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STRATEGIC FLEXIBILITY - KEY TO EVA GROWTH

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ABSTRACT

We shape strategy and strategy shapes us. Winston Churchill (1874-1965) retorted the same thing about shaping environments. Mission defines strategy and strategy defines structure. Strategy is fundamentally about differences. Strategy appears to be simple but no simpler when we just embark upon it, because it has to deal with many complexities of the business world. Strategies become redundant when aims have been achieved. Then, one has to move beyond strategy. If we do not change in response to external changes we become irrelevant and we may die. Primarily, the strategist does not believe that there is only one possibility (or alternative). The strategists must see the changes for survival. He must see many potential features/ futures and patterns in the flow of information- must train himself for pattern recognition.

World has become flat in this e-business era, and conversions and upheaval of informations ushering in more chaos in the organizations. Thus in a slightly uncertain and changing environment, executives need to have the flexibility in ones strategy to identify the problems and respond to them promptly. The strategic flexibility brings in strategic learning, intent and openness which focuses on the adaptive solutions. In a highly uncertain and changing environment, executives and managers need to have the strategic flexibility to respond to problems rapidly. "Strategic flexibility is the organization's capability to identify major changes in the external environment, mobilizing to commit the available resources (which are always scarce) to new courses of action in response to the changes, recognize and act promptly when it is time to halt or reverse existing resource commitments". This strategic flexibility requires managers to find the right balance and investment to the essential creative investments.

In this modern era of chaotic business upheavals, Economic Value Added (EVA) parameter may be a final buzz word to appreciate assets and income, keeping managers aware of the trade-offs between the two. EVA is an accounting metrics that aims to capture how much wealth a company creates in a given year i.e. it measures the true economic throughput/ profit of an enterprise. EVA is flexible which helps generating flexibility within the system of organizations.

Kaizen concept has been revisited, and how it bolsters innovations, as a mix of Kaizen has been discussed as a case-study of strategic flexibility in McKinsey continuous renewal perspective. Its effects are far-reaching. The other case-study of Godrej Consumer Products Ltd. (GCPL) has been discussed implementing EVA Parameters.

Introduction

We shape our strategy, and strategy shapes us. Winston Churchill (1874-1965) retorted the same thing about shaping environments. Mission defines strategy and strategy defines structure

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(Drucker, 2001). Strategy is fundamentally about differences. The successful strategic thinkers, more often than not are 'system thinkers' and they focus less on day-to-day events and more on underlying trends and forces of change, almost intuitively. And, this is the key for sailing through and surviving in the world of pulsating turmoil of new emerging technologies, transforming economies, shifting demographics, fluctuating consumer preferences and dynamic competitions all over the world. Corporations, firms and organizations are required to be constantly aligned with their environments, either by reacting to external events, or by proactively shaping the businesses they operate.

Strategy should be a force multiplier. Strategy Focused Organization (SFO) should link and align the organizations around its strategy (International Leadership Summit, London, October 2005). Management should create the mechanisms for aligning employees to the strategy. Metrics should be relevant to each employee for them to feel connected to the strategy. Though strategy is adaptable by nature than being rigid, the strategic rigidity can be as disastrous as lack of strategy. Thus to meet the challenging needs of the market strategy one needs flexibility (Sushil, 2000 a, 2000 b). Strategic flexibility can be defined as the "organization's capability to identify major problems, changes in the external environments, quickly committing resources to new courses of actions in response to those changes, and recognize and act promptly to halt or reverse existing resource commitments". Strategic flexibility should have inbuilt and inherent, the 'creative flexibility' to cope with the eventualities and achieving competitive advantages (Katsushiko, et al, 2004).

