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DOES YOUR STRATEGY HOLD UP UNDER PRESSURE?

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Does Your Strategy Hold Up Under Pressure?

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The CEO develops strategy, the Board approves it.

Well, not quite.

Not any more anyway.

Why? Corporate directors have long had the responsibility of seeking to assure the long-term viability of the companies they serve, specifically to maximize long-term value. While this standard has been in existence for decades, its application is shifting rapidly. Boards are increasingly seeking to understand not only what their companies are doing, but also why those things are being done. And they want to contribute their own ideas. In short, although management will always play the lead role in strategy formulation, it is increasingly a shared activity with the board. CEOs should embrace this trend, and take advantage of it by stress testing their strategies and involving their boards in the strategy-making process.

The traditional approach to corporate strategy-making has been that corporate executives develop it and boards approve it. This hands-off approach to strategy-making is undergoing fundamental change. For both legal and practical reasons, boards responsible for overseeing who is running the show and what show they are running, are now also seeking to understand the reasons why things are being done. The question of "Why are we doing what we are doing?" is the province of strategy-making.

The annual strategy review should add up to more than a bunch of analyses and associated recommendations done in a pro forma manner in order to comply with the annual planning directive. It should be based on deep thinking and knowledge on several levels, and pressure tested by both management and the board.

In this article, we suggest that greater board involvement in strategy-making is in fact a good thing. We further describe a process whereby CEOs and boards can establish a mutually productive strategy-making dialogue and identify the essential kinds of analyses that boards need to focus on to assure sound strategy formulation.

WHY BOARDS MUST BE INVOLVED WITH STRATEGY-MAKING

Boards cannot run companies. That's the executive's job. However, boards certainly can and should feel responsible to do their best to make sure their companies are well run.

Taking the lead from corporate pioneers such as John D. Rockefeller, boards have traditionally translated the responsibility for assuring well-run companies into the tasks of hiring the right CEOs and compensating them to achieve certain goals. Over the past few decades, this involvement and responsibility has grown to include the oversight of strategy, and more recently, risk. Yet, boards continue to believe they should be spending *more* time on strategy. It is the number one improvement area identified by almost every board survey. Increasingly, board members are seeking to understand the rationale for what their companies do. And they want to contribute to the thought processes. Asserting that "the CEO said it would be a good idea" no longer flies. Direct board engagement in understanding strategy is required.

Boards have long had the responsibility of seeking to maximize the value of their companies. The Sarbanes-Oxley Act of 2002 made board members more responsible for the accuracy and transparency of financial disclosures. More pointedly, the UK's Companies Act of 2006 lays the burden of corporate longevity squarely on the shoulders of boards. Since the 2008 financial crisis, oversight of risk has been added as a major area of responsibility. Although none of these developments specifically focuses on strategy, they inevitably lead to it. Yes, sound execution is essential, but without sound strategy, execution can become meaningless, or worse, it can lead a company decisively in the wrong direction.

Thus, a large measure of assuring long-term viability and value maximization depends on the soundness of company strategy. Other elements, such as managerial competence and operational excellence, also contribute to corporate longevity. We suggest that boards should therefore focus carefully on these three principles: strategy, leadership, and operating competence.

It is unrealistic to expect board members to get a good grasp of whether a company's strategy makes sense in a day-long review session. To paraphrase Julius Henry "Groucho" Marx, outside the corporate annual strategy review, board members rarely engage in structured strategy discussions. Inside the corporate annual strategy review, it's much too dark to see.

HOW CEOS CAN TURN ANNUAL STRATEGY REVIEWS INTO FRUITFUL DIALOGUES

If you are a CEO reading this article, you may be thinking, "I don't want my board involved in helping me *make* strategy. I just want them to agree to the strategy I make."

We understand your perspective. Both authors of this article have had the experience of helping executive teams prepare for their annual strategy reviews where the CEO said, "I don't want to tell them too much. Just enough to get them off my back." After all, who wants board members tinkering in areas they know little about?

However, we urge you to consider this idea:

The best way to get the board off your back is to bring them into your head!

That's right; include the board in your thinking. Open up the process of strategy-making. Don't just let the board throw you curves or pick at the conclusions you've reached. Eventually, they are going to make you get them involved. Take the lead and get started.

