THE STRATEGIC PLANNING PROCESS, PART 1

The first of two articles that focus on applying your knowledge of management and strategy to a scenario situation. Part 1 considers the complexities of strategic planning and how they can be broken down into three main areas

One of the main problems faced by Paper P3 students is application of knowledge. Early on in their preparation most students feel comfortable with all that is discussed in Paper P3 and many develop a false sense of security preferring to concentrate on what seems to be an overwhelming amount of information for Papers P2, P4 or P6. It is only when students enter the revision phase do they realise that you need to do much more than just learn the notes in order to pass the exam. The main skill that a student needs to develop is an ability to apply the acquired knowledge in a scenario situation. The following provides an insight into how to apply your knowledge effectively.

This first article deals with the strategic planning process. Many of the various texts on the market comprehensively cover the key processes involved in strategic planning. These often involve comprehensive flow charts with many subparts. Rather than explain these in detail, let us first distil the process into three main areas:

1. Strategic analysis.
2. Strategic choice.
3. Strategic implementation.

Strategic analysis

Essentially a business will address the following questions:

- Where do we want to go?
- What constraints exist on our resources?
- What are the key threats from the external environment?

Where do we want to go?

The answer to this question is influenced by many factors. Key influencers are often the owners (for example, shareholders) who may have a particular expectation for the organisation. However, one also needs to take into account other stakeholder influences, which could include the government, employees and the general underlying culture of the organisation. These views are very often consolidated into a corporate vision or mission statement.

What constraints exist on our resources?

Resources needed would include finance, plant and machinery and human resources. However, to make it easy, I would recommend that you simply think 6Ms. 6Ms is simply a mnemonic used to save time when thinking about the various resource constraints. It can be summarised as:

- money
- machinery
- manpower
- markets
- materials
- make-up.

The typical questions, which you would ask against each of these resource constraints, would be as follows:

Money

- How much do we have?
- What is the current cost of our capital?
- Is the company excessively geared or are there any opportunities for raising additional finance?

Machinery

This would refer to machinery in the broadest sense of the word, and typical questions one might ask would include:

- How technically up to date is the machinery?
- Is there a danger of obsolescence?
- Has it been poorly maintained over the years?

Manpower

- How expensive is our workforce?
- How efficient are our employees?
- Is the business overstaffed?
- Is it understaffed?
- What is the labour turnover rate?
- What is the absence rate?
- Are there good structures to allow management succession?

Markets

There is a danger of overlapping with the external environment here, so try to keep to such questions as:

- Are the markets declining/growing?
- Where are new markets emerging?
- How strong are our brands in the current market?

Materials

- How expensive are our materials compared to our competitors?
- Do our suppliers have excessive control of materials?
- Do we have favourable access to materials?
- Are our raw materials becoming exhausted?

Make-up

- What type of structures do we have and are they likely to limit future growth?
- What is the culture of the organisation and will it stifle or fuel future developments?

We will explain later how we can apply these concepts to a case scenario.

What are the key threats from the external environment?

Once we have established constraints on our internal resources we need to assess the threat posed by the external environment. The easiest way to assess the external environment is to use the following two frameworks:

1. Porter's five forces.
2. PESTEL analysis.

Porter's five forces

The American management writer Michael Porter describes the main external competitive threats to be summarised by his five forces model. Essentially, this model determines the level of competition an organisation is facing by assessing the extent to which the five forces are relevant. The five forces are summarised as follows:

1. The threat from new entrants.
2. The bargaining power of buyers.
3. The bargaining power of suppliers.
4. The threat from substitute products.
5. The extent of competitive rivalry.

1. The threat from new entrants

This is a problem because if competitors can easily enter your business sector they will be able to put a ceiling on your profits. Therefore, the greater the threat from new entrants entering the sector, the higher the levels of competition. The ease which new entrants can enter the business segment is largely determined by the extent of the barriers to entry. You potentially could get a whole Section B question, which goes into detail on barriers to entry.

The following summarises the main barriers to entry.

