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Palamarchuk, Victor

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An Algorithm for Making Value-Based Strategic Decisions

Victor P. Palamarchuk¹

The latest tendency has been featuring an increase in the number of Russian companies that follow the principles of Value-Based Management (VBM), which is essentially a synergetic combination of corporate finance and strategic management. Strategic decisions are the principal driving force of a company's value growth. Thus, the situation calls for an understanding and adequate evaluation of correlation between changes in a company's value and strategic decisions. A key to such understanding lies in accurate definition and differentiation of such notions as "a company's fair value" and "a company's investment value". The paper contains an analysis of these fundamental definitions for appraisal of a business, which further serves as a basis for making strategic value-based decisions. The suggested algorithm to control a company's value substantiates the following:

- Logic and procedure for preparation and implementation of strategic decisions;
- Differentiation and interrelation between strategic and operational decisions in a company's value-based management;
- Expediency and conditions for use of two intrinsically- different approaches to strategic decision-making (namely, the creative approach and the trade-off approach);
- Approaches to financial assessment and modeling of strategic decisions.

Keywords: value-based strategic decisions, value vs. cost, NPV

¹ Doctor of Economics; Professor of the Limitovsky Chair of Corporate Finance, Investment Planning and Assessment at the Higher School of Finance and Management of the Russian Presidential Academy of National Economics and Public Administration (RANEPA); Coordinating Director for MBA Finance Program of the RANEPA Higher School of Finance and Management, palamarchuk@gmail.com

Value vs. Cost: We will start with terminology – thus, we understand ‘value’ as the productive potential of a company, which is expressed in the form of the company’s capability to generate a free cash flow for owners. Value is measured by discounting the expected cash flows as of the moment of appraisal, taking into account the risk connected with uncertainty in obtaining future results.

In Russian literature, the term ‘value’ is more often construed as ‘cost’ rather than ‘value’. This accounts for a confusion in notions. Many people now tend to take the terms as synonyms, which one can apply at his/her own discretion. In fact, what we essentially need is a clear definition and differentiation between these two notions. It is not the terms themselves that are of importance, but rather the core of the matter. After all, we need to find out what the managers should strive to make higher for shareholders: value or cost?

In the financial science, as well as in economics in general, the basic “unit of meaning” is the choice as made by market participants including investors, company owners, company management, companies (as systems striving to increase their stability and to achieve expanded production), and the market in general. The economic science assumes that any subject of the market makes its choice (in other words, makes decisions) on the basis of assessed economic benefit. A decision is considered an “economically beneficial” one when value of the expected results is higher than the value of the rejected alternatives. On the other hand, the said value of the rejected alternatives is essentially the cost. It should be borne in mind that the cost is determined as the best of the possible rejected alternatives (rather than just any of such alternatives). Thus, cost is an alternative value(2). An interesting fact is that in English ‘an opportunity’ means ‘a chance’, i.e. ‘opportunity cost’ means ‘cost of lost chances’. Thus, value and cost are not synonyms; these are essentially opposed notions – an inseparable couple accompanying any decision-making process.

A company’s value and strategic decisions: A strategic decision is a decision which determines a new principal path for the company’s development, a change in the company’s productive potential. The fundamental tie between a company’s value and strategic decisions consists in that the value changes at the moment when such strategic decisions are made, or omitted, in conditions of a changing structure and behavior of the external and internal environment of the company – because, at such moment, the future path of the company’s

development and its potential change, too. A key to the understanding and adequate evaluation of the change in value resulting from the strategic decision made lies in accurate definition and differentiation of such notions as “a company’s fair value” and “a company’s investment value”.

