



PROFITABILITY ANALYTICS
CENTER OF EXCELLENCE

eBook

Unleashing the Power of Strategy Formulation



www.profitability-analytics.org

GOAL

The goal of strategy formulation is to make a roadmap that guides an organization in pursuing its long-term goals while dealing with the challenges and uncertainties in the business world. To do this, it needs to find a unique and sustainable advantage over its competitors by either doing things differently or finding new ways to do the same things.

The roadmap should be flexible enough to make changes when needed, but also clear and focused enough to provide direction and purpose for the organization and everyone involved. Strategy is not just about what you do, but also about what you choose not to do, and how activities are aligned within your organization to create value.

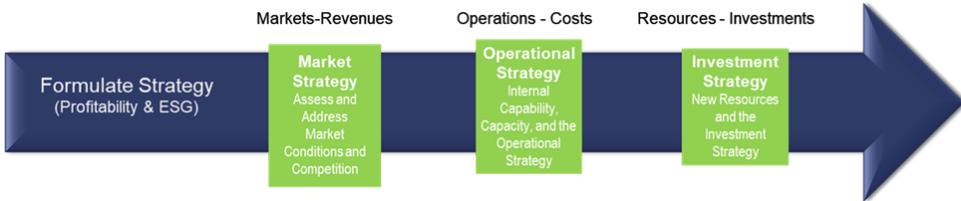
The PACE Profitability Analytics Framework (PAF) provides organizations a framework for developing the roadmap they need to succeed.

"Strategy is the ultimate internal decision. Using the PACE Framework ensures your internal decision support capability is formulating a solid strategic plan."

*Gary Cokins, Founder and CEO,
Analytics-Based Performance
Management LLC and PACE Director*



The PACE Profitability Analytics Framework (PAF) breaks down strategy formulation into three parts: market strategy, operational strategy, and investment strategy.



Strategy Formulation with the PAF

These three phases of strategy development consist of the following:

1. **Market Strategy:** This involves understanding and analyzing your market and customers. You need to assess the conditions of the market(s) you operate in and find ways to differentiate yourself from your competitors.
2. **Operational Strategy:** Here, you evaluate your existing resources and processes to see if they can meet the needs of your market and customers. Both the Market and Operational strategy assessments may reveal areas where you lack the necessary resources or have mismatches that hinder your strategy and goals.
3. **Investment Strategy:** This step involves determining the changes that are necessary and deciding which resources and processes should be invested in or eliminated. The goal is to align your resources and processes with the requirements of your strategy and goals.

PARTICIPANTS IN STRATEGY FORMULATION

Creating an effective strategy usually involves working together with different people who have a stake in the organization. This ensures that the strategy is comprehensive, feasible, and matches the organization's goals. It's best when senior leaders, middle managers, and experts from various areas of the organization are involved. They can provide valuable insights on markets, customers, and the organization's capabilities.

However, there are situations, like crises or turnarounds, where the CEO or a small group make the strategy, and the rest of the organization, follow their lead. The PAF can be used in both cases. It provides a structured process to adjust resources and capabilities when developing a strategy or evaluating a directed strategy.

Every part of the organization is important in strategy formulation. But in the end, the success of a strategic plan depends on whether it can be put into action within the organization's financial limitations. It must also generate enough profit and cash flow to meet the organization's needs and goals.

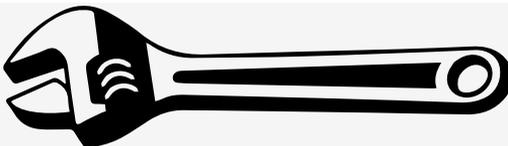


METHODS & TOOLS

To create a strategy, the first step is to analyze your environment. There are different ways to do this; popular methods include:

1. **SWOT Analysis:** This technique helps the organization analyze its strengths, weaknesses, opportunities, and threats. It helps identify potential actions that can be taken to achieve strategic goals.
2. **PESTEL Framework:** This framework provides a template to examine various external factors that can impact the organization's operations. PESTEL stands for political, economic, social, technological, environmental, and legal factors.
3. **Baldrige Performance Excellence (PEX) Framework:** This framework evaluates the organization's performance across seven categories. It helps assess areas for improvement and achieving excellence.
4. **Business Model Canvas:** This is a strategic management template used to develop new business models or document existing ones. It helps visualize and analyze key components of a business model.

These methodologies assist organizations in understanding their internal strengths and weaknesses, as well as external factors that may affect their operations.



