The Dynamics of Strategy - Executive Summary

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As a busy executive, why would you be interested in yet another approach to Strategy? Although existing methods help explain something of business performance, they are declining in use amongst managers who face increasingly complex and fast-changing challenges, and who therefore need quicker, better answers. The Strategy Dynamics approach offers rigorous, fact-based explanations for performance through time, and confident insights for the future, easily communicated to colleagues and investors.

Managers with strategic responsibility for commercial businesses are ultimately concerned with the quest for sustainable advantage. To be practical, 'advantage' for commercial firms concerns earnings, and 'sustainable' means a concern with earnings *into the future.* A truly valuable approach to developing and directing strategy should therefore say something about earnings, not just explaining today's results, but showing how to build performance through time. For non-profit organisations, performance measures may not be financial, but top management's concern is still with building success into the future.

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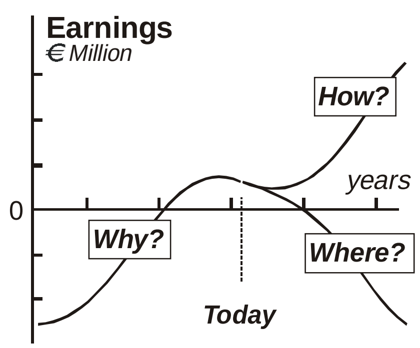
It's the time-path of performance that matters

To find good answers, it is useful to start by asking the right questions. Strategy analysis often seeks explanations for profitability, usually some measure either of return on sales (ROS) or return on assets (ROA). But shareholders don't invest for *ratios,* they invest for future *cash flow.* What management needs, then, is answers to the questions in Figure 1.

- **Why** has business performance followed the time-path that it has?

Figure 1

The fundamental questions of strategic performance



- **Where** is performance heading into the future under current policies?
- **How** can we alter that future for the better?

Performance depends on resources

At first sight, explaining earnings is a rather simple question – our regular P&L and cash-flow analysis does that job at any time we choose. Revenues depend on customer numbers, their rate of purchase, and pricing, and from this revenue stream we deduct costs – driven by how many people we have, salaries, infrastructure and other operating essentials. Customers, staff, infrastructure and so on are the *strategic resources* of the business – things we need, both to operate today and to build for the future.

But there's a puzzle in this 'resource-based view' of strategy. If today's performance is precisely calculated from just a few resources and some external factors, *nothing* else is needed. Yet this surely cannot be enough - what about 'soft' items, like morale, reputation and management experience? And how about capabilities, strategic vision and leadership? Such items *must* make a difference, so we need to know how they impact on this simple notion that performance depends on resources.

The answer to the puzzle lies in the fact that Figure 1 is not posing the question 'what explains today's earnings?', it is asking 'what explains where our earnings are going through time?' If today's resources determine today's earnings, then that always *was* true, and always *will be*. The strategy challenge, then is to explain how resources have developed over time and how we can deliberately build them, robustly, into the future.

Figure 2 shows, simplistically, a business whose revenues depend, over time, on how many customer it has, and whose costs are largely driven by staff numbers. The earnings trajectory is entirely clear, once it is known what trajectory these two resources have followed. Moreover, *future* earnings are similarly knowable, provided that we can anticipate how these two specific resources will develop.