Here are some reasons why CEOs should want to bring the board more onboard with strategy-making:

1. Boards are being held responsible for understanding the strategies of the companies they oversee. Board members are going to want more involvement anyway. If you don't offer it, they will still demand it. The best way to control board involvement is to establish the terms of engagement.

2. Board members can provide ideas and insights not available to your executive team. Board members represent extraordinary, scarce resources. That's why they were recruited to serve on the board. Consider board members as another set of resources you can use to help you strengthen your strategic thinking.

3. Board members can find the flaws in your arguments before the competition does. This is not something executive team members are generally good at, especially if the CEO has a healthy ego (and what CEO does not?). Take the heat from the board, instead of taking it from the competition.

We are not suggesting that CEOs abdicate strategy-making to the board. On the contrary, we are suggesting CEOs take the initiative to help the board see the quality of their thinking process, and to add to it. Involvement is not the same as abdication. Including the board in strategy-making is one way to assure that the board will not attempt to derail your well-considered, well-crafted strategic initiatives.

Here are four specific ways CEOs can involve board members in strategy-making to good effect:

Process participation. Some board members want to be part of strategy-making; some do not. Proactively recruit interested board members into the process. Let the nominating committee know you want their suggestions. The committee searches and recruits individuals to fill specific knowledge or expertise gaps. Leverage these expensive resources. If it's not a formal set up, say an ad-hoc committee for three months a year, then set up an informal group. Who has interest? Who has expertise? Who's willing to make the time? And who's going to argue with your conclusions at the annual review if you don't involve them before that event?

Issue identification. Arie de Geus (*The Living Company*, 1997) pointed out that one of the keys to corporate longevity is sensitivity to the changing environment. CEOs cannot be in a position to see it all. Why not set up both structured and informal ways to solicit board members about the external issues they perceive as having an effect on your company? It's more efficient to solicit this kind of input before the annual review, rather than have to deflect the question of why the PowerPoint deck is missing some critical external change.

Contrary thinking. Scientists typically ignore data that does not conform to accepted theory. Corporate executives can easily fall into the same conceit. Boards often have individuals who can provide "outlier data." They are the ones who ask about the meaning of weak signals and whether you've looked under the stairs. Contrarians are sometimes just that: contrary. But at the board level, they are often the harbingers of change. Ignore them at your peril.

Pressure testing. Our final suggestion for involving the board in strategy-making is to pressure test your conclusions before you get to the annual review. This involves trial running your strategies – and the analyses from which they were derived – with board surrogates. Hire board stand-ins, specifically experienced consultants or trusted colleagues who do not work for you. Get them to critique your conclusions, processes and outcomes. Do they hold up under objective scrutiny?

A pressure test should vet all of the critical information you have used to develop your strategy and challenge the logic you used in the process. Good strategy holds together at multiple levels (see below). If your strategy does not hold together as a systematic way to determine where to invest your company's resources, then the time to fix the leaks is before you stand in front of the board. Don't pressure test your strategy for the first time at the annual review.

There are, of course, other ways CEOs can involve board members in strategy-making. We have found that these four approaches can help CEOs establish a productive dialogue with their boards. Try them, see what works, then adopt what works for you.

HOW TO PRESSURE TEST YOUR STRATEGY

DeNero, one of the authors of this article, recently participated in a board network meeting in which participants – all of whom sit on the boards of major companies – discussed the need for better board oversight of strategy. The strong consensus of the group was that boards must become even more involved than they already are. The question is, how?

The group converged on the view that there are a number of key areas where boards need to probe deeply, and there are a lot of tools to help executive management get prepared for having that kind of dialogue. Participants agreed that board participation in strategy-making should not become an exercise in jumping through hoops. The "how" question then sharpens into, "How to make sure the process is sufficiently robust, yet not overly burdensome?"

Here are the key topics boards and executives need to discuss to understand how the executive group developed the proposed strategy:

1. Environmental Assessment: How broadly does it respond to changes occurring or likely to occur in the external environment? Is it responsive?

2. Competitive Dynamics: How completely does it comprehend and respond to existing competitors and emerging competitive threats? Is it proactive?

3. Customer Value: How well does it reinforce the company's connection with customers and the value customers derive from their interactions with the company? Is it customer-value focused? How satisfied and loyal are customers toward the company's services or products?

4. Execution: How clearly does it direct internal operations to achieve the strategy, including the role of key business processes and the development of appropriate organizational capabilities? Is it operationally clear? Are necessary skills in place? If not, what is the plan to develop them?

