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*Grzegorz Urbanek**

THE ROLE OF STRATEGIC OPTIONS IN SHAREHOLDER VALUE CREATION

Abstract. Realization of principle company objective – shareholder value maximization – requires maintaining of high growth rates coupled with achieving returns on investments higher than the cost of capital for the company. The condition for high growth and return is a possession by a company of sustainable competitive advantage. In times of "hypercompetition" and growing market uncertainty, the key to success is maintaining strategic flexibility. An option approach to strategy gives a clue about how firms can improve their strategic flexibility in order to effectively respond to volatile environment and gain sustainable competitive advantage. The main source of numerous strategic options for the company are its competences and underlying resources (mostly intangible). Thus the value creation process is a result of pursuing strategy aimed at the identification, development and optimal use of competences as a source of strategic options for the company.

Keywords: value creation, strategic options, firm competences, firm value.

1. INTRODUCTION

In the theory of finance, the primary objective of a firm is to maximize its value. This objective for convenience of various analysis is often narrowed to maximizing shareholder value or maximizing the value of company shares. Share prices are observable, reflect long-term effects of decisions taken (assuming market efficiency), and finally, are a measure of real value – they can be sold so created value can be realized in practice (Damodaran, 2006). Value for shareholders is associated with market price of a company's shares (a point in time measure) or the sum of share price appreciation plus dividends (value creation for a given period). The market value of shares and value creation are mainly determined by firm's growth rate, understood as the long term annual increase in revenues and profits, and return on invested capital (ROIC) (Koller et al., 2011). The financial crisis in 2008–2009 confirmed that the basic law governing the value creation and value measurement is timeless and has not changed, despite emerging of the "new economy" and new sources of growth

* University of Lodz.

and business efficiency. Value creation is still related with obtaining economic rent – investing capital to generate return exceeding the cost of capital. Higher than “normal” return (hereafter – abnormal return) and high growth are both signs of possession by the company of sustainable competitive advantage. According to the resource-based theory of the firm, the resources with potential to generate sustainable competitive advantage are heterogeneous and immobile and share the following features: create significant value for the customer, are unique, are not easily imitated or substituted by competitors (Barney, 1991). These criteria are fulfilled by firm’s competences and underlying intangible resources. Competitive advantage based on core competences can be sustainable due to the fact that they are protected against diffusion and accessibility for many actors by isolation mechanism, which is based inter alia on the so-called casual ambiguity (Dierickx, Cool, 1989, p. 1508–1509). Firm’s key competences are the source of numerous strategic options, which create for a company a set of possible future actions, depending on developments in the turbulent environment. Thus the creation of shareholder value is a result of pursuing strategy aimed at the identification, development and optimal use of competences as a source of strategic options for the company.

This paper seeks to explain the role of the strategic options in value creation for the company. Its aim is to integrate strategic and financial perspectives in the analysis of activities leading to gaining of sustainable competitive advantage and, as its consequence, value creation for shareholders.

2. THE OBJECTIVE OF THE FIRM

One of the central elements of corporate governance debate is the issue of defining the principle objective of the firm. Determining a single objective is necessary because managers must have a criterion for deciding between alternative courses of action and evaluating performance. Based on such objective it is possible to define what is wrong and what is a good decision. In Anglo-Saxon countries the universally accepted primary goal of the company is to maximize shareholders value. Proponents of this approach state that maximizing shareholders wealth also leads to the greatest social welfare. In some European countries it is believed that the realization of this goal comes only at the expense of interests of other stakeholders – leads to unemployment, low quality product offerings, and generally poor performance of the economy as the whole (Bughin, Copeland, 1997). The competing stakeholder theory proposes that managers should run the company to maximize value and welfare of all involved constituents – shareholders, but also employees, customers, suppliers, local communities etc. But interests of company’s different stakeholders are often at odds with one another and are irreconcilable (Benson, Davidson, 2010). As a consequence of stakeholder theory approach, company should seek several conflicted goals simultaneously. The question arises how the necessary trade-offs should be made? Without a single objective companies implementing in everyday activities stakeholder theory will experience confusion, ambiguity, inefficiency, and consequently will not be able to satisfy its shareholders and other constituents.

M. Jensen argues that both approaches can be reconciled, provided that the maximization of value remains the firm's primary objective (Jensen, 2010). The author proposes so called enlightened value maximization as a main firm's goal. In this approach, companies work together with stakeholders to create value. He claims that to achieve value maximization, managers must satisfy and also enlist support of all corporate stakeholders. Implementation of enlightened value maximization should contribute to creation of general social welfare better than "pure" shareholder, and all the more, stakeholder value maximization.

