

Preparing a winning business case

Overview

A project lives or dies through its business case. This session combines developing business case writing skills with those of investment management to ensure business activities are evaluated and prioritised according to the economic value they are forecast to deliver.

Learning outcomes

The learning outcomes of the session are:

1. Explain the concept of competitive advantage
2. List the ways of qualitatively analysing competitive advantage
3. Analyse the value a competitive advantage creates compared to the cost to generate it
4. Articulate the two analyses into a concise and readable business case

What is strategic value?

An overall business strategy provides the framework for assessing ideas i.e. in terms of their **strategic value**. So what is strategic value?

Strategic value is more than just strategy. Many companies develop business strategies for the sake of doing so without the intention of using a framework to design and implement strategy. If not reviewed, such strategies become a bunch of statements that sit on corporate mugs and logos. Strategic value is an event or idea that will produce a **comparative advantage** to the business.

Comparative advantage encompasses more than the commonly used term of *competitive advantage* because it allows for the possibility that some projects will be initiated in response to a competitor's actions and are therefore playing catch-up rather than creating a leading competitive advantage itself.

Comparative advantage is an economic term that integrates into the finance concept known as Net Present Value. NPV uses a principle known as the **With/Without principle**. Basically, a project is viable if by implementing it, the company is better off than if it didn't implement it (i.e. better off with than without). In economic terms, this is described in terms of the higher level of shareholder wealth the project creates in being implemented (through increasing marginal revenue or reducing marginal costs) **COMPARED TO** the level of wealth without implementing the project.

In summary:

- Projects must be more than "Strategic"
- Investments must add strategic **value**
- Results in comparative advantage
- Comparative advantage = + NPV/Options

Where does strategic value come from?

- Builds on existing strengths
- Reduces weaknesses
- Creates new businesses
- Creates new options/opportunities
- Reduces risk
- Remember it is transient

Obviously, the value that a new idea or project will add (in terms of the above list) has to be greater in dollar terms than the cost of implementing it. Hence, accurate costing (including the cost of opportunities forgone to undertake this project) is imperative to show the real value of a project.

Create alternatives and outline your approach

- Option 1 – Do nothing
- Option 2 – Your preferred option
- Option 3 – Alternative implementation
- Option 4 – Alternative solution

Executives worth their pay cheques will grill any project sponsor on the assumptions and the proposed benefits of their project. One way of covering the bases is to create alternative solutions to the problem or idea you are addressing/ proposing. One incident experienced by an **mbh** staff member saw that person submit a proposal that would have cost the client £200,000. When the proposal was put to the executive, one of the executive members suggested an alternative that would cost £20,000 and two weeks to implement. This example highlights the danger in blindly accepting (or proposing) your first implementation method or problem solution. This of course requires that the writer and reader strive to achieve more than a mediocre (minimum-thought effort) solution.

As a minimum, each idea or business case you write should have four options:

- 1 – a do nothing option (this becomes the Without scenario when analysing the NPV)
- 2 – your preferred solution option for achieving the proposed situation
- 3 – an alternative implementation strategy for your proposed situation
- 4 – an alternative proposed situation

SWOT Analysis

- **Strengths** – Internal advantages
- **Weaknesses** – Internal issues
- **Opportunities** – External options
- **Threats** – External risks

The next step to analysing the feasibility of the idea is to assess the strengths, weaknesses, opportunities and threats to the concept proposed. Doing this identifies the areas that need to be verified when collecting data for the financial analysis of the business case e.g if internal skills in Java programming is a weakness then the data collection process should cost outsourcing the programming.

STEP 1: Company SWOT
STEP 2: Investment Options SWOT
STEP 3: Implications of SWOT
STEP 4: Feed to financial analysis

To ensure that strategy is linked to the project, a company SWOT should be carried out. The project SWOT can then be completed in light of the company SWOT. Eg: a company with a low competence in software development will obviously have this as a weakness on a

software development project, conversely, a company who has an opportunity to enter a new market place leads to a strength on a project that develops entry into that marketplace.

In terms of the business case, the SWOT helps determine the variability and risk of the project. Hence, a SWOT will enable a financial analyst to determine whether the discount rate needs to be adjusted (see later slides) and how variable the cashflow forecasts are likely to be.

SUCCESS Analysis

- Scale economies
- Uniqueness
- Culture
- Channel of distribution
- Externalities
- Segmentation & Differentiation
- Skills of employees

The next step is to thoroughly test the strategic value of the concept. SUCCESS is an acronym broken up as per below. The idea behind a SUCCESS analysis is if a project can't be categorised into **AT LEAST ONE** of the criteria of SUCCESS then there is no possible way the project will add value to the organisation.

Scale economies:

Projects that increase the capacity of a business to expand creating a reduced unit cost of production.

Uniqueness:

Projects that solve problems or create benefits that are unique to the industry/business sector that the company belongs.

Culture:

Projects that improve the cultural aspects of the business

Channels of distribution:

Projects that improve the movement of the products or services offered from the business to the end customer

Externalities:

Projects that look to improve the external environment the business works in e.g. lobbying government, investing in industry associations etc.