Kaizen concept has been re-visited, and how it bolsters innovations as a mix with Kaizen has been examined with the norms of alignment of human capital, as well as maximizing the 'intangible assets' of the people of the organizations by unleashing their brain power. In this fashion, the dynamic leaders inspire organizations to set the 'stretch targets'. Strategic flexibility combined with Kaizen and innovation with dynamic dimension of 'stretch target' efforts of the people, ushers in an upshot performance of the organization (Intl. Leadership Summit, 2005)

Economic Value Added (EVA) is one among various value-based frameworks, which is based on the common accounting items like equity capital, net operating profit etc. for earning a return that compensates the risks taken by shareholders. It embeds flexibility in the system (Girotra et. al. 2001). A case-study of GCPL (Godrej Consumer Products Ltd.) has been discussed based on EVA. McKinsey case also is presented for evaluating 'stretch target' of human capital and Kaizen-innovation combination.

The 'strategic flexibility' is dire essential for the growth of an organization. The EVA parameters also now a days help appreciating the organizational performance to a greater success level.

Moving from Strategy to Strategic Flexibility

World has become flat in this e-business era, wherein conversions and upheaval of informations, are also ushering in more chaos in the organizations. As has been observed, strategy fundamentally deals with differences. In simplest form 'strategy' is a long-term plan of actions designed to achieve a particular goal, whereas 'tactics' is a short term plan of actions with resources (scarce) in hand (Figure 1 & 2). Tactics are the servant of strategy.

The overall goal and the guidelines are set by the strategy. The idea of giving away something in order to achieve something much more important is one of the basic rules of tactics. A good tactician knows that he may have to retreat at times (De Bono, 2001). There are three basic dimensions of strategy: strategy process (Thinking, forming and changing); strategy content (various corporate levels) and strategy context (industry, organizational and international),

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culminating into organizational purpose (Bob de Wit, 2004). Strategy should have inbuilt and inherent creative tensions (Senge, 1999), and creative flexibility (Pathak, et al. 2007), which should finally have the capability to cope with global technological changes for achieving competitive advantages.

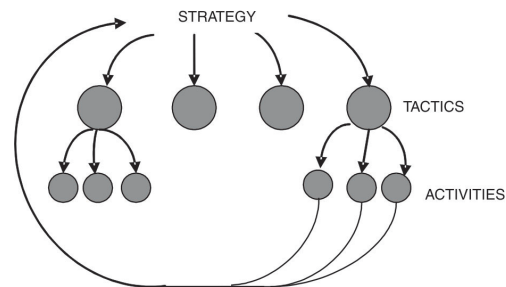


Figure 1: Linkage of Strategy and Tactics

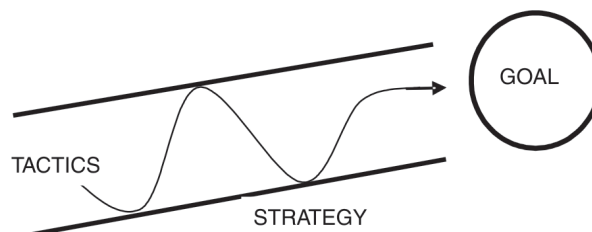


Figure 2: Making Strategy a Continuous Process

The strategist must find order out of chaos and certainty out of uncertainty. “Blue ocean strategy” (uncontested market space) has become more dominant than “Red ocean” i.e. bloody cut-throat competitions (Kim et al. 2005). ‘Value-innovation’ is the corner stone of blue ocean strategy, which is done not on focusing or beating the competition, but concentrating and opening up new and uncontested market space. Thus, value-innovation is the single-most dominant factor of blue ocean strategy. This will be further manifested in the Kaizen and innovation combination in the succeeding paragraphs. Value-innovation should be dynamically vibrant than simply incremental. In this regards one has to reconstruct market boundaries, focus on big picture, get strategic sequence right and reach beyond existing demands. Finally organizational bottlenecks are to be overcome and discipline of execution into the strategy (Bossidy et al. 2002) should be woven through and integrated. Proper product and pricing strategy has to be applied (McGrath, 2001). We have to make an intellectual leap from the linear to non-linear, knowing fully well that future will not be a continuation of the past - it will always be a fleeting target (Gibson, 2002).

Strategy is not only five P’s (plan, pattern, position, perspective and ploy (manoeuvre)) but should set the direction, focus on effort and should be continuous, consistent creation (Mintzberg et al. 2006). Strategy should give a broader picture of the patterns of waves of sea-beach once looked from a Data Collecting Platform (DCP)- a higher cliff or platform, what looks chaotic at lower level has a definite pattern once viewed from a higher plethora. This will provide some definite ‘outcome’ variable from potential unrecognizable variables, (Patel, 2005). Also, thus strategy should provide the concept of interconnectedness.

