Taming the Future
A Framework to Analyse Businesses at the Group Level

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This article attempts to provide a framework for analyzing the capability of business to perform in the future in light of the trends governing the dynamic business environment. The framework developed with some modification can be used to analyze conglomerate performance with an opportunity to compare companies across industries so as to provide strategic thinkers a platform to understand where the business is headed. The Earth Model explains the position of companies in the "layers" of the earth with the core having best performing companies using parameters such as market value and intrinsic value. The 5 As of Strategic Drive further provide a directional viewpoint to the corporate executives on where to take their businesses in the future.

INTRODUCTION

The principal purpose of business is to increase shareholder value over the long term. For this, businesses need to understand and predict how their operations should be aligned to the environment. This paper aims to provide a framework to analyze environmental changes and the best ways to align businesses with them. In the process a framework is presented, viz., the **5 As of Strategic Drive,** which, if applied in its true sense, will help businesses gauge the changing business landscape and calibrate their response accordingly.

GLOBAL FORCES CHANGING THE BUSINESS LANDSCAPE

The changes that are likely to affect businesses in the near future are:

1. Growing number of consumers in emerging economies – The 2011 BCG global challenger report **[1]** says that the middle class in recently developed economies will grow to 30% of the world population by 2020 and to 50% by 2030. Businesses, therefore, would need to segment the world into "developed" and "developing" markets and design focussed plans to serve consumers from both the worlds.

2. Increasing role of External Factors – In the 2010 McKinsey global forces survey of more than 1,400 executives **[2]**, 48% are reported to feel that the environmental factors are affecting their business and a significant 51% say that their company is addressing this issue actively. Nearly half the businesses, therefore, are passive in their reaction to environmental changes, which will be a major factor in determining organizational success.

3. Shifting Industry Structure/Corporate Portfolio building – The McKinsey report "Strategy In An Era Of Global Giants" of 2004 **[3]** says that the net income of mega institutions (world's top 150 public companies at the end of 2004 based on market capitalization) has increased 3 fold whereas their market capitalization has grown 6 fold over 1984. This points to a trend not only of expansion, but also of corporate portfolio building and large businesses using their intellectual and financial assets to acquire smaller companies in a variety of sectors. This phenomenon will accelerate in the future and affect the operations of businesses.

4. More Intense backlash against Businesses – The recent financial crisis and is aftermath have created a backlash against businesses, as witnessed in movements like 'Occupy Wall Street'. Now more than ever, companies need to focus on ethics and transparency. In the 2007 McKinsey survey "Acting on Global Trends", approximately 60% of executives rate social backlash as 'important' or 'somewhat important'. This figure has doubtlessly increased after the financial crisis of 2007 and the Euro crisis of 2011-12.

5. Shift of economic activity to emerging economies – This phenomenon, which dominated businesses in the last 20 years, will continue in the foreseeable future. Businesses will constantly look for new opportunities that will be created by the changing geo-political environment across the world. "Acting on Global Trends" says that 58 % of the executives felt that the effect of increasing global labor has had a significant effect on their business.

6. Increasing communication between social realms and businesses – With the rise of social networking and Web 2.0 tools, communication between businesses and society has increased to a great extent. This will put extra pressure on businesses to be accountable to the society at large.

THE IDEA

In light of the above changes, businesses need a forward looking framework to help analyse their performance. There are two viewpoints from which a framework can be made – one, from the scope of a burgeoning diversified company like ITC Ltd., Tata Sons, etc., and two, from the scope of a growing industry attracting a large number of players (like the telecom industry in India). These viewpoints would help in understanding the competitive position of the firms, where they are at the present and where they want to go.

Thus, the Earth Model is proposed. There are 3 layers – viz., the core, the mantle and the crust. To fit companies into this model, the Market Value and Intrinsic Value of firms are to be calculated. Market value is found out by using the market price of the stock and financial ratios of the firm, mainly using the DCF (Discounted Cash Flow) methodology. Intrinsic Value of the firm is found out by the available cash flow statements of the firms. The Crust consists of companies which have high Market Value and low Intrinsic Value. The Core consists of companies high on Intrinsic Value and Market Value while the Mantle consisting of companies having medium market and intrinsic values. Post that, to understand the movement of companies within the model, the 5 As of Strategic Drive is proposed. In order to give strategic direction to companies, it is critical to establish the 5 Advantages that a company can leverage– viz., competitive advantage, people advantage, learning advantage, social advantage and risk advantage.