- *Capital cost of entry*. The higher the capital cost, the greater the deterrent to someone entering the business and, therefore, the likelihood of competition being less than in industries where it is much cheaper to set up business.
- *Economies of scale*. This will apply if a substantial investment is needed to allow a new entrant to achieve cost parity. Therefore, anyone entering the segment that cannot match the economies of scale will be at a substantial cost disadvantage from the start.
- *Differentiation*. Differentiation is said to occur if consumers perceive a product or service to have properties, which make it unique or distinct from its rivals. The differentiation can be in the appearance of the product, its brand name or services attached to the product – for example, Concorde. Therefore, if new entrants are to

be successful in entering the market they will need to spend a lot of money on developing the image of the product – hence, they are likely to be put off.

- *Switching costs*. This is the cost not incurred by a new company wishing to enter the market but by the existing customers. If the buyer will incur expense by changing to a new supplier, they may not wish to change. For example, when the compact disc was invented consumers had to incur a cost of a CD player, as the new compact discs would not work on a conventional record player.
- *Expected retaliation*. If a competitor entering a market believes that the reaction of an existing firm will be too great then they will not enter the market.
- *Legislation*. There might be patent protection for a product or the government might only license certain companies to operate in certain segments – for example, Nuclear Power.
- *Access to distribution channels*. Existing relationships between manufacturers and the key distributors of the products may make it difficult for anyone else to enter the market.

Therefore, in summary, when thinking about the barriers to entry go through the above list in your planning to see which of them apply. Remember that it is unlikely that they all will apply, but the checklist should ensure that all those that do apply would be picked up.

2. The bargaining power of buyers

Do the buyers of the product have the power to depress the supplier's prices? If the answer to this question is yes, it is likely that competition will increase. Buyers will have power when:

- they are concentrated and can exert pressure on the supplier
- the buyer has a choice of alternative sources of supply.

3. The bargaining power of suppliers

The extent of supplier bargaining power is very closely linked in with the issues of buyer power. The extent of the power of the suppliers will be affected by:

- the concentration of suppliers: if only a few suppliers, the buyers will have less opportunity to shop around
- the degree to which products can be substituted by the various suppliers
- the level of importance attached to the buyer by the supplier. The switching costs of moving to another supplier.

4. The threat from substitute products

If there are similar products that can be used as substitute then the demand for the product will increase or decrease as it moves upwards or downwards in price relative to substitutes.

5. The extent of competitive rivalry

The most competitive markets will be affected by the previously discussed forces. However they will also be affected by:

- the number of competitors and the degree of concentration

- the rate of growth of the industry
- the cost structures if high – fixed costs prices are often cut to generate volume
- the exit costs. If they are high, firms may be willing to accept low margins so as to stay in the industry.

PESTEL factors

The other framework, which should be applied when surveying the external environment, is PESTEL factors:

- Political
- Economic
- Social
- Technological
- Environmental
- Legal.

Again, all of these factors will not necessarily apply but provide a useful checklist against which you can compare in an exam situation. They are explained more fully below.

Political environment

The organisation must react to the attitude of the political party that is in power at the time. The government is the nation's largest supplier, employer, customer and investor and any change in government spending priorities can have a significant impact on a business – for example, the defence industry.
Political influence will include legislation on trading, pricing, dividends, tax, employment, as well as health and safety.

Economic environment

The current state of the economy can affect how a company performs. The rate of growth in the economy is a measure of the overall change in demand for goods and services. Other economic influences include the following:

1. Taxation levels.
2. Inflation rate.
3. The balance of trade and exchange rates.
4. The level of unemployment.
5. Interest rates and availability of credit.
6. Government subsidies.

One should also look at international economic issues, which could include the following:

1. The extent of protectionist measures.
2. Comparative rates of growth, inflation, wages and taxation.
3. The freedom of capital movement.
4. Economic agreements.
5. Relative exchange rates.

The social environment

The organisation is also influenced by changes in the nature, habits and attitudes of society.

- Changing values and lifestyles.
- Changing values and beliefs.
- Changing patterns of work and leisure.
- Demographic changes.
- Changing mix in the ethnic and religious background of the population.