The right strategy can lead to tremendous success and wrong moves to disaster and





devastation. Strategy cannot be static – it has to be brutally dynamic. Thus the core buzz word is ‘flexibility’, which should be embedded into strategy to usher-in ability to change or react with little penalty in time, effort, cost or performance (Sushil 2000 a). ‘Flexibility in strategy’ or ‘strategic flexibility’ has four parameters viz, strategic learning, strategic intent, strategy evolution and strategic resonance. All the four ingredients lead to four dimensions of flexibility (Sushil 2000 b). These are: Openness, focus, adaptiveness and resilience (Refer figure 3).

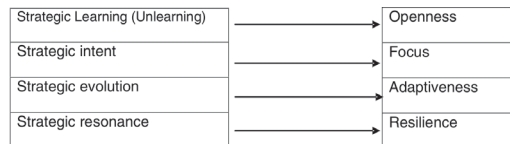


Figure 3: Evolution of Four Dimensions of Flexibility

In basic continuum scales some of the primary extremes can be exhibited as dynamic interplay of two extremes of domain (newer concept) as flexible system approach as depicted in (Figure 4),

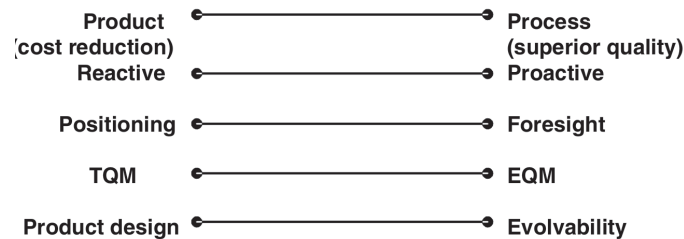


Figure 4: Flexible Paradigms - Extremes on Continuum Domain Mapping

The two ‘extremes of continuum domain’ of flexibility for identifying role space and moving to leveraging from traditional (conventional) to emerging co-creation of experiential learning should be order of the day. We should try to move from ‘Total Quality Management (TQM)’ to emerging ‘Experiential Quality Management (EQM)’, which combines heterogeneity, variability with execution. Similarly one should move from traditional product-design to ‘evolvability’ which caters for designing products to cope with future modifications due to imbedding the intelligence. Co-creation of value-system and interaction with customer-company under ‘experience environment’ system opens a new approach to strategic flexibility (Prahalad et al. 2004). Thus, in a highly uncertain and changing environment, managers need to have the strategic flexibility to respond to the problems speedily. Thus, **strategic flexibility** can be defined as “an organization’s capability to identify major problems/ changes in the external environments, quickly mobilize the resources to new courses of actions in response to those changes, and recognize and act promptly when it is time to halt or reverse existing resource commitments”. Herein, the main focus is on the ability to recognize problems and reverse resource commitments in a timely fashion, under experiential learning environment (co-creation of value-system, continuum domain of flexibility)

Leveraging Organizations to ‘Stretch Targets’

The importance of speed in recognizing and responding to problems has been dramatically accentuated by the dynamic competitive landscape in the recent years. A former CEO of Asea Brown Boveri (ABB) once remarked that “The cost of delay is greater than the cost of an occasional mistake”. Similarly, Juergen Schrempp, CEO and Chairman of Daimler Chrysler, stated in an interview with a Wall Street Journal reporter: “My principle always was...move as



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fast as you can and [if] you indeed make mistakes, you have to correct them It's much better to move fast, and make mistakes occasionally, than move too slowly" (Katsuhiko et al. 2004).

Maintaining strategic flexibility is one of the most important yet most difficult tasks of managers/ CEO's and organizations in a dynamic environment. Also, distinguishing strategic mistakes from temporal setbacks is difficult. Leaders must inspire and make decisions timely. Linking strategy, people and their performance should be the main task of the dynamic leaders. Figure 5 explains the stretch target exercise (Kaplan, 2004).