These parameters (the 5 As) may be calculated based on surveys conducted with senior executives across companies who are asked questions with specific rating scales. After plotting these ratings on a normalised scale to eliminate discrepancies; we get an indexed score to compare companies across sectors, whereby a diversified portfolio of a conglomerate can be analysed. A database approach always helps in quantifying a qualitative finding and giving a standardised platform for cross sector comparison of businesses and finally, provides a direction for strategic movement of companies within the Earth Model framework.

The three step process can be summarized as follows:

Step 1: Measure intrinsic value & market value - Every firm has value creation for investors as its major goal. Measuring value helps to understand the business potential of the company

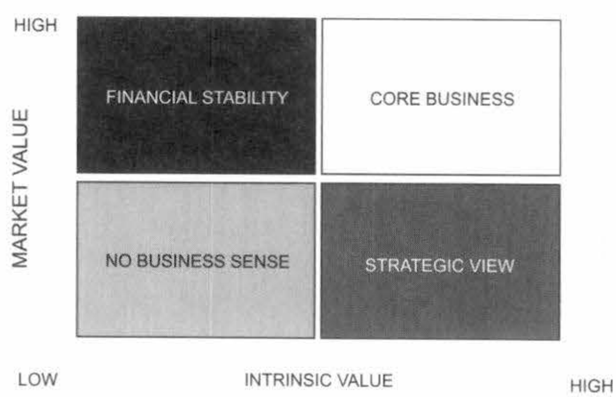
Step 2: Represent the business on Earth model *(explained further)* - This gives a competitive view of the industry and information about the players that have the ability to acquire and the ones that can be acquired. **[5]**

Step 3: **Apply "5As of strategic drive"** *(explained further)* framework to assess whether a conglomerate should continue with a business in its portfolio or move out it.

MEASURING INTRINSIC & MARKET VALUE

Intrinsic value can be measured through the discounted cash flow (DCF) method if a company maintains a stable debt to equity ratio (D/E). When the company's D/E is expected to change then adjusted present value (APV) can be used. However for companies in the banking sector where D/E forms an intrinsic part of business, methods like capital cash flow or equity cash flow can be used **[6]**. Market value calculation for companies that are publicly traded can be done by taking the share price. However, if company is not traded publicly, peer valuation can be used as a proxy.

After that, based on the intrinsic and market values, the companies can be plotted on a 2X2 matrix as shown below.



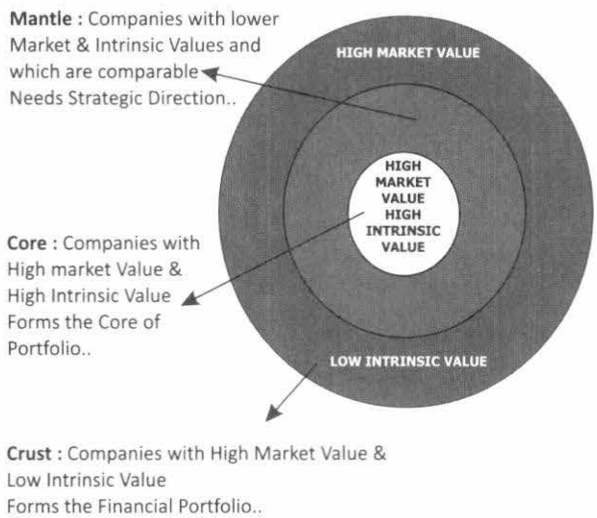
Financial Stability – A company lying in this quadrant should be considered for potential divestment. As the market value is higher than the intrinsic value of the firm, selling the firm could add synergy benefit to the buyer and unlock value for the investors of the company being sold **[7]**.

Strategic View –Firms that are low on market value but have a high intrinsic value need to work on their capital market communication. This shows that the firm is not able to communicate properly to the financial market about its capacity to generate value **[8]**.

Core Business – This is the best position for any firm to be in. This shows that the firm is not only investing in value adding activities but also communicating well with the capital market which is valuing its existence. Firms with low intrinsic and market value need to move out of the business as they are destroying shareholder value and the markets are well aware of their actions.

After calculation of market value and intrinsic value for themselves and for competitors in the industry, all the competitors may be represented on the Earth model.

THE EARTH MODEL



This model will help the managers of a conglomerate understand which businesses it makes sense to be in and in which businesses there is a potential for divestment. For businesses in the future, divestment should also be considered as a value adding activity **[9]**. While striving for growth, companies enter many businesses that never add value to their portfolio in the first place.