The technological influences

This is an area in which change takes place very rapidly and the organisations need to be constantly aware of what is going on. Technological change can influence the following:

- Changes in production techniques.
- The type of products that are made and sold.
- How services are provided.
- How we identify markets.

Environmental

This concerns issues regarding factors that could impact on the ecological balance of the environment and could include such issues as climate change and pollution

Legal environment

How an organisation does business:

- Law of contract, law on unfair selling practices, health and safety legislation.
- How an organisation treats its employees, employment laws.
- How an organisation gives information about its performance.
- Legislation on competitive behaviour.
- Environmental legislation.

Therefore, when surveying the external environment think through Porter's five forces and PESTEL factors and you will have a fully comprehensive framework with which you can assess the case.

Past exam-related example

Championsoft is a specialist software house, which has developed and now markets a modular suite of financial software packages under the product name of Champlan. In addition, the company provides a systems design consultancy service to the financial services industry. The company was established in 1988 and the three founding shareholders are also the three full-time working directors. Extracts from the financial results for the last three years are given below. These show declining profitability although aggregate sales revenue has increased year on year.

Year	Champlan units sold	Champlan sales £	Systems design services sales £	
2010	2,050	922,500	650,000	162,000
2011	2,700	1,080,000	600,000	144,000
2012	3,600	1,260,000	550,000	107,500

Operating profit is before interest charges and taxation. The current interest rate on the medium term loan is 10% per annum.

Year	Fixed assets £	Current assets £	Current liabilities £	Medium term loan £	
2010	950,000	425,000	260,000	200,000	915,000
2011	1,000,000	525,000	375,000	200,000	950,000
2012	1,225,000	650,000	475,000	400,000	1,000,000

The current liabilities figure includes an overdraft with the bank of £300,000. This is also the agreed maximum. The company owns its own premises and these comprise the majority of fixed assets. The premises have recently been expanded to cope with the increased sales volume of the Champlan package. Although the consultancy workload of the company has shown some decline in recent years, this has been due to pressure on the software staff to develop more powerful versions of the Champlan package rather than a shortage of potential work. Championsoft is well regarded in the system design services field and attracts good profit margins on the work carried out. It is estimated that the operating profit to sales ratio on system design services is in the region of 15%.

Championsoft employs 18 people mainly as software specialists. There is little subcontract software development undertaken. The managing director and majority shareholder with 40% of the voting capital is Simon Champion. He was the prime mover behind the creation of Championsoft and has substantial experience in the financial services industry. He sees his main role as ensuring the efficient day-to-day administration of the business. The software technical aspects of the business are managed by the technical director, Dr John Chan, who holds 30% of the voting share capital. He is responsible for research and development on the Champlan product range, customer technical support on software products and systems design consultancy projects.

Jill Mortimer, the third director, holds the final 30% of voting shares and is in charge of sales and marketing of both software products and consultancy services. Her background is in the marketing of fast moving consumer products.

Championsoft see its Champlan product range as a market leader in terms of quality and functionality, although this segment of the software market appears to be increasingly driven by price and product awareness. There is also a recent marked tendency for hardware suppliers to bundle in the Champlan product as part of the hardware price of their product. The main competitor to Champlan is the Pennsoft product range. Pennsoft is part of a large international organisation, and its product range is very similar to Champlan if lacking in its level of functionality. Pennsoft software is marketed at prices, which have always undercut Champlan. Jill Mortimer believes that Pennsoft hold about two-thirds of the market, Champlan about one-quarter and the rest is split among a few other software houses. There are few barriers to other software houses entering this market. Almost any quality software house is able to produce a similar product for this market providing that they are willing to devote sufficient resources.

Jill Mortimer has a strong personality and her views have tended to dominate the recent direction of the business. She believes that Championsoft must cut its prices and put more effort into winning sales. ‘Look at the way the software market is developing. Every year there is a bigger market as new users get access to the hardware. Our extra sales effort and a bigger sales force will easily be covered by additional unit sales. We must tackle Pennsoft head on and capture some of their market share.’ Last year Championsoft spent £100,000 on advertising while Pennsoft spent in the region of £500,000.

