Strategy Process for a Leveraged Middle-Market Organization

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Studies over the last 10-years estimate a 70-90% failure rate for developing and implementing a strategy. Based on my experience, I estimate the strategy failure rate for a leveraged middle-market organization ("LMMO") to approximate 90%. Many of these LMMOs try to implement an approach designed for a Fortune 1000 size organization. Such a Strategy Process won't work.

Developing and implementing a Strategy Process for an LMMO will result in a more predictable and profitable revenue stream and will minimize wasted expenditures. It counterbalances the risks of a leveraged balance sheet and improves return on assets (ROA). An appropriate LMMO Strategy Process will prevent the company from "peanut buttering" its scarce resources throughout the organization or distributing them to the loudest voices. An appropriate Strategic Process is a guide—don't view it as a magic formula. You will get better the more you apply the concepts. The key is: begin the process.

My interest in the Strategy Process began in graduate school when I wrote my master's thesis "Strategic Planning in the Energy Business: Environment Scanning Using the Delphi Method." As a CEO of middle-market companies, a Senior VP & CFO of an NYSE company as well as a turnaround consultant with an international firm, I have learned that a Strategic Process cannot be universally applied. The constraints of LMMO require a different Strategy Process.

Private Equity Firms (“Firms”) have had great success increasing LMMO’s equity value through operational improvements, cost cutting and financial restructuring. All organizations must continually improve operations as well as eliminate unnecessary expenses. However, these Firms have an opportunity to further increase profitable revenue and thereby increase equity value by implementing the appropriate Strategy Process. Such LMMOs are usually constrained by available cash and depth of their infrastructure—as well as management breadth.

Many LMMOs make some or all of the following glaring mistakes:

- Copying competitors’ strategies
- Allowing senior management to dominate the process
- Using inadequate data to sanitize brainstorming
- Including SWOT strengths that competitors possess
- Developing a strategy without the resources to implement
- Not regularly reallocating its resources
- Not identifying things to avoid
- Not focusing on customer needs and wants—what they value

There are endless definitions of strategy. Simply, **strategy is a continual process focused on creating a sustainable, distinctive value for the buyers of your goods or services.** A few of the words defined:

- **Continuous process**: Customers’ needs, wants and preferences keep changing, so the strategy must change to continue providing distinctive value to specific customers.
- **Distinctive:** Offerings to your targeted customers must be something they need and value—as well as something different from what is offered by your competitors. (Distinctive does not refer to the basic skills everyone must have to exist in the marketplace.)

- **Value:** The quality of what you are offering is subjective because what one customer determines as a distinctive value, another customer may not.
- **Buyers:** The specific customers (and groups) identified as "buyers" should be those that will pay a premium for the distinctive value you provide. Just as importantly, the customers to avoid should be identified.

The strategy must achieve greater profitability or you have the wrong strategy. If your current strategy is not working, start over. A few specifics on the Strategy Process:

- Identify and then leverage your distinctive capabilities (skills, services, technology, activities, processes, culture, etc.). Consider grouping together various activities.
- Offer a sustainable, distinctive value proposition—one that competitors can't copy. Support this with your distinctive capabilities so you don't just compete on price.
- Identify targeted market segments and then targeted customers that need and will pay a premium for your sustainable, distinctive value proposition.
- Identify what you need to avoid or sell—customers, product lines, geography, and business units.

Consider the following in beginning a Strategic Process:

- The process must be ongoing and formally discussed at least quarterly.
- The implementation process must include all levels of the organization.
- Creativity must drive the Strategic Process.
- An inductive—rather than deductive—approach should be used: Keep reaching preliminary conclusions and then challenge them

rather than waiting to reach conclusions at the very end of the Strategic Process.

I initially developed a Strategy Process Roadmap Flowchart in 1990. Since then, I have fine-tuned the Roadmap Components based on my experience in leading and consulting to LMMOs. In order to make the Strategic Process less intimidating, I've listed the Roadmap Components below.