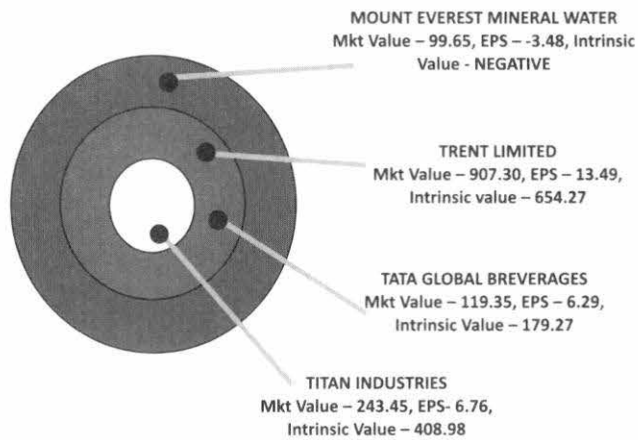
EARTH MODEL EXPLAINED

The Core: The businesses that lie in the core are the ones that not only create value for their investors but also communicate well with the market. These businesses are in the best position to take advantage of innovation, market growth and their knowledge base. These will be the companies that will look for potential M&As in the sector.

The Crust: The companies that are in crust are in need of working on their value creation. They need to take advantage of the high market value that exists for a temporary period to create business synergies and raise their intrinsic value. However they must understand that this state is not going to exist for long and the market will eventually understand the value adding capacity of these companies. These companies should also look for potential buyers because it is the best time for companies to move out of business, thereby creating maximum value for shareholders.

The Mantle: This comprises of companies that have a relatively low market value and possibly low intrinsic value. These are the companies that need a strategic drive to move either towards the core or the crust. The best way to decide which direction they should move in will depend on the strategic drive that exists in these companies.

For instance, based on calculations of the intrinsic & market value **[10]** of consumer product companies of the TATA group, the following earth model was developed:



At this juncture, managers of the Tata group can ask a question, "Is it the right time to divest Mount Everest mineral water?" Reaching a conclusion only on the basis of earth model is taking a narrow view of business, and further analysis is required. This requires a new framework, viz., the 5 As of strategic drive.

5 A'S OF STRATEGIC DRIVE

Strategic Drive is the force that decides the direction of movement of companies within the earth model so that they either move towards the core or to the crust. This strategic drive is measured on the basis of the advantages that the company enjoys in that particular sector. The advantages that will decide the future of the company in that sector are given below. These advantages are hereby referred to as the 5As of Strategic Drive.

COMPETITIVE ADVANTAGE (TO MAINTAIN OR INCREASE MARKET SHARE)

The questions [11] that businesses should ask to understand the competitive advantage of their existence are:

1. How much does the improvement of capability of competitors affect their relative position?

2. How much does the entry of low cost competitors affect their relative position?

3. How does the number of competitors affect their relative position?

4. How does the growth of competitors affect their relative position?

5. How does an innovative market entrant affect their relative position?

6. How does a regulatory change affect their relative position?

7. What is their consumer awareness index?

8. What is the growth potential that exists in the sector?

RISK ADVANTAGE (TO CATER TO OPPORTUNITIES IN THE MARKET)

Managing risk is key to corporate success in a fast moving, increasingly competitive global environment. Strategic risk planning offers a method to identify opportunities that exist for a particular market in the future. The questions that business should ask to understand the competitive advantage of their existence are:

1. How much do regulatory changes affect the sector?

2. How much do currency & exchange rates affect th sector?

3. How much does an economic slowdown affect th sector?

4. How much does a financial market crisis affect th sector?

5. How much do pandemics affect the sector?

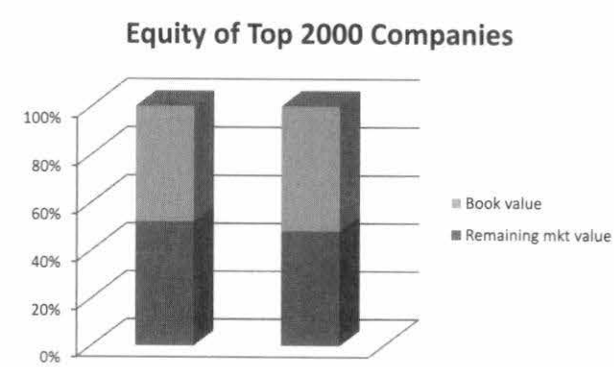
6. How much does a raw material price rise affect th sector?