DATA AND INFORMATION

When it comes to creating a strategy, there's a vast amount of data available, both internal and external. Some basic types of information that can assist your organization in improving its strategy formulation include:

Internal Data & Information:

- **Customer data:** This includes information about customer needs, preferences, and behavior. It helps organizations develop products and services that meet customer expectations, enhance satisfaction, and build loyalty. It's also important to understand customer profitability to assess the financial impact of different customers and products.
- **Resource and Process Information:** It's crucial to have a deep understanding of all your organization's operations and resources, such as production, service delivery, marketing, sales, logistics, finance, and human resources. Knowing the capacity of these processes and the resources required to adjust to changes in customer demand helps in envisioning new strategies and evaluating their feasibility.
- **Supplier/Partner Information:** Understanding the capabilities and capacity of suppliers and partners is essential. It's important to assess their performance objectively and have regular strategic intelligence on their activities and market capabilities.
- **Financial Capability and Flexibility:** Having data on revenue, profits, costs, and cash flow is crucial for understanding the organization's financial position. It helps identify areas for improvement and assess the available options for financing and investment.

External Data & Information:

- **Economic Information:** Organizations should have a set of financial and non-financial data that they regularly review and trust.
- **Market, Competitor, and Customer information:** This includes data on market size, growth trends, customer segments, competitors, and industry benchmarks. This information helps an organization to understand its competitive landscape and identify opportunities and threats in the market. One critical area you need to keep up with is competitor technological changes in production and service.
- **Social and Technology Trends and Developments:** This category looks beyond an organization's current markets, competitors, and customers and focuses on social and technological trends that will exert long-term influence on a company's business. It includes data on emerging social and technologies and trends that may impact the organization's industry or market. This information helps an organization identify opportunities for innovation and stay ahead of its competition.

"Without clearly anchoring strategy on accounting and finance causal models, the organization's strategy formulation will struggle to connect resources and performance to deliver on key strategic outcomes."

*Monte Swain, Deloitte Professor
of Accounting, Brigham Young University
and PACE Director*



Risk Management

Risk management is a crucial part of the strategy formulation phase in the PAF. It helps organizations identify and deal with potential risks related to their strategic plans. Here's how risk management supports strategy formulation:

- **Identifying potential risks:** Through risk management, organizations can spot possible risks that might affect their strategic plans. These risks can come from within the organization (like operational or financial risks) or from external factors (such as changes in regulations or the economy).
- **Assessing risk impact and likelihood:** Risk management helps evaluate the potential impact and likelihood of each identified risk. This allows organizations to prioritize their focus and concentrate on risks that pose the greatest threat to their strategic goals.
- **Developing risk mitigation strategies:** Risk management aids in developing strategies to reduce or manage the identified risks. This may involve taking steps to minimize the chances or effects of the risks or creating contingency plans to address them if they do happen.



As part of strategy formulation, it's important to comprehensively analyze both strategic and tactical risks associated with the proposed strategies. This includes considering a wide range of scenarios to test the strategies' resilience. Contingency plans and relevant metrics should be developed to account for various outcomes.

While risk management often focuses on potential negative events like economic downturns, pandemics, natural disasters, or loss of major customers, it's also important to be prepared for unexpected success. Missing out on potential sales opportunities can result in significant lost profits and open the door for competitors. By incorporating risk management into strategy formulation, you can create more effective and adaptable strategic plans that can withstand uncertainty and change.

"Risk management is about both threats and opportunities. What is worse? Missing a new product sales target by 20% or missing the opportunity to sell 50% more because there was no plan for great success?"

Larry White, Director, PACE



During the formulation of your market strategy, there are several areas you should explore and consider:

- **Economy and Environment:** Take a broad look at the societal, technological, economic, ecological, political, and legal factors that could impact your organization's competitive position. Look for threats to your current strategy and opportunities to expand into new markets.
- **Markets:** Evaluate your existing and potential new markets to identify any changes that could present opportunities or threats to your competitive advantages. Assess whether you should continue, enter, or withdraw from markets based on your evolving strategy.
- **Competitors:** Keep an eye on your competitors as they can have a significant impact on your competitive position and strategy. Are there new competitors entering the scene with innovative products, services, or technology? Have your competitors undergone any changes through acquisitions or other means?
- **Customers:** Gain insight into how customers research and make purchasing decisions. Evaluate the value your products or services provide to your customers and consider if they will continue to find them valuable in the future. Look for emerging customer categories, segments, or buying patterns.
- **Brand/Reputation:** Your organization's brand and reputation play a significant role in marketing strategy. Assess whether your brand is maintaining, growing, or diminishing in proportion to your marketing efforts. Monitor any changes resulting from competitors or societal trends. Explore opportunities to refresh your brand.

- **Selling Capability & Performance:** Evaluate whether your organization's selling ability has improved or declined. Assess the performance of your sales force and supporting information systems. Utilize social media and data analytics to support your sales team. Compare your selling capability and resources to those of your competitors.
- **Pricing and Revenue Management:** Determine how you will establish and manage pricing. Consider how discounts will be applied and managed. Explore various levers of revenue management, such as pricing, inventory allocation, product/service configuration, and duration control.

