Indo-Asian Journal of Finance and Accounting
Vol. 3, No. 2, 2022, pp. 117-125
https://DOI: 10.47509/IAJFA.2022.v03i02.04

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Business Strategy Risk Assessment for the C-Suite - will a Strategic Plan Deliver the Shareholder Value it Promises?*

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Received: 11 August 2022; Revised: 13 September 2022; Accepted 19 September 2022; Publication: 28 December 2022

Abstract: With legislation around the world placing more emphasis on corporate governance and control procedures and with the increasing potential penalties on individual directors, the need for an objective and well-structured review and approval process is becoming greater and spells out the consequences for stakeholder value if this goal is not achieved. This paper makes the case for the supremacy of shareholder value added as the principal goal of corporate strategy. It also spells out a methodology for assessing risk and adjusting corporate strategy accordingly. This methodology is probabilistic rather than mathematical, hence the William Bruce Cameron quotation above.

Keywords: Shareholder value added. Corporate strategy Capital Asset Pricing Model. Market risk. Market share risk. Profit risk.Shareholder value risk.

Introduction. Why Managing Shareholder Value (SV) Must Remain Central to Corporate Strategy

The purpose of this paper is to get to the heart of corporate value assessment. It is currently a major issue following a recent meeting of several major corporations and their very public commitment to stakeholder value. So let us firstly deal with the points of agreement about an article by Ciara Linnane "Maximising shareholder value can no longer be a company's main purpose" (2).

Some of the organisations quoted in this article on shareholder value create shareholder value by applying the values listed in the same article – i.e. an inspiring vision, clear strategies, rigorous segment and brand prioritisation, consistent innovation, superior customer value, high employee

for citation :

Malcolm McDonald (2022). Business Strategy Risk Assessment for the C-Suite - will a Strategic Plan Deliver the Shareholder Value it Promises? *Indo-Asian Journal of Finance and Accounting*, Vol. 3, No. 2, pp. 117-125. https://DOI: 10.47509/IAJFA.2022.v03i02.04

morale, tight cost control and concern for all stakeholders. As chief of Unilever, Paul Polman tapped into the company's history in an effort to make it more profitable and sustainable. "If you want to make the company grow longer term, you have to get out of the rat race of quarterly reports and quarterly behaviour. Many companies manipulate their behaviours and their spending to avoid missing expectations" (3) It is no coincidence that Paul Polman tripled the value of Unilever's shares over a ten-year period.

There are several others in this group, however, whose companies are ranked at the top of unethical companies (4).

Our best scholars have argued the case for decades for stakeholder value and the proof that ignoring other stakeholders doesn't pay off in the long term for all organisations is beyond doubt. There's nothing new in this and any sane person would be in wholehearted agreement.

Over a 20-year period up to 2000, every top performing company in the FTSE in terms of ROI either collapsed or were acquired (4). The reason? Short-termism. We are in agreement that any fool can maximise profit, however measured, in the short term by cost cutting, downsizing and the like, especially in growth markets. ICI was a classic example of being benign to stakeholders, especially employees, but who systematically destroyed shareholder value and who in the process destroyed whole communities.

Turning now to points of disagreement:

> *Every one of the 300 initiatives introduced during the past 30 years has been bad for commerce. Take CRM as an example. Of the $12bn spent each year across Western Europe, about 85% is wasted because CRM is used only to reduce transaction costs rather than to create value for customers (6)*

The reason? Any initiative, including financial measures such as ROI, ROCE, PBT, DCF and the like, not just SV, is bad for marketing unless accompanied by a deep understanding of the market and the segments within it and unless the whole asset base is utilised to satisfy these needs and unless all stakeholder issues are responsibly addressed.

As Collis said in HBR (7), most Directors don't even know what the components of a strategy are, whilst Christensen said, also in HBR (8) of 30,000 new product failures in 2006, most were caused by poor market strategies.

So, after 60 years, modern management, but in particular marketing,has failed to have much influence in boardrooms.