5. Alignment with Mission: How consistent is it with the larger purpose, vision, and values of the organization? Does it line up with the company's mission?

We'll consider briefly some time-tested tools or frameworks that can provide the basis for an engaging and insightful dialogue around each of these strategic dimensions. Not all of these tools or frameworks need be applied analytically. But if you have not at least considered them as a way of thinking, your strategy may be incomplete or worse, flawed. Each underlined term represents a specific tool or framework.

Environmentally Responsive

An external analysis of forces at work typically initiates the strategy review process. The assessment of environmental responsiveness should begin by assembling the relevant set of change drivers or key events that are likely to affect the company's markets, competitive position, or ability to operate effectively based on historic precedent. The PESTLE framework (political, economic, social, technological, legal and environmental) remains a useful tool to facilitate this assessment. Scenario Analysis as first practiced by The Royal Dutch Shell Company may also prove useful in assuring that the strategy-making process has included possible "what if" outcomes in a dynamic and rapidly changing external environment.

The environmental review needs to result in an assessment of the Supply/Demand Outlook for the industry as it might affect the overall prospects for the company's growth and new market initiatives. How likely is continued market growth? What is driving this growth? What factors might trigger a reversal of growth trends? The environmental analysis frames the subsequent dialogue regarding likely competitive activity and the company's position with its customers. What is the supply outlook? Will there be excess or a shortage of industry capacity? What is the shape of the industry supply curve? How will the supply/demand outlook affect market price levels?

Competitively Proactive

Competitive analysis starts with an understanding of industry structure and competitor behavior. *The Industry Structure Model*, introduced by the leading consulting firms and Michael Porter of Harvard Business School in the early 1980s, continues to provide useful guidance in conducting structural analysis. At the core of the analysis is the question of rivalry: What does each firm actually do to gain advantage over its competitors? A deep understanding of industry structure leads to a firm's theory of "How do we compete?" Rivalry in an industry is never general. It is always entirely specific.

One of the limitations of industry structural analysis is that it tends to provide a static view of the company's situation. There are many examples where a major environmental shift or change in an industry's structure affected what a company's strategy "should have been." The landscape is littered with corpses of companies whose management relied on the adage: "Our industry has always worked this way; and it always will."

More dynamic views of industry structure can help dislodge the static view. For example, using Game Theory one company anticipated further consolidation of its industry from over a dozen competitors historically, to a handful in the future. Management had grown up in a world where competitive benchmarking was critical, but they had never considered the competitive responses that can occur in an oligopoly. In short, game theory provided an avenue to consider alternative competitive scenarios.

Business Intelligence focusing on competitor resources and investment programs informs the view of what competitors are actually capable of doing. Game theory, scenario analysis, technology cycle assessments, and an assessment of leadership behavior may further help to illuminate what competitors are likely to do.

The Strategic Issue Map represents a way of organizing the results of the competitive assessment. What are the competitive threats the firm is facing? What are competitors likely to do in the near future with the resources they command? How might such competitor initiatives affect our company's assumed competitive advantage? How are we positioned to preempt or react to such competitive moves? What do we need to do? When?

Customer-Value Focused

The assessment of customer-value delivery begins by establishing the firm's assumed customer value equation. The Customer Value Equation captures the attributes customers consider important as compared to the cost of those attributes to the customer. Customer value, delivered on a dependable, risk-free basis, translates into customer loyalty. Most companies claim to be customer focused. However, most companies also fail to objectively determine how well they are delivering on their promises from the customer's point of view.

Most companies are unaware of the Customer Loyalty Model and the substantial empirical evidence that the relationship between satisfaction and loyalty is not a linear one. There is a proven discontinuity between the indifference of customers who are "just satisfied" and loyal behavior of those who are "highly satisfied" with the most important attributes they seek. Loyal behaviors include higher retention rates, higher prices, greater tolerance for mistakes and higher share of wallet. Loyalty is not just about revenue. It is about profitability. Raising one's average satisfaction score is often misleading or irrelevant. Company managers who do not understand this, and who do not quantify it for their own business, waste enormous resources and potentially put their companies in peril.

The board-level concern regarding customer loyalty should be on proof of efficacy, not just puffery. Just because management asserts customer loyalty, does not make loyalty a fact. Are we really delivering attributes that customers value? How many customers are really loyal? How do we know? Are we doing so on a reliable and consistent basis? What evidence are we using? What else should we be doing for customers? What would it cost? What would it get us? Customer loyalty is central to firm longevity. Its presence and intensity cannot be left to judgment and conjecture.