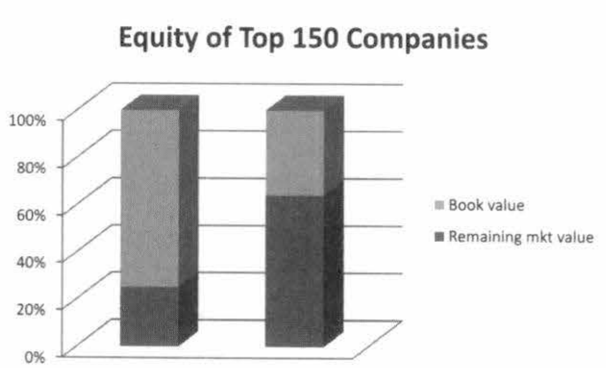
7. How much does a natural disaster affect the sector?

8. How much does geographical instability affect th sector?

LEARNING ADVANTAGE (TO REDUCE COST & GAIN CUSTOMER BASE)

The market/book ratio of top 150 companies ha increased significantly in comparison to the same rati for top 2000 companies [12]. This shows tha businesses are becoming more valuable on the basis o the intellectual assets that they have in the field o operation. This trend makes learning advantage one o the critical parameters for success in the future. So a company needs to understand whether it has th capability to create intellectual assets.





The questions that businesses should ask to understand the learning advantage of their existence are:

1. How much has the capacity to innovate increased in the company?

2. How much do consumer awareness & knowledge exist within the company?

3. What is the company's ability to customize a product or a service?

4. How good is the company in target marketing?

5. To what extent do supply chain insights exist within the company?

6.To what extent does the company involve the consumer in product development?

SOCIAL ADVANTAGE – (TO ATTAIN SUSTAINABILITY)

In the wake of the global financial crisis, businesses across the world are losing traction with the society, which makes this a critical parameter to judge the future viability of a business. Companies need to make social responsibility the core value of their operations. Companies should not only be proactive in compliance with regulatory requirements, but also have a farsighted vision in ensuring sustainability of business processes, restoration of biodiversity, and so on.

The questions that businesses should ask to understand the social advantage of their existence are:

1. What are the social & ecological costs of doing business?

2. What is the level of trust that the company enjoys among suppliers, customers & vendors?

3. What are the social contributions of the company?

4. What is the ability of the company to affect the industry ecosystem?

PEOPLE ADVANTAGE – (TO ATTAIN ADAPTABILITY)

In a world when every tangible capability can be copied by competitors, it's the people who have become a company's most important assets. Moreover, to best use M&As for inorganic growth, companies need to develop people advantage in their portfolio.

The questions that businesses should ask to understand the people advantage of their existence are:

1. What is the company's contribution to an employee's learning opportunities?

2. What is the flow of knowledge to and from the company?

3. What are guiding principles of its operations?

Further to the discussion on Mount Everest mineral water, it seemed that the company is a candidate for divestment. Managers of the group should try to answer the questions that are discussed in the 5A framework. This will give a set of values that decide the either capability of movement of the company towards the core or potential to move out of the model. Based on the analysis, the scores for the company on the 5As are

	Competitive Advantage	Risk Advantage	Learning Advantage	Social Advantage	People Advantage
Mount Everest mineral water	0.36	0.76	0.37	0.49	0.39

*** The detailed calculation is outside the scope of this write-up. The values are worked by writer's analysis of the company as an external agent.*

The values show that all the advantage factors, except risk advantage, for the company are low. The company bears a high risk advantage because as the natural resources across the world are getting scarce, this company gives the Tata group a hold over the supply of pure water. So divesting may not be a great idea, but the company does need to work on the other advantages to move itself towards the core.

CONCLUSION

The implementation of the Earth model to formulate strategy is highly dependent on the data supporting the qualitative factors. The first part of the model, viz., comparison of intrinsic and market values, comes from equity research. The second part, viz., the 5 As of strategic drive, are calculated based on surveys conducted with senior executives across companies who are asked questions, the answers to which have specific ratings, which are then normalized to enable comparison across companies. Ultimately, this provides a direction for strategic movement of companies within the Earth Model framework. This approach needs to be conducted every year to understand how effective the initiatives taken in the past year have been and also to assess new opportunities and risks needing strategic attention that have developed in the environment.

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