How Should Directors Evaluate Proposed Strategies?

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Most of the board strategy review meetings I have participated in over the past thirty years could best be described as "awkward." On one side of the long, polished table sits the management team, which has worked hard to devise the strategy being presented and frequently has a desire to present a confident, united front to the board. On the other side sit the directors, aware of their fiduciary duty to properly vet the proposed strategy, yet also wary of coming on too hard and appearing to usurp the role of the management team. The colorful description of such meetings as resembling "two porcupines mating" is often not far off the mark.

This situation is further compounded by the number of issues today that make demands on the limited time available on board agendas. Too often, growing pressure on directors' time results in strategy reviews that leave them feeling frustrated, particularly in light of the difficulty of exercising their duty of care in an environment that is more complex and uncertain than ever before.

Given these challenges, it is critical that board strategy reviews are carried out as effectively and efficiently as possible.

Having sat on both sides of that table during my career, I have prepared this short, practical guide for directors who are faced with the challenge of evaluating a proposed strategy. I divide my suggestions into two parts: First, how to assess the strategy pre-reading package a director should receive before a board strategy review meeting. Second, systematic techniques a board can use during its meeting with a company's management team to test and improve a proposed strategy.

<u>Before the Meeting</u>

When looking through my strategy briefing materials before a board meeting, I check to see if seven key issues have been logically addressed:

1. **A restatement of the purpose of the organization – i.e., why it exists**. Over the years, I've found that clarity on this point is critical for guiding the evolution of strategy, and driving the long-term survival and success of organizations.

2. **Assumptions about the future environment** (e.g., macro political and economic environment, regulation, technology, industry growth and segmentation, customers, competitors, suppliers, investors, etc.). What I'm looking for in this section is a coherent analysis of the key factors that will affect the company's performance, how these factors are related to each other, and different ways they could evolve in the future (with special emphasis on the potential for significant discontinuities to occur). I also ask if major trends or uncertainties have been left out, and whether a wide enough range of possible futures has been considered (i.e., I'm looking for signs of overoptimism). In this regard, I focus on the "critical assumptions" that will have the biggest impact on operating cash flows and the value of a company's strategic options, especially the ones that seem most uncertain.

3. **The company's "strategic concept" and goals**. The former is a relatively short and high-level answer to five questions: what customers are we targeting? What painful problem will we solve for them? What will we offer them? Why will they buy from us? And how will we make money? To be sure, these questions can be rephrased in many ways; however, the answers to them are always critical. With respect to goals, they should not be generic, but rather should be clearly related to the

strategic concept and the assumptions made about the future environment. There are few regrets as painful as the realization that a great team has flawlessly executed a strategy in pursuit of the wrong goals.

4. **The resources that are or will be available to achieve those goals in the assumed future environment**, including not only money, but the distinctive capabilities and assets that are critical to the execution of a strategy, and make it hard to copy. In particular, I ask whether the management team is being overoptimistic about the resources that will be available to implement its plans.

5. **Plans that show how those resources will be employed to implement the strategic concept and achieve the company's goals**. When evaluating plans, I look for clear and logical linkages between the activities required to achieve the proposed goals, the resources these activities will require, and the total resources that are expected to be available under different scenarios. Again, the danger here is over confidence about the estimated time and cost to complete critical activities.

6. **Metrics that will be used to monitor progress, and indicators that will trigger significant adaptation of the base plan**. When it comes to plans, we all know that few remain unchanged after implementation begins. This is to be expected, because strategies are essentially causal theories about how complex adaptive systems (the external environment and internal organization) operate, and predictions about how they will behave in the future. Because research has repeatedly shown that predictions about complex adaptive systems are almost always very inaccurate (particularly as the time horizon lengthens), we should not be surprised that strategies almost always need to be modified as they are executed. So I always look for how assumptions will be validated over time, how strategic (not just

operational and financial) progress will be monitored (particularly the strength of the relationship between the metrics being monitored and the goals the company seeks to achieve), the conditions that will trigger major adaptations to the base plan, and the extent to which these contingencies have been thought through in detail.

7. **The major risks and uncertainties associated with the strategy, and how they will be managed**. Last but not least, I tend to spend a lot of time assessing management's discussion of the most important risks and uncertainties associated with the proposed strategy, and how they will be managed (see my article on "A Practical Approach to the Vexing Issue of "Risk Appetite", which can be downloaded from ssrn.com). I'm usually less concerned about risks that are easy to quantify (and thus hedge or transfer), and more concerned about true uncertainties that tend to be the real potential company killers (e.g., How long will it take for a competitor to substantially copy our strategy? What are the potential disruptive innovations underway in our industry today?).

<u>During the Meeting</u>

My first and most painful observation about what happens during strategy review meetings is the cumulative amount of valuable time that very smart people have wasted over the years listening to presentations of the same material that was included in their briefing book. This usually results in a few questions from the board to clarify or challenge some aspect of the proposed strategy, but fails to produce the kind of comprehensive, insightful discussion that many board members seek (and often believe their fiduciary duty requires). Too often, I've walked out of such meetings thinking we should and could have done a better job on this critical task.

I have also learned that there are some simple techniques that can be used to produce a much higher quality discussion. Here I'll briefly describe three:

1. **Pre-Mortem**. Following the presentation of a proposed strategy, ask the management team to assume it is some point in the future and the plan has completely failed. Have the management team and board members independently write down a list of reasons why this failure occurred, and what, in retrospect, the company could have done differently to avoid this painful outcome. Collect and organize the results, then systematically discuss them. This almost always results in better recognition of the external and internal sources of uncertainty facing the company, and a better plan for achieving its goals. In essence, this approach takes advantage of our hindsight bias, which causes us to ascribe higher probability and to be able to describe in more detail events which have already occurred than those we see as uncertain.

2. **Testing Against Outside Scenarios**. A number of organizations, such as the U.S. National Intelligence Council and Royal Dutch Shell, regularly publish detailed scenarios for how political, economic, and technological conditions could evolve in the years ahead. A board can ask a management team to discuss how a proposed strategy would fare under each of these outside scenarios, how it would need to be modified (or replaced) in order to achieve critical goals, and what indicators need to be monitored to provide early warning about the scenario that is developing.

3. **Certainty Equivalent Cash Flow Valuation**. Strategic plans should be accompanied by financial model analyses that assess their expected consequences for future cash flows and valuation. At minimum, these modeling results should show the most likely cash flow over each year of the planning horizon. Often, they will also show an "upside" and a "downside" scenario, based on an alternative set of assumptions (either

strategic, financial, or both). After hearing this presentation, tell each board member that they have the opportunity to exchange each projected uncertain annual cash flow for a risk free payment from the U.S. (or other government). Ask them to write down the amount they would accept from the government each year in exchange for the projected cash flow (typically, these risk free cash flows are lower than the projected cash flows). Collect from each director these "certainty equivalent" cash flows, and then use them to produce a range of possible valuations (i.e., discounting the risk free cash flows at the appropriate risk free rate). Then for each year discuss which uncertainties caused board members to accept the lower payment. In my experience, this technique always surfaces a range of concerns with the proposed strategy, in a way that, because of the linkage to valuation, most directors find quite intuitive.

Conclusion

A growing number of issues today demand the limited time available on board agendas. Too often this results in strategy reviews that leave many directors feeling frustrated, particularly in light of the growing challenge of exercising their duty of care in an environment that is more complex and uncertain than ever before.

Given these challenges, it is critical that board strategy reviews are carried out as effectively and efficiently as possible. Hopefully, the suggestions I have offered will enable you and your board to do just that.

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