Regardless of the choice for primary firm's objective – shareholder value maximization or enlightened value maximization – company value is a central reference point in evaluation of strategy effectiveness. The value of the company is determined by its current market position and future prospects. This is reflected in the valuation model based on economic profits. According to this model, the enterprise value equals the book value of invested capital plus the present value of future economic profits. Algebraically it can be presented using the following formula (Koller et al., 2005, p. 695):

$$V = IC_0 + \frac{EP_1}{wacc - g} = IC_0 + \frac{IC_0 \times (ROIC - wacc)}{wacc - g}$$

where:
V – enterprise value,
$ROIC$ – return on invested capital,
IC_0 – current capital invested,
EP_1 – next year economic profit,
$wacc$ – weighted average cost of capital.

According to the above formula a firm creates value above invested capital, by investing capital at rates of return exceeding the cost of that capital. The main determinants of value are, therefore, the amount of return on invested capital (*ROIC*) and the growth of the company (*g*). Most of the firms have a limited ability to generate value (by increasing returns) from existing assets. For firms that achieve high returns, competition often intensifies, driving returns down. Therefore in order to maximize value they must take on new investments with high return potential. But more investments usually means lower marginal returns. So to maximize value a proper balance of growth and return has to be chosen. As it was stated before the general criterion for making investment is that projects should yield a return greater than cost of capital. But in certain conditions firms can add value even when making investments that yield a modestly negative net present value. The value of such investments comes from the fact that they create strategic options, giving firms the right but not the obligation, to either expand further or cut back investment, depending on future circumstances. The value of strategic options can very often explain a gap between firm's market capitalization and its present value of future cash flows as determined with traditional discounted cash flow valuation. So in order to calculate the overall returns to firms, the option value has to be taken into account. The existence of valuable strategic options makes company's value management more complicated but at the same time gives managers opportunity to exploit additional tool for value creation.

Long term value creation of the firm is always connected with possession of some kind of sustainable competitive advantage. The next section of this paper will review the evolution of opinions on sources of competitive advantage.

3. SOURCES OF COMPETITIVE ADVANTAGE

The precondition of long-term value creation for the firm is to gain and maintain a strong market position. As a result, a firm will be able to yield a persistent economic rent on invested capital, which is a sign of possession of some kind of sustainable competitive advantage. Finding the clue about actions that lead to competitive advantage is, from this standpoint, the key to success. According to J. Barney *a firm is said to have sustained competitive advantage when it is implementing a value creating strategy not simultaneously being implemented by any current or potential competitors and when these other firms are unable to duplicate the benefits of this strategy* (Barney, 1991).

In strategic management theory, the point of reference for assessing the effectiveness of strategy is *explicitly* competitive advantage. Maximizing the value of the company is treated *implicitly* as a result of having some form of competitive advantage. Yet these two concepts – competitive advantage and value creation – are closely linked. So for completeness of analysis they have to be considered together. In order to maximize value, the firm has to possess a sustainable competitive advantage.

Since the beginning of 70s a great deal of subject literature has emerged which relates to the different types of strategies that lead to sustainable competitive advantage and its sources. In the 70s and 80s strategy literature focused on the external environment of a company. The dominant theory then was a model by M. Porter, in which searching for sources of competitive advantage began with analysis of the external corporate industry environment (strategic group and competitive forces). Porter argued that a firm has to know the structure of its industry in order to choose its strategy – position within the industry (Porter, 1985). This approach to strategy underlined the importance of positioning of the organization within its environment for coping with external pressures. The goal of the strategy was to adequate position of the company and its products in a market segment where they were protected from intense competition, leading to a extraordinary results. These results were the effect of supremacy based on existence of entry barriers, which lead to imperfect competition and allows companies to obtain higher profits than under “normal” competition. To achieve a competitive advantage, firms had to make a choice among possible “generic” strategies such as becoming the cost-leader, differentiating the offerings, or focusing on narrow market segments (Porter, 1985). In this approach, the essence of strategy is to identify segments with existing or possible to erect barriers to entry. When a segment is identified, the company is trying to enter it. At the same time it takes actions that restrict entry for other companies and the bargaining power of buyers and customers, which will enable the realization of monopoly profits – Figure 1.