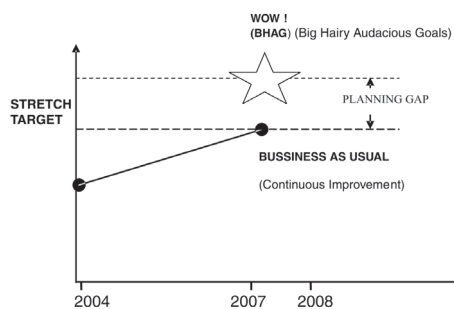


Figure 5: Stretch Target Goals for Organizations

To have a competitive edge, the top management has to plan for a stretch target, which is shown as 'planning gap' in the Figure 5. BHAG is a 'Big Hairy Audacious Goals', and this cannot be achieved without a high level commitment of the top management. (Intl Leadership Summit, London, 2005; Collins et al. 2000). The 'stretch target' is also described by Jack Welch (2005, personal interaction) as 'over deliver'- one must give his best, however any amount of constraints be there.

Management by Strategic Objectives (MBSO) and Strategy-Focused Organization (SFO) are such techniques/ tools propagated by Kaplan (2004), by which organizations can translate strategy to aligning people in the organizations to achieve the designed tasks. Mobilizing resources, motivation and strategy is a continual process. It is dire essential that scorecards, targets and links to compensation should be cascaded throughout the organizations to create a common focus on and awareness of the strategy. Each employee should be connected to the strategy. Levers of control (Simons, 1995) should be exercised between management and leadership by obtaining commitment to the grand purpose. It is finally interconnectedness to all people and system of the organizations.

Synergetic Convergence of Kaizen and Innovation-A Powerful Tool

Kaizen nurtures small and ongoing incremental change, while innovation is like magma that appears in abrupt eruptions from time to time. One big difference between Kaizen and innovation is that while Kaizen does not necessarily call for a large investment, but it does warrant a great deal of continuous effort and commitment. Thus Kaizen strategy brings about gradual progress (small steps), whereas innovation strategy brings about a staircase progression (big steps, which is fast growth). Kaizen is people-oriented, whereas innovation is technology and money-oriented. Kaizen is concerned more with the person than with the results. Innovation and innovation plus Kaizen are schematically depicted at Figure 6 & 7.



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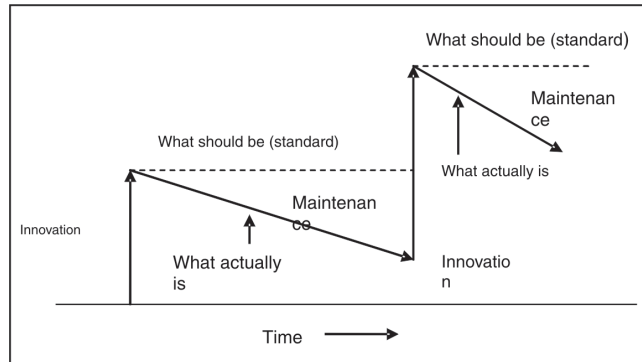


Figure 6: Innovation Alone

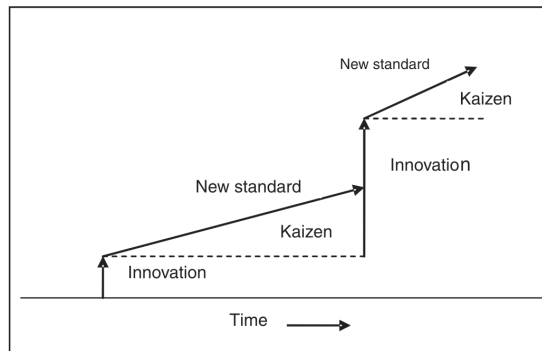


Figure 7: Innovation plus Kaizen

Kaizen philosophy is better suited to a slow-growth economy while innovation is better suited to fast-growth economy. While Kaizen advances inch-by-inch on the strength of very small efforts, innovation leaps upward in hopes of landing at a much higher plateau in spite of gravitational inertia and the weight of the investment costs. The Western world like USA, works on the combination of innovation plus Kaizen, while Japanese and some European countries work on Kaizen principle only. Strategic flexibility, 'Over-Deliver' and leveraging organizations to 'stretch-targets' are the buzz words for achieving organizational excellence.

