Strategy

Stay Loose

By breaking decisions into stages, executives can build flexibility into their plans

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In turbulent times, adaptability is critical. That's why today, flexibility is more valuable than ever in business strategy.

Markets, technologies and competition are becoming more dynamic by the day. To succeed in this environment, companies need to position themselves to capitalize on opportunities as they emerge, while limiting the damage if adversity hits. This requires a whole new level of flexibility.

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Good managers have always been able to think on their feet. But many widely applied tools of strategy development were designed for relatively stable environments. As a result, business strategy may too often lock managers into decisions that turn out to be flawed because something outside their control doesn't go as planned. What is needed is a systematic translation of managers' flexibility into strategy -- a plan that lays out a series of options for managers to pursue or decline as developments warrant.

That is the essence of what is known as "real options" analysis, an approach that borrows from the workings of the financial markets. Just as stock options, for instance, give the holder the right, but not the obligation, to buy or sell shares at a given price at some time in the future, real options give executives the right, but not the obligation, to pursue certain business initiatives.

Start Small

Instead of making rock-hard plans and irreversible long-term commitments, the idea is to create flexibility by breaking decisions down into stages. When building a new plant, for example, it may be tempting to realize the full economies of scale by building the biggest facility the company can manage. But it may be wiser to first build a smaller plant that can be easily expanded later on. That way, if the market for the products the plant produces should decline, a smaller investment has been put at risk. At that point, managers have the option to scale down or abandon operations. On the other hand, if things turn out well, they have the option to expand the plant.

As a mind-set, this approach encourages managers to be flexible in their planning. In more concrete terms, it allows them to value investment decisions and business initiatives in a new way. Instead of making a decision based on a rigid financial analysis of a given project as a whole, managers can analyze, from the start, the financial implications of each step along the way and every potential variation -- without committing to anything before they must. Once the project is under way, they also can account for the changing value of each option as events unfold. All that information gives them a clearer framework for decisions on whether to launch a project and whether to proceed, hold back or retreat at each stage.

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What does this look like in practice? A leading European auto maker was considering two investment alternatives for the production of a new vehicle. Under one alternative, production would be based entirely in one country. Under the other, the company would set up plants around the world, allowing it to switch production from site to site to take advantage of fluctuations in exchange rates or labor costs. The cost of the flexible system would be higher. But the company decided that the value of that flexibility, with its promise of cost savings and increased profits, exceeded the difference in cost between the two alternatives. So it chose the multinational plan.

Competitive Edge

Real-options analysis can also be useful in helping strategic planners address the challenges of competition. Many managers already incorporate game theory into their planning to help predict how competition will play out. But with competition emerging and evolving more rapidly than ever, supplementing game theory with real-options analysis can help companies be more flexible in how they react.

Consider, for example, the question of whether a company should aim to pre-empt competition or choose to cooperate with other players in a way that could expand the market. This is a question of growing relevance as sometimes-competing technologies are at the heart of more products. In deciding whether to fight or cooperate, companies can use real-options analysis to better quantify the value of each contingency, including the value of the options that would be lost or gained depending on what competitive course is chosen.

What this all adds up to is a portfolio of corporate real options, each with a value that will change along with the company's developing markets. Those who manage that portfolio most effectively will be in the best position to realize their company's growth potential.

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