Strategy Process Roadmap Components for an LMMO Organization

1. **Stakeholder Expectations**
2. **Critical Assumptions**
3. **Hard Data Guardrail**
4. **Existing-Strategy Critique**
5. **Internal and External Assessment**
6. **Available Resources**
7. **Distinctive Capabilities**
8. **Value Proposition**
9. **What to Avoid**
10. **Targeted Audience**
11. **Business Model**
12. **Financial Objectives**
13. **Strategic Priorities**

1. Stakeholder Expectations—employees, debt and equity holders and other stakeholders Tension among various stakeholders is often common. Generally, the greatest tension is between the debt and equity holders—especially if the company has violated the debt covenants. This violation can enable the debt holders to "encourage" the equity holders to take certain actions which they might not want to take—such as: restrict spending and dividends, sell off business units, or replace senior executives. Don’t begin the Strategic Process without documenting the expectations of each stakeholder and making sure the expectations are compatible. Even though establishing expectations is an initial step, you must determine if you have the resources—cash, debt capacity, employee skills, infrastructure, technology, culture—to achieve the stakeholders’ expectations. If you don’t have the necessary resources, the stakeholders must change their expectations.

2. Critical Assumptions. Critical Assumptions provide both the foundation and guardrails for the Strategy Process. Typically, they include 10-20 possible criteria: technology, economy, competition, market, new customers, backlog quality, revenue growth, interest rates, quality of earnings, etc.—that could have a major effect in both implementation and the Strategic Process Outcome. All the stakeholders should participate in developing the Critical Assumptions. Following are actual Critical Assumptions. Regarding the shaded rows, the Outcomes were dramatically worse than the Assumptions—resulting in the LMMO having inadequate cash to implement the strategy. Bad Critical Assumptions destroy the Strategic Process because the company’s foundation is on quicksand.

Critical Assumptions	Outcomes
3.6% growth in the targeted segments will continue for the next 24-months.	Actual growth approximated 4% for the 24-months
Ba2 credit interest rates will approximate current rates for the next 18-months.	Minor changes in Ba2 credit rates
Backlog profit margins are fairly presented.	50% of the backlog was at negative or nominal margins.

In prior years, maintenance spending had not been deferred, the needed capital expenditures were spent and appropriate capital expenditures are forecasted.	In prior years, the company only spent 50 % of the needed capital expenditures and understated projected critical capital expenditures by 25% over the next 2-years.
Current year's financial statements fairly represent the company's financial position.	Surprise P&L write-offs exceeded 50% of the prior 2-years EBITDA.
Company will correct the serious catheter quality problems within 6-months.	Company succeeded.

3. Hard Data Guardrail—data must be trended, consolidating and consolidated. It's reckless to brainstorm without the appropriate data that will determine if the discussion is based on facts or hearsay. This seems like a non-issue, but few companies have the appropriate data available to make sure the Strategic Process participants are using the correct fact-based assumptions. Remember that **hard data is used to refine or substantiate strategic options but is not the route to developing a strategy**. Following are a few suggestions (not a complete list):

- 3-year trended **revenue by customers and customer profitability** data—by geography and each business unit
    - ❖ Ranked by dollars (Top 50 customers' revenue as well as Top 50 customers' profitability)
    - ❖ Ranked by profitability percentage (Top 50 customer profitability as a percentage of revenue)
    - ❖ List all negative margin customers.

- 3-year trended **product line revenue and profitability**—by geography and each business unit
    - ❖ Ranked by dollars (product revenue and profitability)

    - Ranked by profitability percentage (product profitability as a percentage of revenues)
    - List all negative margin products.

- 3-year trended working capital invested for each business unit and then further broken down for each product line
- 3-year trended detailed list of all P&L **unusual (positive and negative) events**
- 3-year trended detailed cash flow for each business unit
- 3-year trended ROA for every business unit
- 3-year trended capital expenditures summarized by business unit and expenditure category
- 3-year trended analysis of legal expense—List all lawsuits (including plaintiff and defendant) as well as disputes and then provide a brief description of status and legal dollars spent.
- 3-year trended analysis of all fines paid

Some readers may think the last two items get too much into the weeds—absolutely not. They will provide evidence as to how well the company's infrastructure is working. Frequently, I see continued legal expense for disputes with both customers and suppliers. This is usually an indication of a breakdown in company processes which damages the company's reputation of providing consistent value. Also, it may be an indication of customers with whom the company should avoid doing business.

