Nine Basic Findings on Business Strategy

Sidney Schoeffler was the founding genius of the PIMS® programme. This article is a 2020 up-date of his 1977 research. The intervening 43 years have amply demonstrated how timeless his findings were: remarkably little needed changing.

Study of the 4000+ businesses in the PIMS® data bank clearly establishes the following nine propositions:

Finding I: business situations generally behave in a regular and predictable manner.

The operating results achieved by a particular business - its profit, cash flow, growth etc. - are determined in a rather regular and predictable fashion by the "laws of nature" that operate in business situations. (By a "business situation" we mean the competitive interplay among the various buyers and sellers of a particular product line or service in a particular served market.) This does not mean that we can foretell the exact results of every business in any given short period. It means that we can estimate the approximate results (within 5 points of after-tax ROI) of most businesses over a moderately long period (3-5 years), on the basis of observable characteristics of the market and of the strategies employed by the business itself and its competitors.

Business situations can be understood by an empirical scientific approach, and therefore the process of formulating business strategy is becoming an applied science.

Finding II: business situations basically obey the same "laws of the marketplace".

In the same way that human beings - despite their many differences in appearance, personality, religion, behaviour, state of health, etc. - obey the same laws of physiology, businesses - despite their many differences in product, company personality, state of profit health, etc. - obey the same laws of the marketplace. The first fact makes possible the applied science of medicine, in which a trained physician can usefully treat any human being. The second makes possible the applied science of business strategy, in which a trained strategist can usefully function in any business. Of course, many physicians and many strategists elect to specialise, but that merely implements a division of labour; it does not argue against the principle.

Finding III: the laws of the marketplace determine most of the observed variance in operating results across different businesses.

Some businesses are very profitable or have favourable cash flows; others are very unprofitable or have unfavourable cash flows. When we try to understand the variance between them, the laws of the marketplace account for most of that variance.

This means that the structural characteristics of the served market, of the business itself, and of its competitors constitute about 75% of the reasons for success or failure, and the operating skill or luck of the management constitute about 25%.

Another way of stating Finding III is to say that doing "the right thing" is three times more important than doing "the thing right".

Finding IV: there are nine major strategic drivers of profitability and net cash flow.

These nine influences constitute most of the determination of business success or failure. In approximate order of importance, they are:

1. Asset Utilisation: Technology and the chosen way of doing business govern how much sales or value added are generated for each dollar of fixed and working capital in the business. Lean investment generally produces a positive impact on percentage measures of profitability or net cash flow; conversely, businesses that are mechanised or automated or inventory-intensive generally show lower returns on investment and sales than businesses that are not.

2. Customer preference for the products and/or services offered: The specifying customers' preference for the non-price attributes of the business's product/service package, compared to those of competitors, has a generally favourable impact on all measures of performance.

3. Market position: A business's share of its served market (both absolute and relative to its three largest competitors) has a positive impact on its profit and net cash flow, but tends to create a ceiling for growth. (The "served market"; is the specific competitive arena within which costs and marketing actions are set).
4. Managing complexity: Many costing systems underestimate the true costs of supplying small orders, so businesses unnecessarily proliferate products and customers. This hurts performance.
5. People: Businesses in periods of opportunity and change need adaptability, participativeness and incentives to thrive. In maturity, businesses need discipline and clear systems to survive.
6. Innovation/differentiation: Extensive actions taken by a business in the areas of new product introduction, R&D, market effort, etc., generally produce a positive effect on its performance if that business has strong market position or customer preference to begin with. Otherwise they can create growth but destroy profits.
7. Customer power: Customers buying (or specifying) in large money amounts, particularly for customised products, are in a clear position to demand big discounts and costly features. This impacts negatively on performance.
8. Growth of the served market: Growth is strongly favourable to dollar measures of sales and profit, weakly favourable to percent measures of profit, and negative to free cash flow.
9. Vertical integration: For businesses located in mature and stable markets, vertical integration (i.e. make rather than buy) generally impacts favourably on performance. In markets that are rapidly growing, declining, or otherwise unstable the opposite is true.