McKinsey Case Study – A Continuous Renewal Perspective

McKinsey which was founded in 1930's, has been guided by a set of values and principles which have remained virtually unchanged over the years. It has a very solid position in corporate markets which it has achieved by adopting the management practice of continuous renewal through 'UP OR OUT POLICY' or 'GROW OR GO' system which forces every consultant in the firm to constantly rise through the ranks, or else to leave. Even senior directors have to move on, leaving an open space for a rising newcomer to occupy and to learn the necessary skills for this level afresh.

Also, as an open space is reoccupied, it is reshaped to adjust to the then somewhat different external business environment, different business cycle and change in industry or shift in regional focus. McKinsey values 'Client First, Firm Second and everything else Third'. "McKinsey is really reinventing, reshaping and rethinking of future and works on 'stretch target' as well as 'over-deliver principles'.



EVA Manifestations for Organizational Growth

EVA (Economic Value Added) is a value-based measure that was intended to evaluate business strategies, capital projects and to maximize long-term shareholders wealth. Value that has been created or destroyed by the firm during the period can be measured by comparing profits with the cost of capital utilized to earn them. This can help, managers in deciding to withdraw value-destructive activities and invest in projects that are critical to shareholder's wealth. This will also lead to an increase in the market value of the company.

EVA imbeds flexibility, which helps generating adaptability in the system (Girotra, et al. 2001). Also, apart from EVA being accounting metrics, it is a true measure of economic throughput/ profit of an enterprise.

EVA is not a discovery, but a new innovative measure useful for corporate managers. Other traditional measures commonly used are :

- a) ROI – (Return on Investment)
- b) ROE – (Return on Equity)
- c) RONW – (Return on Net Worth)
- d) ROCE – (Return on Capital Employed)
- e) EPS – (Earnings per Share)
- f) EBIT – (Earnings Before Interest and Tax)

EVA can be calculated by subtracting the cost of capital from post tax operating profit or Net Operating Profit After Tax (NOPAT) earned by a company.

EVA = NOPAT - Cost of capital employed, or,

EVA = NOPAT - WACC * Capital Employed(1)

NOPAT = EBIT - AT

Where NOPAT = Net Operating Profit After Tax

EBIT = Earnings Before Interest & Tax &

AT = Adjusted Taxes &

WACC = Weighted average cost of capital

Point to be noted here is that other measurement tools can be misleading as they show profits without deducting the price of producing them i.e. a company which spends Rs. 100 to earn Rs. 100 can still appear profitable. As a result, analysts have the opinion that, those tools can often show “accounting profits” rather than true profits as does EVA.

EVA encourages managers to think like owners and eventually may impel them to strive for better performance. While implementing the EVA model an organization needs to keep its focus towards the ultimate goal of aligning people to the corporate mission, creating an entrepreneurial culture through an empowered work force and building ownership with accountability.

EVA vs Traditional Performance Measures

The development of the concept of EVA has added flexibility in measurement of performance. The traditional methods can continue side by side with EVA. Some of the major conventional corporate performance parameters are:

a) Return on Investment (ROI)

Return on capital is a good performance measure. Different companies calculate this return with different formulae and call it also with different names like return on invested capital, return on capital employed, return on net assets, return on assets etc. The main shortcoming with all these rates of return is that in all cases maximizing rate of return does not necessarily maximize the return to shareholders.

b) Return on Equity (ROE)

The level of ROE does not tell the owners if the company is creating shareholder's wealth or destroying it. With ROE, this shortcoming is much more severe than with ROI, because simply increasing leverage can increase the ROE. In other words, decreasing solvency does not always make shareholder's position better because of the increased financial risk.

c) Earnings per Share (EPS)

EPS is raised simply by investing more capital in business. If additional capital is equity (retained earnings) then the EPS will rise if the rate of return of the invested capital is just positive.