A company’s value without taking into account the decision is often referred to as ‘value of the company “as is”’; what is meant here is that this is a value, which is determined by results achieved in the past, and does not take into account the potential for future growth. We believe that this approach is not quite correct and may entail incorrect evaluation of strategic decisions made. Therefore, it is essential that there be a clear understanding of the notion of a company’s value without taking into account the decision made – that is, fair value of the company. Fair value is a basic notion in business appraisal, and is essentially a judgment of the most probable price of the company in a hypothetical transaction of its purchase and sale, which is equally acceptable for the buyer and for the seller. Here, the buyer and the seller are also hypothetical, typical for the market, and equally informed. All this means that the value and cost of such an abstract transaction for each of the parties are equal, whereas in actual transactions they are always different. Fair value is a judgment of price of an even exchange; this is a transaction of zero efficiency, NPV is zero both for the buyer and for the seller. The determination of fair value provides a basis for the science and practice of a business assessment. This is a price, at which control over business would change hands in an absolutely efficient market. It should be noted that in a well-developed stock market the price of an asset, on the whole, corresponds to its fair value. At any specific moment of time, price of shares may, under the influence of various market behavior factors, deviate from the fair-value level. Appraisal of a business by an informed appraiser or manager may as well be referred to as ‘fair value’ solely as a judgment by such appraiser or manager; it becomes confirmed only when the assumptions, which were used by such appraiser or manager for appraisal, are accepted, in negotiations, by such persons or parties, for which such appraisal was made. Thus, the fair value reflects the potential of a company, but only before the decision under consideration is made.

Investment value reflects the changed potential of a company with the made decision taken into account. To make an informed strategic decision, one usually has to evaluate several strategic alternatives. Investment value is the value of an investment (strategic) alternative.

According to NPV concept, an increase in value resulting from making the strategic decision is expressed using the following formula:

$$NPV = V_i - V_f, (1),$$

where:

NPV= Net Present Value of the strategic decision;

V_i = investment value of the company;

V_f , = strategic value of the company.

When does a company need to make strategic decisions? When there is a gap between structure and dynamics of the external environment and the structure and dynamics of the internal environment. Working-out and implementation of a company's development strategy are closely connected with financial issues relating to appraisal of the company. Strategy, marketing, operation management, and finance management are the components that are closely interconnected in business appraisal and management; however, this is the strategic decisions that are determinant for growth of a company's value.

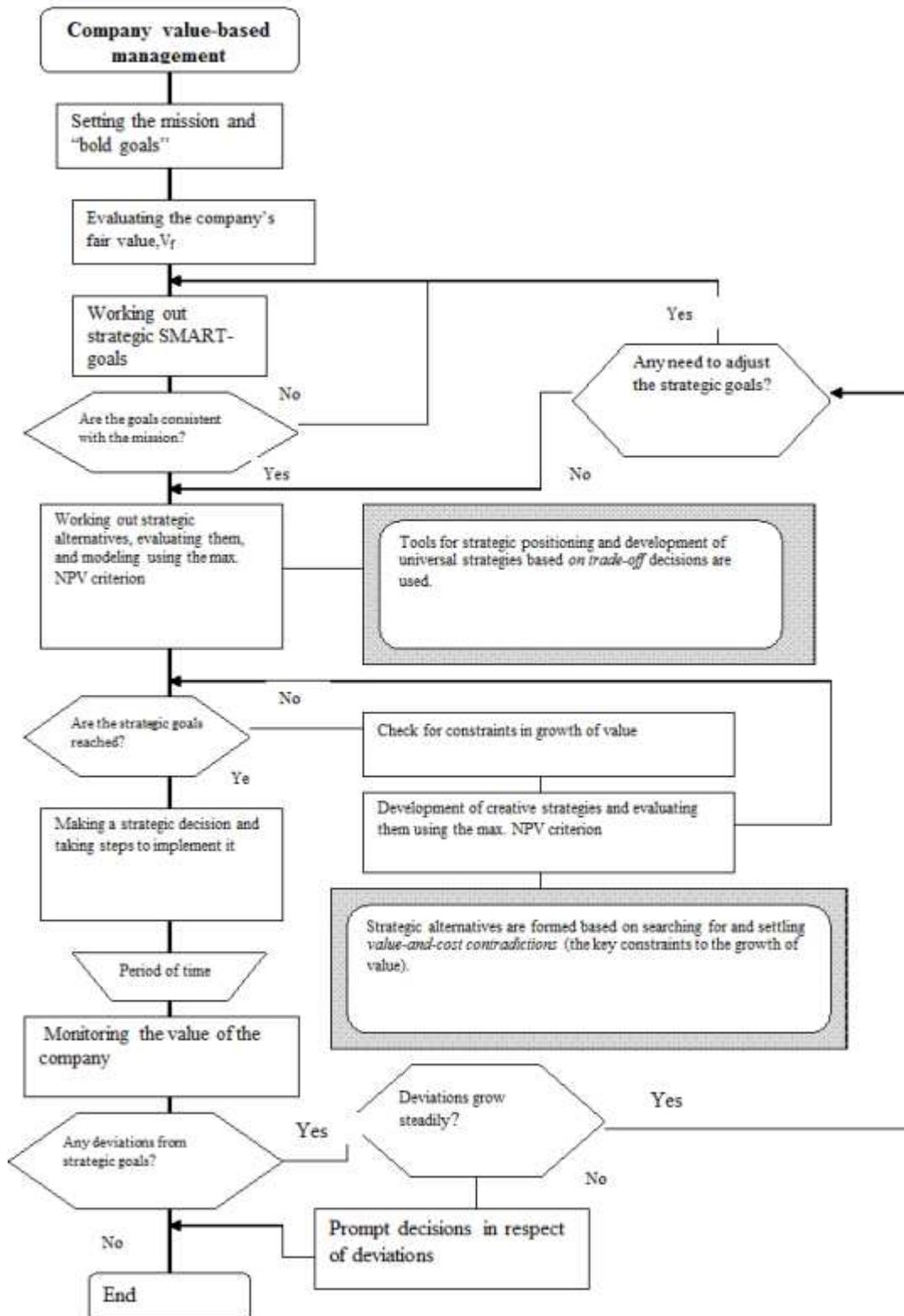
It should be noted that value-based management of business is essential not solely for big stock market participants, but for any company, which is able to generate cash flows for owners. Managing a company efficiently is possible only if the management, in making decisions (first and foremost, strategic ones), is governed by the general target quantitative parameter, the latter being the growth of the business value for owners.