Operationally Clear

Ultimately, strategy translates into action. The question is, how? The Business System, developed by McKinsey & Co., or the Value Chain description of a firm, as described by Porter, elegantly captures the day-in, day-out realization of strategy. Both frameworks conceptualize a firm as a set of processes or transactions designed to deliver customer value with the greatest efficiency possible, and with competitive differentiation.

Developing a business system level understanding of the firm provides the language for fruitful dialogue about how management intends to implement strategy within each value-adding process of the firm. If the purpose of externally directed strategic analysis is to address the question "Where do we compete?" the purpose of business system analysis is to answer the question "How do we compete?"

The process-oriented view of what the firm does provides board-level insights into how well management has thought through the operational implications of proposed strategic initiatives. Specifically, changes in strategy imply changes in the business system. What needs to change? What should stay the same? How are we organized like our competitors? How are we different, and why? Where are resources deployed now? Where could they be better deployed?

Changes to the business system have economic impact. Where are we investing? What returns do we expect? If we make those changes, how will that affect shareholder value?

Finally, a process-level understanding of what management intends to change in the business system opens the discussion of what results management will be held accountable to deliver. Using the business system to discuss operational implications is a great way to begin the compensation discussion. If the proposed strategy works, what can we reasonably expect to hold management accountable to deliver? What would that be worth?

Mission Aligned

The last area of board-management dialogue regarding strategy-making should entail a consistency check against mission. Boards, not management, are the keepers of corporate purpose. The dialogue about how strategy fits with purpose must begin with a shared understanding of the Vision and Strategy statements of the company. The question is this: Where are they consistent, and where are they not?

If the company is clear about what it is trying to achieve in the world, then gauging whether a particular strategic initiative supports that purpose should be relatively straightforward. However, technological innovation, social developments, or competitive actions may test the frontiers of consistency. It may not be as easy as it seems to ascertain whether a particular strategic initiative supports or veers from the company's reason for existing.

Boards need to know whether management has considered the question of consistency of purpose before put ting forward strategic initiatives. How will the proposed strategic initiatives support the mission? How might those initiatives detract from the mission? And if they appear to detract, is this warranted? If so, on what basis?

Management needs to pressure test its strategy against each of the above dimensions. It should use outsiders (yes, consultants) to do this in a way that ensures it is not falling prey to "not invented here" and "I know my business" traps. Then management needs to engage the board, early and often. Correspondingly, boards need to understand these frameworks and press management as to whether they have been adequately considered. Just as an architect uses design principals to plan a skyscraper, companies must use strategic frameworks to plan their future development. Otherwise it's a crapshoot.

SEEING THE BIGGER PICTURE, TELLING THE LARGER STORY

Participating in strategy-making at the board level is ultimately an exercise in making sure management has considered the larger picture. It may be useful in this regard for board members to seek analogies for the initiatives being considered, or even to employ checklists.

Boards need to make sure their companies have learned from the experience of others. For example, boards may challenge management to provide examples of similar strategies where those deploying them either garnered success or encountered failure. The response, "It's never been done before" is quite often just an excuse for lazy thinking. Alternatively, board members may bring forward their own stories to provide evidence for consideration. Board members may also employ sources of collective wisdom to test whether they, or management, committed any of the most common errors in strategy-making (see *McKinsey Quarterly*, January 2009).

In the end, strategy-making involves both seeing the potential for re-directing a company's narrative and taking the initiative to do so. Like any good narrative, a company's strategy story must hang together to be compelling. It must clearly define who the main character is and what that character is capable of doing. It must set the story in the context of external circumstances. It must reveal the main character's desires and objectives. It must sharply draw the main character's opponents. It must elaborate the character's plan for overcoming all obstacles. And it must result in tangible outcomes that represent the rewards to the hero for having reached the goal.

Like the creator of stories, those involved in strategy-making should bear in mind that the purpose of strategy is to bring into existence something that does not exist. If the role of a leader, in the words of McKinsey & Co.'s Marvin Bower, "is to define reality," then the role of strategy-makers is to identify realities than can be defined, or perhaps, re-defined. Subjecting strategy-making to board scrutiny can be one of the most effective ways to assure that the company's strategy is both coherent and compelling as a narrative for carrying the company forward.

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