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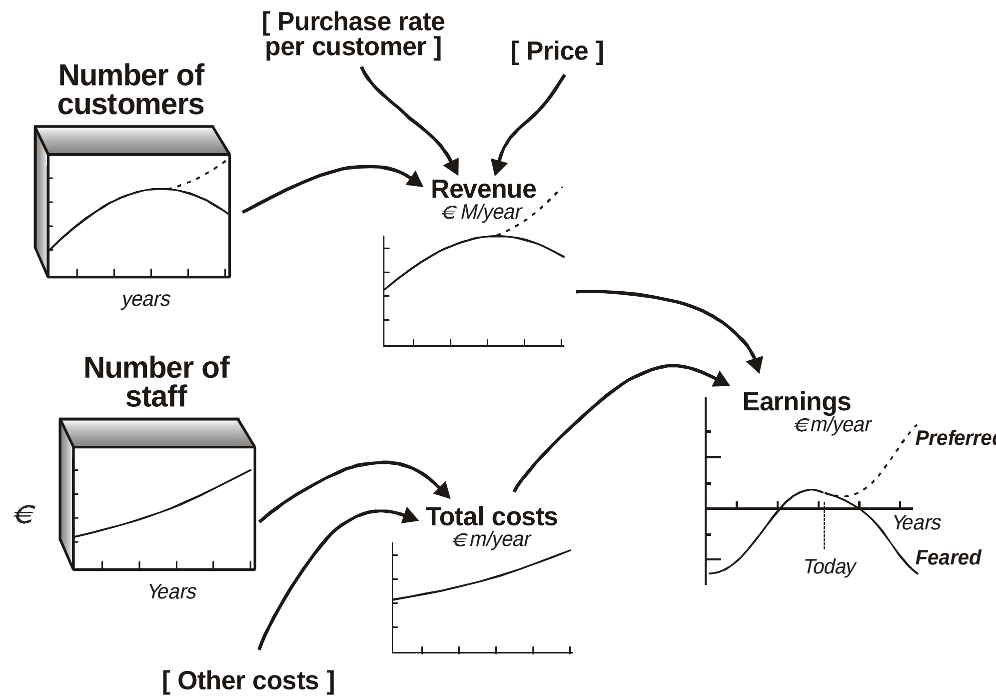
Figure 2
The time-path of earnings ... and the time-path of resources



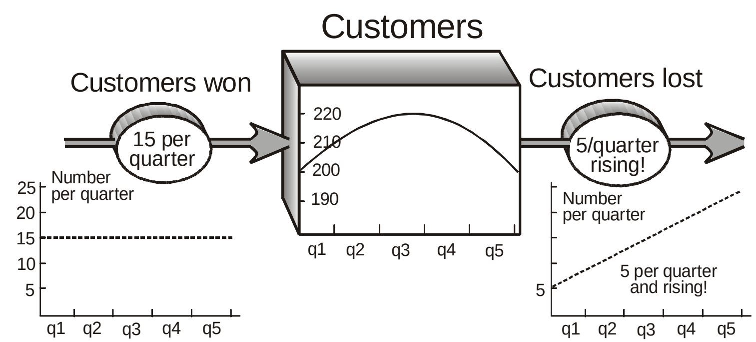
('Word-and-arrow' diagrams feature widely in contemporary management writing, but the items and connections have a wide variety of meanings. In contrast, each element in these Figures has a specific meaning. The boxes simply denote containers holding a certain amount of resource. The curved arrows do not mean merely that there is some vague relationship between two items, they state that one item can be immediately calculated or estimated from another).

Resources build and deplete over time

Strategy writers (and business managers too!) have long recognised the critical management challenge that arises in trying to *build and* *maintain the level* of resources through time. The missing element in a rigorous understanding of performance is therefore an explanation of how the level of each resource changes over time.

Resources share a tricky characteristic, they *accumulate* as new resource 'flows' into the current stock of what we have, and *deplete* or decay as resources flow away. Tomorrow's customer base is therefore equal to today's, plus any customers we win, minus any we lose. Again, this always *was* the case, and always will be. The same applies to staff (tomorrow's staff = today's, plus any hires, minus any resignations), and to every resource in the business. *(A frequently used analogy for these processes is to think of a resource as liquid flowing in or out of a tank. This helps explain why it takes time to detect changes in strategic performance. Even substantial changes to the in-flows and out-flows have little visible impact on the levels of liquid in the tank. Only after some time does it become apparent that change has occurred, and is continuing to do so).*

Figure 3
Building, and losing, a customer-base resource



This process of accumulation through time is neither intuitively easy to estimate, nor properly dealt with by spread-sheet approaches to strategy. The mechanism is only captured properly by what is known as the 'stock-and-flow' framework (Figure 3).

The time-path of the resource *level* for 'customers' is shown on the graph inside the central tank. Customers are being won by an in-flow through the 'pipe' entering from the left – think of the oval on the pipe as a pump, pushing customers into the firm's stock. The time-path for this rate of in-flow appears on the time-chart below the pipe, and is a constant 15 customers per quarter. A similar pump drives customers out through the pipe from the right of the stock - this loss, though starting at a low rate of 5 per quarter, is rising steadily.

Figure 3 starts to explain why the time-path of performance is rarely intuitively obvious – even simple changes to rates of gain and loss create a quite complex trajectory for any resource-level. Here we start in q1 enjoying a *net* gain of 10 customers per quarter, by q3, losses equal gains, and our customer-base is static, and by q5 we are suffering net *losses* of 10 customers per quarter – 25 minus 15.