Unlike conventional profitability measures, EVA helps the management and other employees to understand the cost of equity capital. At least in big companies, which do not have a strong owner, shareholders have often been perceived as free source of funds. These flaws are taken care of by the concept of economic value added. The key feature of this concept is that for the first time any measure takes care of the opportunity cost of capital invested in business.

Utility of EVA

- a) Better Decision-Making
- b) Fosters New Era of Corporate Control
- c) Long-Term Thinking
- d) Capital Allocation Tool
- e) Bonus System

Flexibility in EVA

Flexibility has assumed key role in every facet of organization management and finance function, known for its rigidity, is not too far from application of this paradigm. EVA can lend a helping hand in this connection in two ways: one that it is inherently flexible and second, it helps generate flexibility within the organization.

Implementing EVA

Implementing EVA should be more than just adding one line in the monthly profit report. EVA affects the way capital is viewed and therefore, it might create some kind of change in management's attitude. This, of course, depends on how shareholder-value-focused the management is and how the company has been in the past. While implementing EVA represents some kind of change in the organization, it should be implemented with care in order to achieve understanding and commitment.

Case Study of GCPL – Godrej as Application of EVA

At Godrej Consumer Products Ltd. (GCPL) EVA has not only been used as financial tool but also as a way of structuring performance-linked variable remuneration. The following exhibit shows the EVA calculations at GCPL:

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EVA Calculations

1. Calculation of NOPAT	2001-2002(cr)
PBT	63.2
Interest	2.5
Net operating profit before tax	65.7
Cash operating tax on PBT	15.4
Cash operating tax on interest	0.9
NOPAT	49.4
2. Calculation of WACC	2001-2002
Leverage (l)	0.63
Market risk premium (m)	10%
Equity risk premium (l*m)	6.3%
Risk free return (r)	11.5%
Cost of equity (r+(l*m))	17.8%
Equity/ market value (e)	0.96
Wt cost of equity ((r+(l*m))e)	17.1%
Pretax cost of borrowing (p)	14%
Retention rate (1-tax rate)	65%
Debt/ market value (d)	0.04
Wt cost of debt	0.4%
WACC	17.5% (18%)
3. Calculation of EVA	
EVA parameters 2001-2002(in crore)	
NOPAT	49.4
Capital charge	19.3
EVA = NOPAT - Capital charge = 49.4 -19.3 = <u>30.1</u>	

As can be seen from above GCPL was able to create a positive EVA of Rs.30.1 crores during the year 2001-02. The EVA target set by the company was not only met but exceeded. GCPL continues to maintain its growth and profitability despite the sluggish market conditions thereby consistently providing value to its shareholders. (Reeta Gupta, ET – GMR Research team, 2007).

For Godrej, the EVA implementation surely was a rewarding experience as the employees were clear about how they are contributing to increasing the EVA, it worked as a tremendous motivator for them. Moreover, the objective of continuously working towards increasing EVA ensured that capital efficiency improved and that shareholders were happy. Therefore, EVA serves as a one point indicator for business performance. It aligns employee, owner and shareholder interests.

Conclusion

World has become flat in this e-business era, and conversions and upheaval of informations ushering in more chaos in the organizations. In today's highly uncertain and changing business environment, executives need to have the flexibility in ones strategy to identify the problems and respond to them rapidly. Thus 'strategic flexibility' is the key word today for achieving an upshot in the productivity of the corporate world. 'Stretch-targets' and 'over-deliverance' are the two very vibrant, dynamic and passionate buzzwords for transforming the organizations into ones with passionate work-culture.

In the present paper case-studies of Godrej Consumer Products Ltd. (GCPL) implementing EVA parameter and McKinsey's continuous renewal perspective using Innovation coupled with Kaizen leading to strategic flexibility have been discussed. EVA is flexible which helps in generating flexibility within the system of organizations. EVA also sets managerial performance target and links it to reward systems. And Kaizen with innovation also makes the organization strategically flexible.

The case studies discussed may open up new avenues for organizations in dealing with the changing business scenario thereby helping them in achieving organizational excellence.

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