4. Existing-Strategy Critique—using the LMMO Strategic Process Roadmap Components Even if you don't have an existing strategy, critique how you conduct business. Determine what has been successful and what has failed and then determine the root causes of each. The critique should include each of the Strategic Process Roadmap Components because it will force you to have discussions that will help you better conduct the Strategy Process and provide good data for the assessment.

5. Internal and External Assessment The Strategy Process must be based on fact-based information—not corporate hearsay and innuendos. The Strategy Process participants should include: key customers, key suppliers, and representatives from the ranks throughout the company. Assessments should NOT BE dominated by senior management. Skilled workers should definitely participate in the Strategic Process. As I mentioned in my article, “Create, Revise Channels for Customers” published by Marketing News, “prepare a supply chain analysis for the company’s products and services—beginning with the end-user and working backwards. Determine the value that your customers are trying to offer their customers and end-users.” Following are a **few of** the assessment recommendations:

- Interview customers
- Interview suppliers
- Perform market analysis
- Develop competitive profiles
    - Distinctive capabilities
    - Distinctive values
    - Targeted customers
    - Financial strength
- Supply chain analysis
    - Flowchart supply chain
    - Work backwards from end user
- Customers:
    - Concentration and geographic coverage
    - Pricing and profitability
    - Needs and wants

    - That value your distinctive capabilities
- Company analysis:
    - Evaluate each function and department
    - Document the existing business model
    - List distinctive activities and processes
    - Identify distinctive products and services
    - Determine market perceptions of value provided by products and services
    - Identify current and future drivers
- SWOT's and trends

Summarize the assessment and rank the opportunities: Include the company's available resources to implement—while ranking perceived threats.

6. Available Resources—cash, debt capacity, employee skills, infrastructure, technology, culture Remember to concentrate your resources on your distinctive capabilities. Don't "peanut butter" your resources. This is a sanity check. You must have the resources to implement your strategy. If you don't, start over and change the strategy. Begin by fine tuning the available resources you developed in the Stakeholder Expectations Component. Continually ask the question during the Strategy Process: Do we have the resources to implement the strategy? Asking this question continually will save you from wasting time on strategies that sound good but can't be implemented.

7. Distinctive Capabilities Jack Trout and Steve Rivkin said it well, "Differentiate or Die: Survival in Our Era of Killer Competition." You must determine what you can offer a targeted customer group that other competitors don't and can't readily offer. Usually it's a combination of services or activities that competitors can't duplicate—at least in the near term. Your culture is distinctive and will enable you to offer distinctive services.

8. Value Proposition This is the heart of your strategy. It defines the identity of your organization. It says what distinctive value you will offer to targeted segments and customers that will result in a superior price. Your distinctive value should be a collection of activities grouped together and then offered by you or in conjunction with one of your value chain partners. Consider creating a new segment through your distinctive offering or redefining your exiting target market.

9. What to Avoid In my experience, this is a key part of the Strategic Process Roadmap Components because it stops you from wasting time. It establishes guardrails for brainstorming growth opportunities.
The VP of Sales for a plastics' manufacturing company initially thought "What to Avoid," was putting handcuffs on his sales force, and he completely disagreed with the concept. By the way, he was both outspoken as well as a great contributor. After about a month, he became the biggest advocate of "What to Avoid" because he said it focused him and he didn't waste time pursuing opportunities that were non-starters. Even though some opportunities initially sounded great to him, he realized these opportunities didn't fit the company strategy and only limited resources were available.

10. Targeted Audience—segments and customers. The key is to identify specific industry segments and then specific customers that want, need and will pay a premium for the distinctive capabilities you offer.

