Contemporary Strategy Analysis **(10th edition)**

SUGGESTED ANSWERS TO SELF-STUDY QUESTIONS

Chapter 2

Goals, Values and Performance

1. *Since long-run profitability requires that a firm is sensitive to the interests of its customers, employees, suppliers, and society-at-large, whether a firm is run in the interests of its shareholders or its stakeholders makes no real difference. Do you agree? Are there situations where shareholder and stakeholder interests diverge?*

   As chapter 2 notes: "Profitability over the long term requires loyalty from employees, trusting relationships with suppliers and customers, and support from governments and communities" (p. 38). The more volatile a firm's environment, the more attentive it must be to the changing needs of these constituencies in order to sustain a competitive advantage.

   Yet, this does not mean that pursuing the interests of all stakeholders is the same as pursuing shareholder value. There is a region of consistency, but also a region of conflict between the interests of different groups. E.g.:

   - Consumer interests are served by lower prices—clearly this is injurious to profitability
   - Employees prefer job security and defined-benefit pensions—a major source of low profitability among legacy airlines, automobile manufacturers, and other companies

   Hence, the importance of Porter and Kramer's "shared value" notion: "creating economic value in a way that also creates value for society" (p, 52).

2. *Table 2.1 compares companies according to different profitability measures.*

   a. Which two of the six performance measures do you think are the most useful indicators of how well a company is being managed?

   b. Is return on sales or return on equity a better basis on which to compare the performance of the companies listed?

   c. Several companies are highly profitable yet delivered very low returns to their shareholders during 2017. How is this possible?

   a) There is no unambiguously correct answer here. All performance measures are imperfect. Important criteria are, first, consistency with value maximization, second, usefulness in comparing with other firms. On this basis, I offer the following comments:

      - Market capitalization is the best available indicator of the NPV of a firm's future profit flows. Hence, it has the key advantage of being forward looking rather than backward looking. Its flaw as an indicator of management performance is that a firm's stock market value at any point of time reflects many influences other than how well the company is being managed including the overall level of the stock market and the likelihood of a takeover.
      - Increases in a company's net income are normally associated with increases in the value of the firm. For comparing performance between companies, net income is

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not a good indicator when the companies are of different sizes: it is better to look at profitability ratios.

- Return on sales is generally not a good indicator of management effectiveness. Margins vary between greatly between different businesses (depending on their capital intensity).
- Return on equity and return on assets are usually closely correlated. However, return on equity is influenced by a firm's ratio of debt/equity. Hence, as an indicator of management effectiveness, the more broadly-based return on assets is better in comparing the performance of different firms.
- Return to shareholders (i.e. share price gains plus dividends) is typically an unreliable performance indicator, especially over the short term. It is highly sensitive to (a) choice of time period and (b) general movements in the stock market.

b) See the point made above: "Return on sales is generally not a good indicator of management effectiveness. Margins vary between greatly between different businesses (depending on their capital intensity)." See for example, the miniscule ROS earned by Amazon and Walmart compared to the fat margins of Apple, Alibaba, and JPMorgan Chase.

c) Return to shareholders is determined primarily by changes in the stock market's expectations about a firm's future profit streams rather than the levels of expected profitability—hence current market capitalization (either in absolute terms of relative to a company's net asset value) is probably a better indicator that historical returns to shareholders. For example, Amazon's return to shareholders was vastly superior to ExxonMobil's despite inferior ROS, ROE and ROA.

3. *With regard to Strategy Capsule 2.2, what additional data would you seek and what additional analysis would you undertake to investigate further the reasons for UPS's superior profitability to FedEx??*

The analysis of the financial statements of UPS and FedEx in Strategy Capsule 2.2 is only the starting point for a more probing analysis. The key here is to use the financial analysis in order to target the underlying strategic and operational factors that give rise to the financial numbers.

UPS's higher ROCE is primarily the result of UPS's return on sales (almost double that of FedEx). In all the major cost items: labor, fuel, maintenance and depreciation, UPS is at an advantage to FedEx. To investigate further we need to determine whether UPS's higher sales margin is the result of (a) its business mix (i.e. ground transportation being more profitable than air transportation), (b) superior efficiency—i.e. UPS's operational management and/or ability to motivate its employees exceeded those o FedEx, (c) lower input costs—in particular, lower wage and salary rates. The financial data can shed light on some of these, e.g. annual compensation per employee for the two companies. However, for the most part this will require looking beyond the financial data to inquire into management and operational systems.

4. *The CEO of a chain of pizza restaurants wishes to initiate a program of CSR to be funded by a 5% levy on the company's operating profit. The board of directors, fearing a negative shareholder reaction, is opposed to the plan. What arguments might the CEO use to persuade the board that CSR might be in the interests of shareholders, and what types of CSR initiatives might the program include to ensure that this was the case?*

The key here is to identify convergence between the firm's CSR policies and the interests of shareholders. The arguments made by Porter and Kramer (see p. 54) provide the basic arguments. In terms of the "sustainability argument" this implies that the pizza chain should invest in the communities within which it resides. This might involve providing jobs for

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disadvantaged youths, involving its self in local charities, using local suppliers and contractors wherever possible. In the long terms it would mean supporting the natural environment through involvement in energy reduction and waste recycling programs. In terms of the "reputation argument" the chain might seeks to improve its image among its customers by many of the same policies—the key however is (a) to focus on initiatives that are clearly visible to key stakeholders (e.g. customers) and (b) select initiatives that are most appealing to the most important of these stakeholders and have the biggest potential payoff to the firm in terms of future revenue generation.

5. *Nike, a supplier of sports footwear and apparel, is interested in the idea that it could increase its stock market value by creating options for itself. What actions might Nike take that might generate option value?*

   The discussion of real options (pp. 54-58) points to two major types of option: flexibility options and growth options. Nike could create options be increasing flexibility throughout its whole range of activities. For example, to take account of opportunities to exploit lower costs resulting from exchange rate movements it could move to shorter contracts with its suppliers or have contracts which are more flexible with regard to quantity. It could require that suppliers reorganize their production processes to allow greater flexibility with regard to color and size to permit faster responses to market preferences. In terms of growth options, Nike could make initial investments in new product areas, new markets, and new product and process technologies. Alliances including minority investments in companies which offer the potential to diversify into new product areas would also create option value.

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