An algorithm for business value management: Figure 1 shows an algorithm for business value management demonstrating the logic of choosing and implementing a strategy and tying together the consecutively tackled issues of business appraisal (up to the moment of making a decision), analysis of its strategic positions, detection of strategic alternative, their evaluation, financial modeling, and monitoring the value in the course of implementation of the strategy.

Setting the mission and "bold goals": The process of strategic value management starts with goal-setting. Several publications on strategic management (1) state that work on a company's strategy should start with setting and decomposing a general goal, with a requirement to conform to SMART criteria. In our opinion, in a situation of strategic uncertainty, and before a clear understanding of the company's position is achieved, setting specific SMART-conforming goals or objectives is inexpedient and even may lead to adverse consequences, since the setting of such goals/objectives reduces decision-making flexibility.

At the initial stage, only general goals may be set, such as the mission of the company, the formulation of intentions, and a descriptive and visible representation of the mission in the form of “bold goals”.

Fig. 1- An algorithm for business value management



The company's estimated fair value (V_f) is always a basic estimate, which is used as a basis for comparison with variants of steps to take, which are under consideration. This is an evaluation of the company, which reflects the company's potential in terms of receiving income without changing the existing strategy, management system, and structure of the company. Also, the fair value takes into account potential for growth (including the strategic flexibility); thus, fair value of a company may be represented in the form of the following formula:

$$V_f = V_{op} + V_{st}(2)$$

where:

V_f = Fair value of the company;

V_{op} = Operating value of the company; and

V_{st} = Strategic value of the company.

Splitting the fair value of the company into operating value and strategic value is determined by the corresponding splitting of the company's assets².

Operating assets of the company include the assets-in-place, which generate cash flows at present time, without taking into account new strategic decisions or investments.

Strategic assets are the assets, resources and competences, which enable the company to make strategic decisions or investments now or in the future, under certain circumstances. Strategic assets are not generating any cash flows now; however, they are of value, which can be measured using the real option technology.

Evaluation of the company's fair value is a result of an integrated evaluation of the situation and its development prospects, and involves the analysis of:

- Market conditions;
- Competitive position of the company;

²Traditionally, a company's value is subdivided into base value and added value; the base value is linked to the available assets, whereas the added value is linked with values generated by new investments. We believe that such interpretation is less efficient, because, first, it mixes together the value of the company before and after making the decision, and, second, the growth potential is correlated only with new investments (in spite of the fact that the available assets include certain growth assets – e.g. those having the real option properties).