But to single out SV as a major cause of this is ingenuous in the extreme, for it is MANAGERS who are short term in their behaviour, not the financial investment community. It also reveals a common misunderstanding about what SV really is and how stock markets around and world work.

This paper explains how the investment community works and why SV is good for management, the precise opposite of what Ciarra Linnane said in her article. (for a technical explanation of the Capital Asset Pricing Model— CAPM— see page 51 of reference 9).

The Central Role of Risk Assessment in Value Creation

Let's first look at the concept of risk. For most companies, the current share price already reflects some expected future growth in profits. Thus, these current investors and, even more particularly, potential future shareholders, are trying to assess whether the proposed business strategies of the company will produce sufficient growth in sales revenues and profits, both to support the current share price and existing dividend payments and to drive the capital growth that they want to see in the future. At the same time these external stakeholders also need a method of assessing the risks associated with these proposed strategies as, obviously, those risks have a direct link to their required rate of return. This is where commercial strategy should play a role rather than complaining about SV. As Figure 1 shows, the perceived risk profile of the investment drives the level of return required by investors in each particular investment.

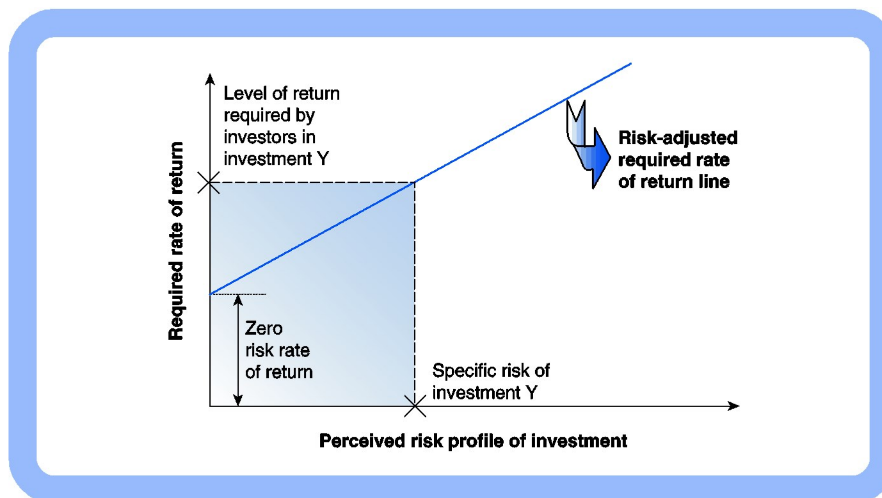

Figure 1: Risk-adjusted required rate of return

Logically, therefore, a normal, rational, risk-averse investor requires an increase in expected future return from any more risky investment in order to compensate for any potential volatility. Figure 2 illustrates this cause-and-effect relationship.

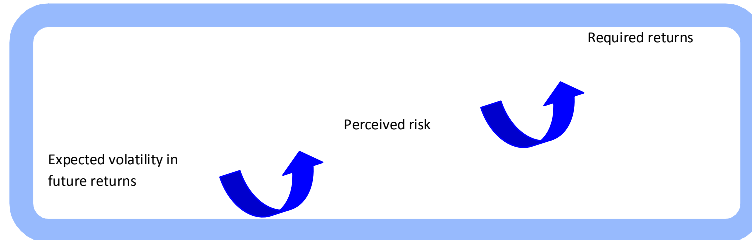

Figure 2: Risk and Return

NO AMOUNT OF ARTICLES WILL ALTER THIS INARGUABLE FACT OF LIFE. IT WAS EVER THUS AND CERTAINLY LONG BEFORE RAPPAPORT PROPOSED EVA (the antecedent of SV).

While investors know in advance of making their investment in most government-backed debt investments exactly what their return will be (i.e., the interest rate payable is stated on the debt offering), this is clearly not the case with most equity risk perceptions and hence required rates of return. Further, if the historical track record of a company's shares shows significant volatility in share prices and even dividend payments, investors will require much higher returns from the company, as they will extrapolate from this past performance as their best guide to the future performance of the company's shares. Thus, life is much more challenging for a highly volatile company, caused by shareholders' natural dislike for risk.