11. Business Model The business model spells out how you will execute your strategy and how you will make money. You must be specific about how you intend to create value in your targeted market-place. **Following are the key components of a business model:**

i. Value Proposition

As a reminder, the Value Proposition says what distinctive value you're providing your targeted customers; it must be something the customer values and other competitors are not providing. You already determined the needs and wants of your targeted customers in the assessment.

ii. Culture

Your culture will determine whether you will successfully execute the strategy. Just as strategy provides direction to an organization, so does culture because it establishes guardrails for how the people within the organization act. Communication is a primary driver of an organization's success, and strategy and culture are key communication megaphones within the organization. Your organization's culture will determine whether your Value Proposition as well as your overall Strategy will succeed. Culture influences behavior and determines what's sacred to the people within the organization. Successful companies don't have the same cultures, but they have an appropriate culture—given their Value Proposition and overall strategy. I believe the CEO drives the culture, and that's one of the most important CEO responsibilities.

iii. Key resources:

Again, concentrate your resources on your distinctive capabilities. What specific resources are required to implement the Value Proposition as well as the overall Strategy?

- People skills
- Infrastructure and processes
- Physical assets

- Financial—cash, debt and working capital
- Technological capabilities
- Intellectual property

iv. Customers

- Identify who you are targeting—segments and customers—that need and want the sustainable, distinctive value you will provide.
- Identify the products and services you will provide.
- Establish pricing.
- Identify channels.
- Establish positioning.

v. Cost structure:

- Determine the costs of key drivers to successfully provide the promised distinctive value.
- Determine the costs of the capital and expense resources needed to deliver the value.
- Identify your distinctive capabilities that need to be continually strengthened and are off limits to any cost reductions.
- Determine the overall cost structure in order to realize superior profitability and provide the value as specified in the Value Proposition.

vi. Key processes and activities

What are the sustainable distinctive processes and activities that are the basis of the Value Proposition? They need to be explicitly identified, and adequate resources must fund them so they become even stronger.

vii. Location of facilities

Given your Value Proposition and targeted customers, where do your facilities need to be located to deliver the value you promised?

As the CEO for a nationwide organization, we determined to target the railroad industry and specifically two Class I railroads. As a result, we opened a new facility in Denver—close to one of the targeted customers—as well as designated certain facilities as railroad "centers of excellence." This enabled us to focus these specialized skills in a few facilities located close to the targeted customers.

viii. Strategic Priorities

Finally, translate the Strategy into the most important Strategic Priorities so that the entire organization can understand and help implement the strategy. The most important objectives must be linked to metrics that will focus the organization on successfully implementing the Strategy. Consider recording the Strategic Priorities on a laminated pocket card that can be readily accessed—each day—by every team member in the organization.

12. Financial Objectives Your Strategy must achieve a superior profitability—compared to that of your competitors—or you probably have the wrong strategy. Establishing financial objectives will help you determine whether your Strategy has been successful. As part of your projected consolidating financial statements—monthly and for 3-years, on a continuous roll-forward basis—you must select metrics that will most appropriately measure your progress. **Some** financial objectives **could be**:

- Revenue growth of targeted customers/segments
- EBITDA dollars
- EBITDA as a percentage of revenues
- Working capital per dollar of revenue
- ROA
- Cash flow dollars
- Cash flow as a percentage of revenues

Some Final Thoughts

Everyone in the organization should be able to explain your Value Proposition—the distinctive value you're providing to targeted customers as well as your distinctive capabilities that support that distinctive value. The organization will then better understand its future direction. As I said previously, an appropriate Strategic Process is a guide and not a magic formula. The key is to begin applying the concepts so you can refine this guide to your specific situation. If you want to start playing golf, you may initially pick up a few books to get a feel for the sport, but until you start swinging the club, you haven't started playing. The more you play—the better player you'll become.

I cringe when I hear a CEO announce across-the-board expense cuts. That's the least strategic action a CEO can take. Why? Because across-the-board cuts will cut some of your distinctive capabilities that enable you to offer distinctive value to specific customers. Identify those activities, processes and people that provide you the distinctive capabilities, and then make those off limits. I suggest you read my other articles on the Flatirons Management Group website (flatironsmanagementgroup.com):

"Why Middle-Market Organizations Struggle Developing and Implementing a Strategy."

"How to Profitably Grow Underperforming Companies."

"Create, Revise Channels for Customers."

"Tips to Turn Around a Distressed Company"

I also suggest you read the books and articles in the references, which are great strategy books to continually consult.

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