- Financial performance.

Besides, it includes forecasting the company's future incomes (based on generalization of the analysis) and risks connected with uncertainty of receiving such incomes.

Currently, many companies (especially those engaging the services of consulting firms) use a wide range of tools for analysis of market conditions and the company's competitive position. Some of the well-known models, such as Porter's five forces, the value chain (M. Porter) (3), the positioning matrices (GE, BKG, Ansoff Matrix),(1), the strategic canvas (Ch. Kim & R. Mauborgne)(7) etc. have become an attribute of strategic analysis for companies striving for competitive success. Unfortunately, one can often see these tools used formally and unsystematically; results of the analysis are not tied into an integrated picture and do not end up in evaluation of value, which is an integral parameter characterizing the company's strategic position and potential in a quantitative way. As a result, multi-page reports on market position and prospects of a company fail to enable the company's management to find out strategic alternatives for the company's development, to evaluate and compare them, and to make an economically justified strategic choice.

To obtain the required result, it is essential that the analysis of qualitative non-financial factors and quantitative financial factors, which determine the company's value, be tied up into an integrated non-contradictory system. Principal attention in the analysis of market forces and competitive positions should be given to driving factors and constraints of value. Therefore, the analysis should be tied with such parameters as growth rate and return on investments, since these are the principal factors determining a company's value.

An integrated analysis of the company's strategic positions allows the following:

- Detecting the principal and most probable path for the company's future development if the existing strategy is preserved;
- Estimating the company's value if the existing strategy is preserved;
- Detecting the principal opportunities and threats; finding out discrepancies between the desired and the forecasted future situation; and
- Detecting and formulating the principal strategic alternatives, and setting the strategic goals.

Strategic SMART-goals are expressed in the form of quantitative strategic objectives, such as growth of the company's value, market share, sales, return on invested capital, etc. Reaching the strategic goals should be consistent with the company's mission and implementation of "bold goals". The goal-setting process is iterative.

Working out universal strategic decisions based on the positioning: Further we proceed with detection and analysis of alternative variants of goal-reaching strategies under the existing conditions and constraints. Approaches to the working-out of strategic decisions based on positioning are developed and described in a number of publications on strategic management (1,3,4). The essence of such approaches consists in the formation of the "choice space" with the help of several well-known positioning matrices, on the basis of analysis of the market situation and competitive position. Such matrices allow reducing the uncertainty and seeing the situation as a whole and choosing one of the recommended strategies. Such strategic decisions are based on a trade-off in the choice of priorities between:

- Low costs and differentiation;
- Growth of sales (market share) and increase in returns on invested capital;
- Rate of return and liquidity;
- Diversification and focusing;
- Others.

For the majority of situations, these approaches are efficient and have already proven their viability. However, under conditions when competition in the market is high, and the rivals are able to respond promptly and flexibly, selection of a strategy based on standard recommendations may be predictable for the rivals, and growth of value may level off or continue for a very short period of time. When standard universal strategic decisions do not allow bridging the gap between the high strategic goals of a company and its current state of development, then searching for creative strategic decisions becomes expedient and necessary. Analysis of a number of successful strategies allows making a conclusion that there are certain objective laws governing the search for such decisions and certain typical decision techniques. The main principle of creative strategic decisions consists in that such a decision results not in a trade-off between the detected opposed priorities, interests, ways or resources, but the settling (removal) of a systemic contradiction, which acts as the major

constraint for the growth of the company's value. To detect the major value growth constraint, a diagnostic algorithm is needed.