This accumulation process has important consequences. For example, the number of customers we have today is not 'correlated' with anything – you cannot estimate it with any reliability from knowing the firm's advertising spend or size of sales force. And if you cannot estimate the customer base so simply, then neither can you estimate anything that depends upon that number – revenue or earnings, for example.

The simple truth of Figure 3 applies to *anything* that accumulates and depletes, whether cash, customers, staff, capabilities, reputation or morale. Moreover, the process has profound implications for explaining firms' performance, offering an explanation for why conventional tools of strategy analysis are so inadequate:

- ***If performance depends on resource-levels, which accumulate and deplete over time, there is no way to explain performance at any time except from the gains and losses to all resources at all times,***

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- ***there is similarly no way to produce a confident view of future performance without estimating how gains and losses will develop, and***
- ***there is no way for management to alter strategic performance except by actions that affect resource-flows*** *(though short-term performance can be changed by making simple allocation choices, especially between expenditure and declared earnings).*

Since companies' strategic plans, and consultants' strategic recommendations, rarely address the mechanism described in Figures 1 to 3, it is hardly surprising that our understanding of performance, and our confidence in future expectations, are so poor.

Established approaches to strategy focus attention on external influences – market conditions, industry structure, competitive forces and so on. Whilst these are clearly important influences, a complete understanding of performance through time needs to address three further vital questions:

- how organisations build a *complementary* set of resources through time,
- how the dynamics of competition plays out, and
- how to deal properly with the influence of soft factors.

Indeed, strategy research itself suggests that these considerations are *more* important than the competitive environment – you can still perform well, even in difficult conditions, if you have a strong strategy, and (unfortunately!) you can still do badly, even in favourable circumstances.

Complementary resources

Managers use resources they already have to develop others they need. They have no choice in this matter - it is unavoidable. There is no way to pump any resource into the firm without using others that already exist. For example, a sales force can only win customers if they have a good product range to work with and a good reputation in the market place. Even entrepreneurs, who appear to start with nothing, need the resource of credibility with investors to raise the cash needed to start everything else.

Take for example the launch of consumer electronics devices, such as games consoles. Consumers buy such an item if it offers some useful functionality at an attractive price. Existing owners also encourage new people to buy, but this is only possible if the product is available in stores (or other channels). *Growth* of the customer resource, therefore depends on the *existing* customer resource, and the stores resource. Similarly, stores

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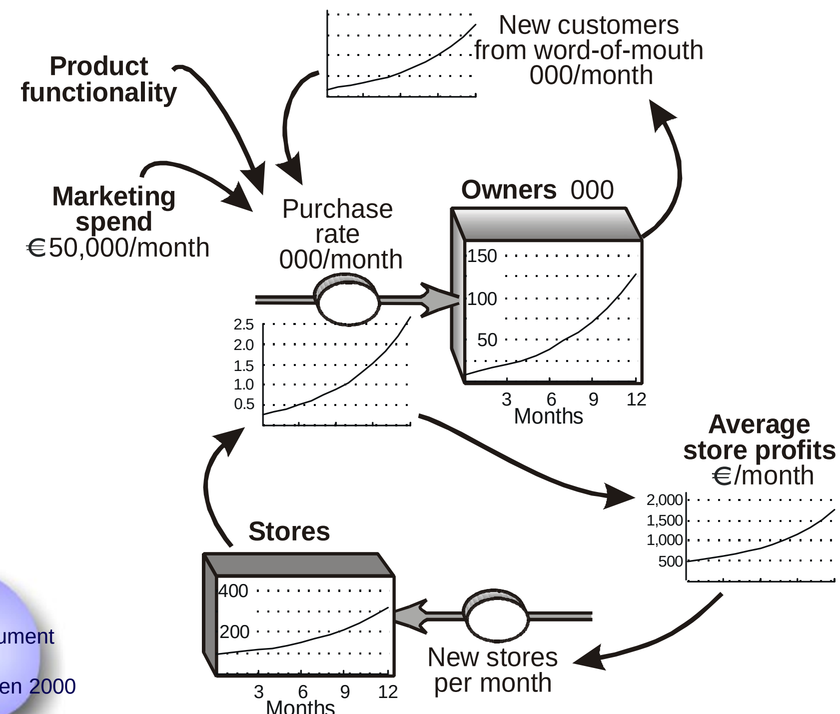
Figure 4

Growth of a customer base that depends on product functionality and availability – illustrates the 'strategic architecture' of a business



want to stock products because demand will drive retail revenue and profitability. Increases in the stores resource thus depends upon consumers' purchase rates, which depend on the existing customer resource. The *speed* of the pumps driving in new consumers and stores thus depend on the *existence* of the other resource (Figure 4).