"Cost and capacity analytics, if looked at creatively, provide insights for marketing and sales. Customer segmentation and product or service differentiation require both marginal pricing and costing data. Idle or excess time and capacity can create low cost, high profit differentiation opportunities"

*Doug Hicks, President, D. Hicks
& Co. and PACE Director*



OPERATIONAL STRATEGY

Formulating the operational strategy is closely connected to formulation of the market strategy. The focus should initially be on being creative and thinking outside the box when developing the market strategy. However, it's crucial to consider the organization's ability to actually deliver on those strategies. This requires a deep understanding of the organization's current resources, capabilities, and its capacity to adapt and grow.

During strategy formulation, it's important to strike a balance between being creative and realistic. As the strategic process progresses into the Strategy Validation phase, more detailed modeling and assumptions will be needed. The Operational Strategy formulation takes practical realities into account while still encouraging creativity and not dismissing ideas and options too quickly.

The main goal of the operational strategy is to ensure that an organization can effectively implement its market strategy or identify any gaps that need to be filled through investments in new resources or capabilities.



Some key areas to consider during operational strategy formulation include:

1. **Capacity and Capability:** It's essential to have a clear understanding of your organization's resource capacity and capabilities. This goes beyond financial resources and includes intangible resources. The key question is whether your organization can successfully deliver its strategy to the market.
2. **Quality:** Improving the quality of products, services, and supporting functions can be a crucial part of the market strategy. It requires an organization-wide focus on resources, processes, and the ability to change and improve.
3. **Quantity:** Marketing strategies often aim for growth, which requires the ability to produce more products or deliver more services. While this may involve investments, there are also opportunities to improve the efficiency of existing resource utilization.
4. **Scenarios:** As you delve into the organization's operational capabilities and possibilities, scenarios will become clearer and sometimes more complex. This exploration may uncover insights into risks and opportunities that should be documented for future risk management analysis.

INVESTMENT STRATEGY

An organization's Investment Strategy is its plan to bridge the gap between its Market Strategy and its existing operational capabilities. This strategy outlines how your organization will fill those gaps and may determine the timeline of the strategic plan. Some investments, such as major capital projects, acquisitions, green initiatives, or IT projects, can take several years to complete. The Investment Strategy is also influenced by the availability of financial resources and the risk tolerance of major financial stakeholders.

During the strategy formulation phase, it's recommended to focus on bold and creative solutions without being overly limited by practical constraints. In the subsequent strategy validation phase, strategies are examined more rigorously, and the focus shifts towards crafting strategic solutions that are optimal within the financial and operational limitations. This process may uncover new solutions that challenge existing assumptions.



Here are some key aspects of Investment Strategy to consider:

- **Capacity:** Increasing capacity to produce more goods and services can involve various investments beyond traditional capital projects. This can include additional equipment, process improvements, better utilization of existing capacity, outsourcing, and more. Similarly, increasing service capacity may require investing in more people, IT tools and automation for efficiency, reducing non-productive work, or outsourcing. Each solution requires an investment, whether tangible or intangible.
- **Capability:** Investing in organizational capability, such as education, retention, innovation, and data/analytics, often leads to increased capacity. However, capability investments are often seen as operating expenses rather than capital investments and may receive less strategic consideration at the organizational level. It's important to give equal strategic consideration to investments in both capacity and capability.
- **Tangible Investments:** Traditional capital investments have established practices for strategic capital management and evaluation, often using return on investment (ROI) techniques. However, these practices can be flawed and misleading as they primarily rely on financial accounting and reporting systems. Solid investment management should focus on comprehensive, long-term internal decision support information that follows guidelines for revenue, managerial costing, and investment assessment.

- **Intangible Investments:** Intangible investments and assets increasingly drive organizational profitability. They have a significant impact on capacity and capability. Unlike tangible assets, intangible assets can grow in value over time if properly managed and maintained. Various forms of intangible capital, such as brand capital, human capital, innovation capital, and data and analytics capital, contribute to organizational growth and effectiveness.
- **Scenarios:** Investment scenarios require evaluating how to finance the investment and estimating the time it will take for the investment to generate cash flow and profitability. Significant investments often require a thorough evaluation of project management options that align with the organization's goals and its financial capacity.

Overall, the Investment Strategy involves careful consideration of different types of investments, their financial and operational implications, and their potential impact on the organization's growth and profitability.

"Investing in improving capabilities, often a non-capital investment, is increasingly being shown to appreciate in value as the capabilities are used. These can be critical investments"

Raef Lawson, Executive Director, PACE



STRATEGY VALIDATION: A PREVIEW

In our next eBook we discuss Strategy Validation, the next step in the PACE PAF strategy management process. In that phase, models are used to project the outcomes of different strategy options. These models consider both the operational feasibility and financial performance of each option. It's the quantitative part of strategic planning, whereas Strategy Formulation is more focused on qualitative analysis, using data and market insights to identify potential solutions.

During Strategy Validation, the operational and financial models are modified and adjusted to fit the scenarios developed in the Strategy Formulation phase. These models will help you understand how the strategies would work in practice. The same models are also used in Strategy Execution, based on your organization's operations and reflect the actual resources, processes, and sales of the organization.



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