Diagnostics of constraints to the growth of a company's value: The task of value diagnostics is to detect constraints for the value, i.e. the factors that restrain the growth of value or result in its destruction. The principal area under consideration is the value-versus-cost choice, which is made by stakeholders (buyers, suppliers, employees, creditors, investors) in respect of the company (5). One should consider the actual alternatives and choice problems, which every stakeholder encounters in the process of making a decision. On the other hand, in the course of diagnostics, one considers the value-versus-cost choice, which the company, as a system striving to enhance its stability, makes in respect of the existing and potential stakeholders. Such expansion of the "field of view" allows re-focusing the analysis from rivals to alternatives, from customers to non-customers in the area under consideration, and detecting the company's major problems. The picture of the situation becomes clear when a fixed cause-and-effect relation between the problems is established. For this purpose, a decision tree of problems is prepared, using which one can, following a certain algorithm, find out cause-and-effect relations and detect the root problem (6). Diagnostics of the problems enables one to avoid dissipating efforts on all problems of the company and to focus on solving the major problem. If the root problem is not solved because the way to solve it is not known or the previously used ways failed to return a positive result, this means that the problem has an underlying contradiction, which should be detected and eliminated. To achieve this, the problem should be presented in the form of a contradiction/conflict (in terminology of E. Goldratt) (6), and a model for solving the problem should be prepared. In this case, no trade-offs are accepted as a solution, because a trade-off is a variant that fails to bring the required result or the result is negligent.

Working out creative strategies: Elimination of the value-vs-cost contradiction may be referred to as an innovation of value, which brings forth creative strategies resulting in a considerable growth of the company's value. Innovation of value takes place when the company eliminates or reduces the impact of factors causing competition in its niche, thus reducing the costs. Value for buyers grows as a result of creation and development of factors, which have never before been offered by the industry under consideration. Thus, the company eliminates the need to make a choice between differentiation and costs by offering a differentiated product and, at the same time, reducing costs in comparison with the rivals (7).

Evaluation and financial modeling of strategic alternatives: After detecting and formulating the alternative variants of the company's strategy, the company proceeds to the final stage of working out the strategy, this being the evaluation and financial modeling of strategic alternatives, which allows choosing the best option for the investment and financial strategy, giving the company the maximum added value. The choice of the most valuable alternative is made following the NPV maximization criterion.

A critically important is the statement that the value of a strategic alternative under consideration should be higher than the company's strategic value net of the decision to be made, which includes the best potential alternatives for the company's development (among them strategical flexibility), since the decision, when made, will cut off an entire "branch" from the company's tree of decisions. Usually, there are attempts to compare the decision or project under consideration with the company's value "as is"; in this case, efficiency of the decision to be made is overestimated, and an invariably positive result is obtained. In the suggested structure of making strategic decision, the standard "bar" is raised.

First, strategic alternatives have to be shaped. The financial model, in its structure, input parameters, evaluation criteria, and a set of modeling capabilities, shall be accurately consistent with the task of comparing strategic alternatives. The financial model shall be formatted to solve the task of strategic choice. It is not the details that matter, but the accuracy of formulated alternatives. The necessary and sufficient thing is a limited set of enlarged input data, to which oppositions are found in the strategic alternatives under consideration. In the course of evaluating the strategic alternatives for a company's development, it is expedient to use evaluation models, which allow separating the modeling of investment decisions and financial decisions (8). First, an evaluation of investment alternatives is done, and a decision in respect of choosing the best of them is made; then, financial restrictions are imposed. This allows modeling the situation and finding the optimum financial strategy for the company.

After accepting the strategy, a package of measures for implementation of the selected strategic variants is developed, and reference indicators are detailed, which are used to control the implementation of the company's strategy.

Monitoring and operating management of the company's value is carried out within the accepted strategy, with a focus on reaching strategic objectives.

To create an efficient system for company value-based management, an operating financial model is required along with the financial model for the strategic choice. The task of

such a model is the current monitoring of the company's value and budgeting. Therefore, it must include a rather large number of input parameters, and allow analysing and evaluating data per periods, by creating data archives. This model is very important, and is required to constantly monitor the dynamics of the company's value and make operating decisions over the entire range of the company's activities. Target criteria for this model include strategic references for the implemented strategy, since the major task is to detect and eliminate deviations from the set strategic objectives and to provide signals on increase of value-versus-cost gaps calling for a new strategic decision.

The above value-based management algorithm allow tying up, into an integrated logical process, the principal attributes of strategic value managements, such as goal-setting, strategic positioning and selection of alternatives, methods and techniques of searching for strategic decision, financial appraisal of the company and its development alternatives, criteria for making strategic decisions, and control over implementation of the strategy.

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