Note that financial performance can only be calculated once these substantive factors are known – money flows are the speedometer of the business, not its substance. A more complete architecture of this case would include the firm's investment in product functionality and in manufacturing capacity. Unit costs, price, and marketing spend, too, would change from month to month. However, in spite of these extensions, the basic principles remains the same – earnings depend on resources, resources accumulate over time, and depend on each other to do so.

(Incidentally, both Nintendo and Sega have struggled with this particular challenge. The user-base is strongly loyal to Sony's Playstation, principally due to the wide range of appealing games available, which has effectively 'closed the tap' on the inflow of new users for its rivals).

Management's challenge, therefore, is to design a strategic architecture that can build, powerfully and sustainably, the resources needed to deliver future performance. Figure 4 illustrates the tools that the Strategy Dynamics approach offers to accomplish this challenge. Note once more that the curved arrows reflect each item being calculated or estimated from those that connect to it – this is a fact-based approach.

Occasionally, people protest that they cannot estimate these relationships, but this does not remove the challenge. Executives constantly make decisions on implicit assumptions about such connections – so if they don't do so this way, how *are* decisions being made?

WARNING – whilst capturing the existing strategic architecture of any situation is a powerful start, this focuses attention on the *status quo.* Management should always explore possibilities to adapt or redesign that architecture into a new form, capable of radically improved performance.

Rivalry

Once the strategic architecture of the business itself is clear, the frameworks can be extended to deal with the warfare of competition. Work with a wide variety of organisations has identified that rivalry in the market place takes just three forms:

- the race to develop and exploit new customers,
- the tug-of-war to steal customers from competitors,
- the battle to win a greater proportion of sales to shared customers.

One or more of these mechanisms may also occur when organisations compete for other scarce resources, such as skilled staff, investment or access to marketing channels. This makes 'rivalry' as important – and just as understandable - for non-profit organisations as for commercial firms.

The Strategy Dynamics approach extends the quantitative understanding of how a single firm operates, to explain the *relative* performance of firms as they engage in these competitive processes. This enables management to identify precisely where high-leverage opportunities exist to both boost the resource-building performance of their own organisation and to disrupt the efforts of competitors.

Once the core mechanisms of competition have been captured, it is relatively straightforward to extend the framework to deal with rivalry between several competitors. The insight can even capture how entire industries evolve – for example, as new competitors start up, compete away industry margins, causing others to fail and leave the industry.

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Dealing with soft factors.

Whilst strategy writers acknowledge that soft factors are important - staff skills, investor confidence, customer loyalty, reputation, morale and so on – management currently lacks any means of understanding how they alter firm performance over time. To arrive at this understanding requires a distinction between two broad classes of intangible resource:

- **Characteristics or 'attributes' associated with tangible resources.** Each customer, for example, brings with them whatever purchase rate they demand; each product delivers a certain benefit to customers; each employee possesses skills that we need, and so on.
- **'Indirect' resources, reflecting how certain important groups feel.** Examples include staff morale, reputation amongst customers, or support from investors.

An organisation's 'capabilities' are a further matter altogether, and are best thought of as 'things the firm is good at *doing*' rather than things it *has.* These factors, too, can be assessed and integrated into the organisation's strategic architecture and explanation of performance.

The Strategy Dynamics approach explains how to define and measure all such soft items, how to assess the impact of each on the firm's ability to build resources for the future, and hence how to uprate and consolidate its performance. Unless managers (and the consultants who advise them!) take account of these factors, their plans must inevitably be flawed, and their aspirations unlikely to be fulfilled.

Conclusion

The complexity and dynamism of modern industries and businesses has exposed shortcomings in the strategy tools currently in widespread use. Senior management is in urgent need of a practical, fact-based, but rigorous approach for understanding how their organisations function, interact with competitors and their market place, and deliver performance over time. Strategy Dynamics offers a means for accomplishing this task, and building a more confident and prosperous path into the future.

Additional articles, book chapters and learning materials, discuss the principles in more depth (available from www.strategydynamics.com).

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