The new opportunity of commercial strategy from SV

In the best companies, directors carry out proper due diligence on declared future strategies, taking into account the associated risks, the time value of money and the cost of capital. New strategies have significantly different impacts on risk which may change their potential for creating shareholder value..

Optimal market-facing strategies seek to increase returns whilst reducing associated risk levels and it is these which create SV. Remember, investors are interested in SUSAINABLE SV, as it is this which impacts the capital value of shares, not results in a single year manipulated by short termism on the part of managers.

Measurable benefits to the business

Objectively assessing the risks associated with the business plan and adjusting net free cash flows accordingly can add value for all stakeholders. The knowledge that all proposed market-facing strategies have been subjected to a rigorous and structured review should provide reassurance

that the resulting critical resource allocation decisions are more likely to be shareholder value enhancing.

Market-facing strategies are closely correlated to shareholder value.It is the choice of which customer segments to focus upon and what to offer them that lies at the root of sustainable competitive advantage. Good choices create customer preference which, in turn, creates better return on investment. Looked at through the lens of business risk, as investors do, strong strategy reduces the risk associated with a promised return. To investors, it is the risk-adjusted rate of return that matters, and managing risk is as important as managing returns, sometimes more so.

The strategy risk assessment process involves both diagnostic and therapeutic stages. The first evaluates business risk and assesses whether the plan creates or destroys shareholder value. The second, building on the outcomes of the first, adapts the business plan to improve its risk profile and enhance shareholder value creation.

Market-related risk assessment begins with explicating the strategy, which is often implicit and unclear even to those who need to implement it. This explication results in a clear definition of which customers are to be served and what products, services and overall value proposition are to be offered to them. This explicit strategy is then assessed for market risk, share risk and profit risk.

Market risk arises from the possibility that the market may not be as large as hoped for in the business plan. It is, to a large degree, a function of the novelty of the business plan. Strategies involving new customers and/or new products are more likely to have high market risk than those involving existing products and customers.

Share risk arises from the possibility that the plan may not deliver the hoped-for market share. It is the corollary of the competitive strength of the strategy. Share risk is reduced when homogeneous segments are targeted with specifically tailored value propositions which leverage strengths, negate weaknesses, avoid direct competition and anticipate future trends.

Profit risk arises from the possibility that the plan may not deliver the intended profits. It is a function of the competitor reaction engendered by the plan and of the aggressiveness of cost assumptions.

Significant levels of market, share or profit risk, or some combination of the three, suggest that the returns delivered by the plan are likely to be less than promised. The final stage of shareholder value creation is therefore to calculate whether this risk-moderated return represents the creation or destruction of shareholder value. This involves calculating the full value of the assets put at risk, including intangibles. Only if the likely return is greater than the cost of this capital is shareholder value created.

In addition to shareholder value creation or destruction, a third possible outcome of this diagnostic phase is that the plan is insufficiently thought out to enable a judgement to be made about its value-creating potential.

We call this detailed risk assessment process Marketing Due Diligence and the details of this quantitative process are spelled out in an award-winning book called "Marketing and Finance; creating shareholder value" (McDonald M, Smith B, Ward K. Wiley 2013 (9)).This book's co-authors have kindly given their permission to cite some of the book's material in this paper.

Strategy risk measurement summary

The overall assessment structure is shown in figure 3, whilst some further detail is show in tables 1, 2 and 3.

