the right thing to be at the right time in the right place
Information	Querying and reporting systems, web sites, help desks	Reduces uncertainty and improves decision-making
Simulation	Financial modeling, flight simulators, virtual reality	Reduces risk, enabling learning to take place without affecting the real world

To provide the IT capabilities listed in Table 2, IT organizations deploy application systems. Applications, in turn, run on technology infrastructure such as networks and servers. And to manage the capabilities, the applications, and the infrastructure, IT needs to have in place competent management, skilled staff, and suitable processes; i.e. an IT organization. These elements can be linked together by extending the strategy tree as shown in Figure 5.

Figure 5. Linking IT Capabilities and Systems to Corporate Strategy (Deloitte Methods)

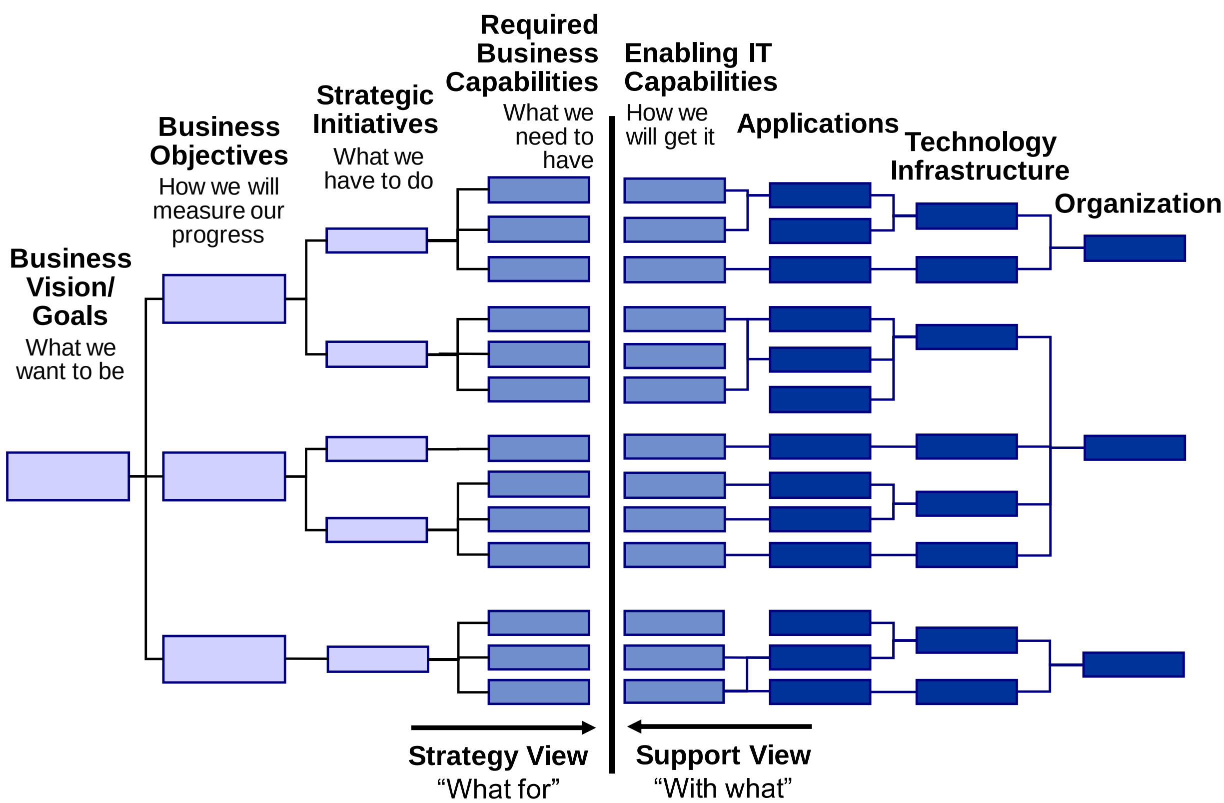


Figure 5 shows how the assets and activities of a support function, such as IT, can be systematically linked to the organization's strategically required business capabilities. The mapping enables, for example, the managers of a particular application, or a particular infrastructure component, to visualize how their efforts ultimately tie to the organization's overall vision and objectives. Moreover, it enables IT management to compare the needed IT capabilities and systems with the existing ones, and to prioritize enhancement and/or implementation efforts based on the importance of the corresponding business capability.

The meaning of each level of an expanded strategy tree is perhaps most effectively illustrated by extracting one branch from an educational institution tree:

Strategic Vision: Be the dominant education provider in our region

Strategic Objectives: Grow program X net income to $30 million by 2010, etc.

Strategic Initiatives: Enhance the customer experience, etc.

Required Business Capabilities: Readily available customer information, etc.

Required IT Capabilities: Information efficiently obtained and analyzed, etc.