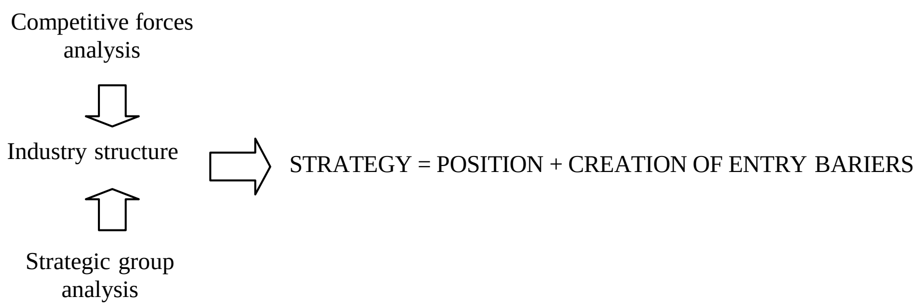

Fig. 1. Positioning approach to strategy

Positioning approach was under increased critique on the turn of the 80s and 90s. Numerous researches have failed to prove the link between sector characteristics and firms performance. Many studies had showed however that differences among firms within industry are more significant than between industries (Grant, 1991, p. 117). So firms’ internal resources and capabilities differentiate their performance, while the sectors in the long run achieve similar results. In the early 90s, the focus in strategic management has shifted towards factors that are internal to the firm. This new school of thought about strategy was later called the resource-based view of the firm. The resourced-based view is associated with the writings of David Ricardo, Joseph Schumpeter and Edith Penrose (Grant 1991, p. 114). According to resourced-based view, competitive advantage is a result of exploitation of unique internal resources and competences. In this approach firm is perceived as heterogenic entity that is characterized by its resource base and distinct competences. Principal to resourced-based view is that not all resources are of equal importance for competitive advantage. J. Barney states that advantage creating resources have to be: valuable, rare, inimitable and non substitutable (Barney, 1991). For R. Grant (1991) most important features of value creating resources are: durability, (non)transparency, (non)transferability and (non)replicability. In general knowledge-based intangible resources are those which best fulfill these conditions. Since majority of intangible resources are not transferable or imitable, to search for explanation of competitive advantage one have to apply internal perspective and analyze resources within the company. The inability of competitors to duplicate resources is a central element of resourced-based approach. There are several views on this point. R. Rumelt introduced bioecological concept of isolating mechanism as a factor that prevent resource imitation (Rumelt, 1987, p. 145). Some other authors state that the most important protective factors are associated with the properties of the development process of subject resources. Because they are developed over long periods of time, they are inimitable since potential imitators would need to duplicate the entire accumulation path to end up with the same "quality" of resources (Dierickx, Cool, 1989). G. Hamel and C. K. Prahalad (1990) state that firms should combine their resources and skills into core competences – defined as what firm does well in relation to competitors. Competences are more than a sum of their underlying resources, which means that their creation goes far beyond assembling their constituents.

In the resourced-based approach strategy formulation starts with identification and analysis of company resources and competences in regard to their rent generating potential as a result of cost efficiency or value added. Based on this analysis a strategy is designed that shapes company internal resources and competences and makes the best use of them – Figure 2.

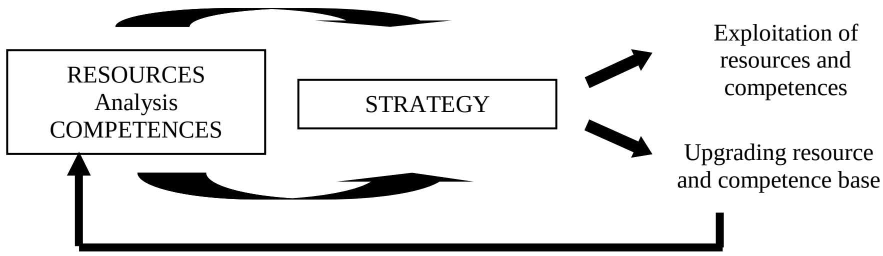

Fig. 2. Resourced-based approach to strategy

In recent years the prevailing concepts of sustainable competitive advantage have been challenged by changing market conditions. The emergence of "hypercompetition" led to further evolution of views on the nature of competitive advantage. Studies on the businesses performance indicated that preservation of long-term competitive advantage based on favorable position within the industry or unique resources is difficult. Therefore, the process of strategic value creation is the result of formation and implementation of a sequence of short--term competitive advantages, which sources change over time. As a result, instead of sustainable competitive advantage based on immutable market position or the same unique resources and competences, a firm may possess a "dynamic" competitive advantage, which bases are constantly changing.