Simon Champion is not fully convinced. ‘Although our current advertising has generated lots of enquiries, very few of these resulted in firm sales. In fact, the high level of spending on promotion is straining our cash flow.’ He was thinking about the letter recently received from the bank which, while professing continuing support, pointed out that Championsoft’s overdraft was rising year on year and that this must not be seen as a permanent source of finance. The bank had concluded that it would like to see some medium-term projection about how the overdraft was to be brought under control.

As usual John Chan took the opportunity to launch into his familiar attack on the marketing strategy or lack of strategy as he was heard to remark to his software team: ‘We should move away from the package market and into consultancy activities. These build on our reputation and software expertise.

‘The margins are good and we can sell on recommendation not expensive advertising campaigns. As it stands, my team is being torn between development of Champlan and working on software projects. We cannot do both well, we are in danger of losing clients and at the same time failing to keep the edge over Pennsoft.'

Simon Champion was at a loss how to respond. Something had to be done, but what?

Simon Champion has come to see you, as the company's auditor, and has asked for your objective advice. He feels that Championsoft needs a strategy but is not sure what it should be or how to go about preparing it. 'Events move so fast in our industry that plans are out of date before they can be implemented' was a comment made at your meeting.

Requirements

(a) Identify any additional internal and external information, which you need before you could set about writing your report and indicate how you would gather such information. (12 marks)

Suggested approach

As you can see, the question asked above in the case scenario clearly seeks for information of both an internal and external nature together with how you would gather such information.
All answers in the exam should be roughly planned out and all you need to remember to score well in this part of the question are the mnemonics to help you break down the internal and external factors.

So, to help get some structure for internal factors, think 6Ms and you think:

- Money
- Markets
- Machinery
- Materials
- Manpower
- Make-up

We then need to quickly think which of these 6Ms would be most relevant to the answer. I would expect your thought process to go something like the following:

- Machinery? Is machinery relevant to Championsoft's business as a specialist software house? How cost effective is the current use of the machinery? You may comment on the fact that in order to remain competitive ongoing investment in the latest equipment is likely to be relevant.
- Money? An analysis of profitability of individual products, how competitive is the interest on the medium-term loan?
- Manpower? Cost/productivity/staff turnover of the current employees compared to the industry average.
- Markets? The growth potential for financial software and the systems design consultancy market.
- Materials? In the case of Championsoft, materials do not seem to be so relevant so I would suggest no comment is needed.

- Make–up? We would need to look at the current culture of the staff and assess whether it would be happy if one side of the business was run down – for example, software development.

Therefore, we have shown how, by using the 6M's approach in our plan, we can provide ourselves with more than enough criteria on which to comment. We should now be confident in applying five forces and PESTEL in much the same way – for example, questions regarding the five forces would include:

- What are the main barriers to entry for new entrants entering the software and design consultancy business and how much of a deterrent are they?
- Do buyers have the power to ask Championsoft to reduce its prices? You may comment on the fact that it has an alternative choice in Pennsoft and therefore may be able to get a more competitive price than if Pennsoft was not there.
- Are there any other packages out in the market that could be used as a substitute for Championsoft's products?
- Questions of a PESTEL nature would be similar to those used above.

Armed with this information in your plan you should now be able to develop an answer that should fulfil the 12 marks allocated. Do not forget to answer the entire question, which required suggestions as to how you would gather such information suggested. It must be stressed that all of the 6Ms, five forces and PESTEL need not necessarily be used in your answer, but they should almost certainly be used in developing your answer plan.

Past exam-related example

Bowland Carpets Ltd

An example of a question that concentrates on a specific part of the above environmental analysis is given below.

Bowland Carpets Ltd is a major producer of carpets within the UK. The company was taken over by its present parent company, Universal Carpet Inc, in 2012. Universal Carpet is a giant, vertically integrated carpet manufacturing and retailing business, based within the US but with interests all over the world.