The Components of business risk

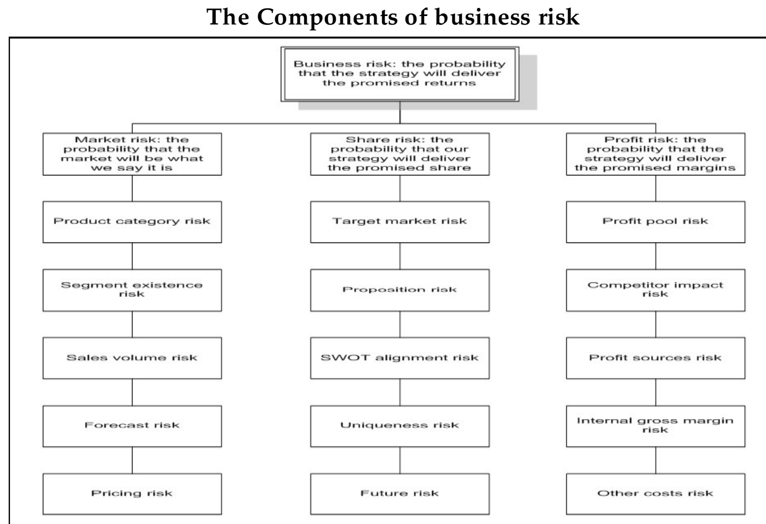

Figure 3

Table 1

Market risk profile

• Product Category Existence	The marketing strategy has a higher probability of success if the product category is well established
• Segment Existence	If the target segment is well established
• Sales Volumes	If the sales volumes are well supported by evidence
• Forecast Growth	If the forecast growth is in line with historical trends
• Pricing Assumptions	If the pricing levels are conservative relative to current pricing levels

Table 2

Market share risk profile	
• Target Market Definition	The marketing strategy has a higher probability of success if the target is defined in terms of homogeneous segments and is characterised by utilisable data
• Proposition Specification	If the proposition delivered to each segment is different from that delivered to other segments and addresses the needs which characterised the target segment
• SWOT Alignment	If the strengths and weaknesses of the organisation are independently assessed and the choice of target and proposition leverages strengths and minimises weaknesses
• Strategy Uniqueness	If choice of target and proposition is different from that of major competitors
• Anticipation of market change	If changes in the external microenvironment and macroenvironment are identified and their implications allowed for

Table 3

Shareholder value risk profile	
• Profit Pool	The marketing strategy has a higher probability of success if the targeted profit pool is high and growing
• Profit Sources	If the source of new business is growth in the existing profit pool
• Competitor Impact	If the profit impact on competitors is small and distributed
• Internal Gross Margin Assumptions	If the internal gross margin assumptions are conservative relative to current products
• Assumptions of Other Costs	If assumptions regarding other costs, including marketing support, are higher than existing costs

This process, whilst not strictly mathematical, uses a probabilistic assessment using the well tried, tested and researched tools of management science

Conclusion

With legislation around the world placing more and more emphasis on control procedures and corporate governance and with the increasing

potential penalties on individual directors, the need for an objective, recognised and well-structured review and approval process should be obvious.

Let me conclude with a real case of misguided corporate priorities. One of the UK's most famous and longstanding companies was truly outstanding with most of its stakeholders. Employees loved them, they supported local communities, gave money to charities and so on. Alas, they were not as good as their competitors such as DuPont and Siemens at understanding and satisfying the needs of their customers, the end result of which was hundreds of thousands of redundant employees, the end of charitable and community support and the like. None of this was due to short termism.

Whether we like it or not, SV will persist as the most logical method of measuring corporate performance, for without creating it, all stakeholders will suffer. This provides an unprecedented opportunity for strategists to show their true worth, especially as today intangible assets now account for 65% of all corporate value in the UK (10).

(Emeritus Professor Malcolm McDonald was formerly Marketing and Sales Director of Canada Dry before joining the academic community as a Professor of Marketing. He is a Professor at six of the UK's top Business Schools)

Note

* The strategy literature is vast and will not be referenced in this paper. For our purpose here, "Strategy" will be confined to: defining and understanding markets; need specification; value proposition development; and the resources required to fulfil those needs, together with the financial consequences. The author's book on this topic, now in its 9th edition, has sold over half a million copies worldwide and is a standard text on the topic of marketing strategy. (1)

The author would like to thank Professors Brian Smith and Keith Ward for their permission to use extracts from our jointly authored book, referenced in this paper.

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