Additionally:

There is such a thing as being a good or poor "operator". A good operator can improve the profitability of a strong strategic profile or minimise the damage of a weak one and is therefore a favourable element of a business; a poor operator is the opposite. But the 75/25 logic says that really excellent managers spend most effort on improving their strategic profiles.

Finding V: the operation of the nine major strategic influences is complex.

Sometimes they tend to offset each other. For example, lower customer purchase amount (which tends to increase earnings) often goes along with more complex customer logistics (which tends to decrease earnings). Similarly, lean investment often goes with outsourcing. In these cases, the net effect is what matters.

Sometimes they reinforce each other. For example, strong market position (which by itself acts favourably on earnings) and high quality (which also acts that way) usually go together. In that case, a cumulative effect occurs.

Frequently the effect of a strategic factor reverses, depending on other factors. For example, a high level of R&D effort tends to increase earnings, if done by a business with strong market position, and to decrease earnings, if done by a business with weak position.

Therefore, when formulating business strategy, it is dangerous to use a simplistic logic.

Finding VI: the product is not the issue.

In modelling profitability for a business, it doesn't matter if the product is chemical or electrical, edible or toxic, large or small, or purple or yellow. (Except insofar as these are attributes of customer preference - e.g. the banana business!). What matters are the characteristics of the business, such as the nine cited before. Two businesses making entirely different products, but having similar market growth, customer structure, production structure, market position, etc., usually show similar operating results. And two businesses making the same products but differing in their profile generally show different operating results.

Finding VII: the strategic business characteristics tend to assert themselves over time.

This means basically two things. First, when the "fundamentals" of a business change over time (for example, its relative quality improves or its vertical integration goes down, whether by inadvertence or as a result of deliberate strategy) its profitability and net cash flow move in the direction of the norm for the new position. Second, if the actually realised performance of a business deviates from the expected norm (expected on the basis of the laws of the marketplace), it will tend to move back toward that norm.

Finding VIII: business strategies are successful if their "fundamentals" are good, unsuccessful if they are unsound.

A good strategy is one that can confidently be expected to have good consequences; a poor strategy is one that can confidently be expected to have poor consequences. The laws of the marketplace are a reliable source of confidence in estimating both the cost of making a given strategic move and the benefit of having made it.

The fundamentals do not always operate in a simplistic way, as noted before. Thus, it is not always a good idea to expand a strong, well-situated business, or to harvest or divest a weak one. The former business may well be on the verge of trouble; and the latter may be in a situation where a minor effort can produce a major improvement.

Benchmarks firmly based in the empirical laws of the marketplace are therefore very helpful tools of business strategy.

Finding IX: most clear strategy signals are robust.

Where a particular strategic move for a business is clearly indicated to be a good idea (i.e. where the cost/benefit projections look clearly favourable), that signal is usually quite "robust". This means that moderate-sized errors in the analysis - such as wrong assessments of current customer preferences or wrong estimates of future market growth - don't usually render the signal invalid; and moderatesized changes in the position of the business – such as its vertical integration or operating skill - don't either.

These nine findings, taken together, clearly say that it is productive to think about business strategy in a thoroughly professional manner, by supplementing the executive's imagination and creativity with a rigorous and science-based estimate of the probable consequences of strategic moves.

Since Sid's piece was written, the PIMS® databases have expanded in types of business, geographical coverage, and business metrics. The PIMS® findings have stood up through all this diversity and through the information revolution. In general, even the coefficients haven't changed: a doubling of relative market share is worth the same amount of ROI or ROS in the 1970s, the 1980s, the 1990s, the 2000s. and the 2010s. Some factors reflecting technical progress (e.g. capital and labour productivity) have improved steadily, of course, but the profit benefit has generally gone to the customer. The only exception to the PIMS laws is "non-marketplace" businesses where success is artificially regulated or dependent on a unique factor cost: e.g. water supply or Saudi oil. Sid's framework foreshadowed successive fashions for "excellence", five forces, TQM, core competencies, shareholder value, reengineering, benchmarking, balanced scorecards, the "dot-com" boom, the financial crash and artificial intelligence. This timelessness only underlines his achievements and the confidence with which we can rely on them for the next 40 years. Of course it's too early to prove their invariance through the Covid crisis, but just seeing who the winners are currently, they are well–positioned on Sid's factors.