The new approach to creating competitive advantage, emphasizing the growing importance of flexibility and adaptability in response to changing environmental conditions, is based on real options theory (Mun, 2002). In this approach a fundamental way of improving a firm's strategic flexibility to respond to changing environmental developments is creating a range of available strategic options (Sanchez, Heene, 1997, p. 311). A real option is the right, but not the obligation, to make an investment decision if market conditions are favorable. The real option approach allows managers to make better strategic decisions based on learning about development of business conditions. When uncertainty is high and is resolved through the passage of time, managers can make appropriate strategy corrections through a change in business decisions. For instance an expansion option gives managers the right and possibility to expand into new markets or products under the right conditions. In case of abandonment option, management has the possibility to abandon or exit from investment program if conditions are bad. The resources saved in that way can be redeployed to other projects. Important point is that strategic options have significant value, but only when management decides to execute them. Due to possession of various options, the company can gain sustainable competitive advantage, as a result of increased flexibility. In the realm of "hypercompetition", when uncertainty about future market condition is high, company can maintain portfolio of options and then choose for execution the ones that are best for resolved uncertainty. The role of managers then is to identify, create and make optimal use of available options.

To avoid surprises from environment, managers should maintain a portfolio of new options for the future by investing in upgrading present or new resources and competences. According to P. Williamson these options may take a various forms: an idea that has been well thought through but not tested, an experiment to test new business model or product, a venture where pilot has been launched on the small scale (Williamson, 2006, p. 852). The choice, at what level to keep the option (idea, experiment or separate business) requires a tradeoff between the cost of its maintenance in comparison with the speed of possible implementation. When the option is just an idea, its maintenance costs are small, but its implementation requires a long time. When option is maintained as the project on a small scale the cost of maintenance is high, but it gives the possibility of fast execution of this option. In practice, the company should build and maintain a portfolio of options at different stages of development (Williamson, 2006, p. 853). Costs of building and maintenance of options should be kept at minimum level possible, since by definition most of these options will not be executed.

4. RESOURCES AND COMPETENCES AS STRATEGIC OPTIONS

Competitive advantage does not arise simply from the fact of possessing unique competences and resources. Regardless of the strength of isolation mechanism, only through application in specific advantageous situations, resources and competences do generate economic rents. Therefore a proper fit between competences and certain market conditions is necessary for achievement of competitive advantage. This is consistent with the theory of the configuration, which states that competitive advantage is the result of proper strategic fit between internal strategic configuration of elements with external competitive and market conditions (Tallman, 2006, p. 390). Resources and competences develop evolutionary, through learning by selection and retention of processes in a specific environment. Their evolution should be inspired by external factors – market requirements and competitors' moves. Otherwise, the controlled evolution of a firm in search of increased efficiency, inspired only internally without the external constraints, may result in a dead end and fall into a "competency trap" of developing competences that do not add value (Tallman, 2006, p. 387).

Firms may seek to gain competitive advantage and create shareholder value through the "double activities" – the leveraging of its existing competences, and building new ones (Abell, 1993, p. 303–316). Competence leveraging and building are two sources of value creation for a firm. These are cash flows from the use of existing competences and value of the options to create new financial flows – form current competences deployed in new application and investments in new ones. In case of leveraging current competence by its new application, a possible limitations of this process must be taken into account. First – competence diversification to new area may fail due to its non transferability, even within one company. Second – in a given market, depending on the moment of entry, different competences may be essential for the success. Therefore competence diversification should be done in small steps – using trial and error approach.

A firm wishing to pursue its goals should create and leverage competences based on knowledge of the specific markets targeted, so that it can better fulfill existing and create for servicing new customer needs. Due to this knowledge a firm is pursuing refined strategy, which essence is to take actions leading to improved service of current and potential customers. An effective strategy must go beyond improving existing activities, since markets and customers needs are evolving all the time. Therefore, to keep pace with developments in the environment, firms in pursuit of an value building strategy should create new competences will facilitate them to compete effectively in the future. Investments in new competences should be treated as buying new options, which can be executed in the future under favourable circumstances.

Competence leveraging occurs when a firm sustains implementation of the resources in a way that does not require qualitative changes, both in terms of the resources itself, and the way they are applied. Competence building requires qualitative changes in resources itself, as well as in the way they are coordinated and used (Sanchez, Heene, 1997, p. 303–317). Each company in pursuit to achieve its goals is using its own approach to competence building and leveraging. It leads to the emergence of differences in implemented strategies even among firms from the same industry. Also as consequence of implementing different strategies, firms end up with different sets of resources and competences.