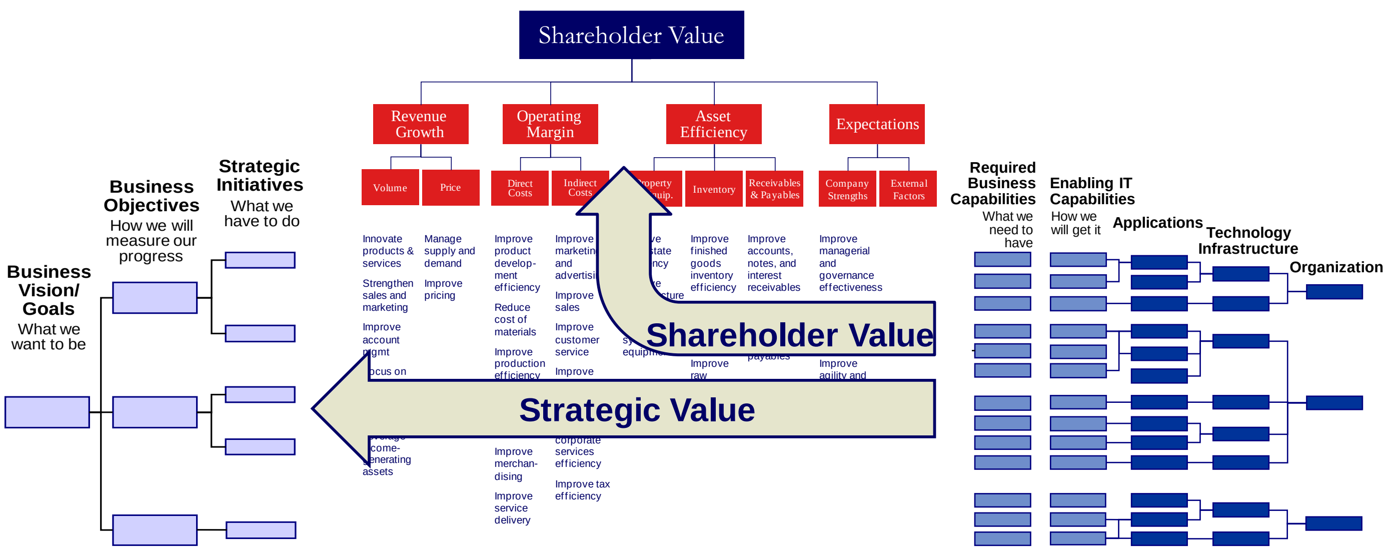
Applications: Data warehouse and data mart, etc.

Technology: Servers and storage facilities, etc.

Organization: Architecture management, etc.

Although it is common practice to justify large IT investments by developing a business case, it is not enough for an investment to yield a positive return that clears the required threshold. It must also visibly support the organization's strategic goals. As shown in Figure 6, the expanded strategy tree when linked to the shareholder value map provides a framework that managers at each level of the tree can use to justify investments and efforts based on both their strategic and value merits.

Figure 6. Framework for Justifying Support Initiatives (Deloitte Methods)



One large financial organization, for example, uses the framework to score potential IT investments on both their relative shareholder and strategic values. Each potential investment is given two scores. The shareholder value score depends on how the opportunity compares against other opportunities on its risk-adjusted shareholder value. A similar strategic value score depends on the importance of the strategic initiative with which it is aligned. With guidance from the Board, senior executives make periodic adjustments to the relative weighting of the two scores. Applying these weightings helps the organization create a prioritized ranking of investment opportunities in its support functions in a way that reflects both dimensions: shareholder value and strategic value.

Conclusions

After summarizing how organizations map shareholder value, and how they can depict strategic efforts using strategy trees, we demonstrated a straightforward, practical way of linking the two. As several examples have shown, the link provides a framework that management can use to communicate to shareholders, customers, and employees the value of strategic objectives and initiatives. Furthermore, the framework also provides an orderly structure for identifying and discussing strategic options that were not adopted.

We also demonstrated how the strategy tree can be extended to include the strategic support provided by functions such as Finance, HR, and IT. This extension can help the managers of those areas maintain a direct line of sight between their efforts on the one hand, and corporate strategy and shareholder expectations on the other. The tight alignment helps organizations maintain focus and minimize wasted efforts.

The approach described has been used effectively by organizations ranging from not-for-profit educational institutions to commercial oil and gas companies and financial services organizations. It has been used by senior executives to prepare for Board communications, and by department managers to make a funding case to their leadership. Their collective experience attests to the broad appeal of the framework linking strategy to value.

Acknowledgement. The authors gratefully recognize the enormous influence and contribution of numerous clients and colleagues that have helped develop and test these ideas over the course of many years.

[1] See, for example, Deloitte's Enterprise Value Map™ available at www.deloitte.com .

##

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.