Bowland Carpets operates within the UK in various market segments, including the high value contract and industrial carpeting area – hotels and office blocks, etc – and in the domestic (household) market. Within the latter the choice is reasonably wide, ranging from luxury carpets down to the cheaper products. Industrial and contract carpets contribute 25% of Bowland Carpets' total annual turnover, which is currently £80m. During the late 1980s the turnover of the company was growing at 8% per annum, but since 2011 sales have dropped by 5% per annum in real terms. Bowland Carpets has traditionally been known as a producer of high quality carpets, but at competitive prices. It has a powerful brand name, and it has been able to protect this by producing the cheaper, lower quality products under a secondary brand name. It has also maintained a good relationship with the many carpet distributors throughout the UK, particularly the mainstream retail organisations.

The recent decline in carpet sales, partly recession-induced, has worried the US parent company. It has recognised that the increasing concentration within the European carpet-manufacturing sector has led to aggressive competition within a low growth industry. It does not believe that overseas sales growth by Bowland Carpets is an attractive proposition, as this would compete with other Universal Carpet companies. It does, however, consider that vertical integration into retailing (as already practised within the US) is a serious option. This would give the UK company increased control over its sales and reduce its exposure to competition. The president of the parent company has asked Jeremy Smiles, managing director of Bowland Carpets, to address this issue and provide guidance to the US board of directors. Funding does not appear to be a major issue at this time as the parent company has large cash reserves on its balance sheet.

Requirements

Acting in the capacity of Jeremy Smiles you are required to outline the various issues, which might be of significance for the management of the parent company. Your answer should cover the following:
(a) To what extent do the distinctive competencies of Bowland Carpets conform with the key success factors required for the proposed strategy change? (10 marks)
(b) Suggest and discuss what might be the prime entry barriers prevalent in the carpet retailing sector. (7 marks)
(c) In an external environmental analysis concerning the proposed strategy shift, what are likely to be the key external influences that could impact upon the Bowland Carpets decision? (8 marks)
(Total: 25 marks)

Suggested approach

If we are to concentrate on Part (b), you can see that it asks for the prime entry barriers in the carpet retailing sector. All that you need to do here is undertake a quick brainstorm of what we described earlier as barriers to entry and then see whether any of them will apply to the carpet retailing sector.
So thinking back the main barriers to entry which we listed were:

- Capital cost of entry
- Economies of scale
- Differentiation
- Switching costs
- Expected retaliation
- Legislation
- Access to distribution channels

Most of the above could be a potential barrier in the carpet retailing sector, but in order to score high marks you need to apply them in the context of carpet retailing rather than just list them.

- *Capital cost of entry*. How much investment would be required in a lease and stock?

- *Economies of scale*. Are there any current carpet retailers that have superior buying power and economies of scale in distribution and marketing?
- *Differentiation*. Are there any retailers that have high levels of customer loyalty to their shop, which would prevent them from buying carpets from anyone else?
- *Switching costs*. Switching costs are not relevant and one would become relevant if a householder were to enter into a lifelong contractual agreement to buy all their carpets from one particular retailer, which is clearly unlikely.
- *Expected retaliation*. If a retailer existed in the carpet retailing sector that was very aggressive to any potential new competitor this could prove to be a potential barrier.
- *Legislation*. Are there any planning constraints or specific licences that are needed to operate in the carpet retailing sector.
- *Access to distribution channels*. How easy will it be for a new entrant in the carpet retailing sector to find a prime retailing site that is appropriate for the sale of carpets.

Therefore, using the framework in an applied way, we have been able to construct an answer that, if presented appropriately, will be worth almost maximum marks. If you look at Part (c) you will see that the external analysis frameworks fit in perfectly again – see if you can do it.

Summary

Hopefully now when we think about the strategic planning process we think about:

1. Strategic Analysis.
2. Strategic Choice.
3. Strategic Implementation. This article has explained in detail the process of strategic analysis, which we should all be able to break down into:
   - Where do we want to go?
   - What constraints exist on our resources? (6Ms)
   - What are the key threats from the external environment? (five forces, PESTEL)

The next article will take a similar approach to the issues of strategic choice and implementation.

Sean Purcell BA ACMA is a leading freelance lecturer for Paper P3 and lectures on the ACCA Study School and Train the Trainer Programme for Paper P3