5. STRATEGIC OPTIONS AND COMPANY VALUE

By creating a portfolio of strategic options a firm is increasing its strategic flexibility to respond adequately to various threats and opportunities which emerge in the world of uncertainty. As a result a firm is better equipped to compete effectively and achieve sustainable competitive advantage. The main source of strategic options are firm's unique resources and competences. In order to gain value created resources and competences, a firm must undertake activities in two directions. First is to create the necessary resources and competence internally. Second is to acquire knowledge about evolutions of markets and customer needs, both those which arise as a result of trends in the environment and those that are stimulated by the company. Valuable options for the firm emerge "in a crossroads" of internal resources and competences and external market opportunities (Figure 3). Each of the identified in that way option should be evaluated due to the cost of its creation and maintenance, the likelihood of execution in the future, and finally the ability to create on its basis other options in the future (Williamson, 2006, p. 863).

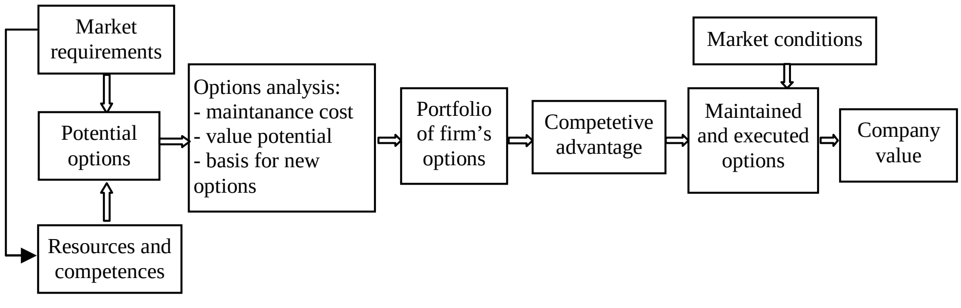

Fig. 3. Resources and competences as the sources of strategic options

Competence building is a process by which a company creates for itself a new "remote" strategic options, which will be a source of cash flows in the future. Competence leveraging means execution of present strategic options to generate cash flow from sales of current products, as well as creation on their basis of new, "close" strategic options. Some of the cash flows from competence leveraging can be used to build new competences, which in effect will create new strategic options and new cash flows in the future, which will be allocated then for building new competences, and so forth. From this point of view, the essence of strategy can be summarized as building and leveraging of competences for creation and use of the next "generation" of strategic options (Sanchez, Heene, 1997).

The processes of building and leveraging of competences can be characterized by particular modes of the funds flows within the company. By leveraging the current competences, a company will make the exchange of financial resources for reconstruction and strengthening of the resources already available. In the case of the simultaneous competences' building, a company allocates part of its funds to acquire new assets. These may be a new technology, new employees, new processes and procedures, etc. Accumulation of new resources can be done either by their internal development or acquisition from outside. In the process of competences' building and leveraging, a the company operates as an open system that acquires and coordinates a variety of inputs from different sources.

Options value is manifested twofold, depending on whether it relates to already executed or maintained strategic options – Figure 4. In case of implemented options, a company generates cash flows that are reflected in the financial statements for the current period or in the financial projections. In the case of strategic options not implemented yet, but maintained, their value is reflected in the company's future growth rate (g) – over that part of it which arises from the implementation of the current options – and in future return on invested capital (*ROIC*) above that resulting from the cost of capital.

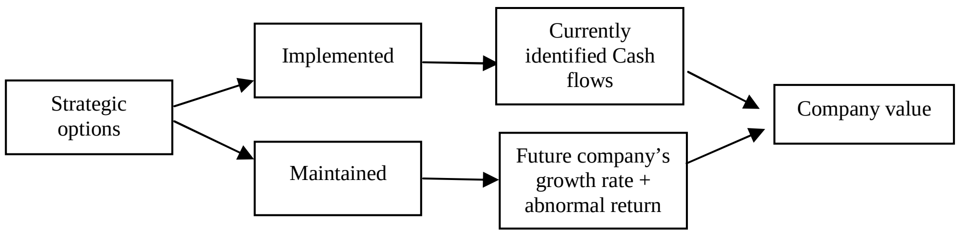

Fig. 4. Strategic options and company value

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