Segmentation & Differentiation:

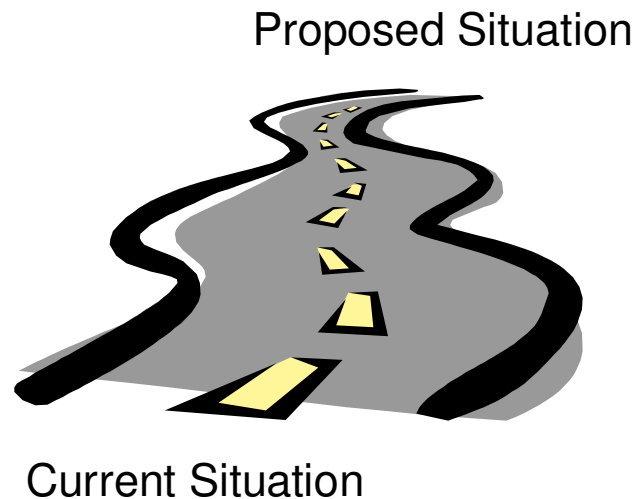
Projects that improve a businesses access to its target markets and demographics as well as differentiates the style or types of products or services from that of its competitors

Skills of employees:

Projects that improve the core competences or create new competencies within the human resources of an organisation.

The Content

Concept statement



The reference point for any feasibility study is the concept statement. This concept is project specific and is made up of a description of the current situation (A) and the proposed situation (B). It does not include how to get from A to B.

Objective Statement

- Align to strategic objectives
- **S**pecific
- **M**easurable
- **A**ttributable
- **R**ealistic
- **T**imely

The objectives should be S.M.A.R.T. S.M.A.R.T objectives are obviously going to be a gut feel guess as no feasibility testing has been completed. Hopefully, the corporate culture of the business is not such that the person putting forward the positional paper is hung, drawn and quartered if the objective turns out to be optimistic.

If the organisation has a clearly defined corporate strategy, the objectives of the business case should drop out from the metrics being used to track strategy.

Justification Statement

- The why of the project
- Where the value will come from
- The business reasons for the project
- Explains the strategic link

Finally, the last part of the positional paper is the justification as to why the business would want to achieve such an objective. This justification should link the objective to the corporate strategy of the firm and outlines why achieving such an objective is crucial to moving a step closer to the vision of the business.



Case Study – Australian Major Appliance Manufacturer

Background

Electroflux is an Australian white goods manufacturer. The company was founded in 1912, was incorporated in 1932 and listed on the Australian stock exchange in 1937. It manufactures whitegoods, refrigerators, freezers, cooking products, washing machines, dishwashers, room air conditioners, vacuums and appliance services. Brand names include Whatsinthehouse, Colddare, Kevinator, Chief, Dishlix, Hoocher and Sampson.

In the main whitegoods area, competition is restricted to Electrofulx, Fishing for Pykel and a variety of imported brands. This Oligopoly fight it out for the spoils of a very mature and declining market. In the other home appliance area, competition is significantly greater. While growth is still minimal at best, innovation in this field has seen wild variations in Market Share. Tyson for example has gone from no sales in 1996 to market leader in the selling of Vacuum cleaners.

Current situation

Electroflux have been in a state of flux for 30 years. A company that was once seen as an innovator and leader in new technologies has slipped behind its competitors. Having said this, their brands are still extremely strong and as can be seen by the Market Share, they are still the dominant player in Australia. The issue is that this dominant position is in a declining market and the room for growth is limited. They currently do not export any of their products. In a desperate bid to change this and to breakdown the riskless strategies of the past, Electroflux has just hired a new CEO. This CEO comes from an innovative background having cut her teeth in the software development industry running a company out of Silicon Valley in California, growing the company at a rate of 300% for the last 5 years. She took on this new role due to a desire to return to her native country Australia. Her immediate action taken was to develop a new Vision and Mission for the company. This has been completed and is outlined below:

Vision and Mission

Electroflux's vision is to be the largest manufacturer of household appliances in the world. Their mission is to be the largest manufacturer of household appliances in Asia Pacific.

New Investments

the new CEO had already sponsored 25 new R&D projects, one of which is described below.

Product Development Project

The product development area has been prototyping a number of different products. One of which is a new vacuum cleaner which is aiming to retrieve lost ground from such brands as Tyson and Tax.

Prototyping results demonstrate that this new product will achieve more suction than any other brand. It is bag-less Vacuum cleaner (Electroflux do not currently have a bag-less Vacuum) and uses a new Elastomer composite material which is considerably lower in cost (by up to 20%) than the normal Vacuum plastic and allows for a larger and more efficient motor. The plastic material makes up 70% of the total costs of manufacture for the average Vacuum. Total costs of the prototype to date = \$800k. It is believed that this product could reverse the declining trend in market share for vacuum cleaners and due to its low cost structure provide a launching pad for selling Vacuum cleaners in Asia.



Activity – Qualitative analysis and the Positional Paper

Complete a SUCCESS and SWOT analysis for the product development project outlined above. Use this analysis to write a positional paper. Remember, opportunities and threats as well as your SUCCESS analysis directly feed into the justification statement. Also, try not to describe how you are going to get from point A (now) to B (post implementation). Finally, use the objectives generated in the strategy formulation exercise in session 1.



Activity – Comparative advantage

Identify the components of your project that create a comparative advantage.

With / without principle

The with/without principle needs to be prevalent in all business cases you write. It is the financial equivalent to the qualitative current situation/proposed situation. What will happen

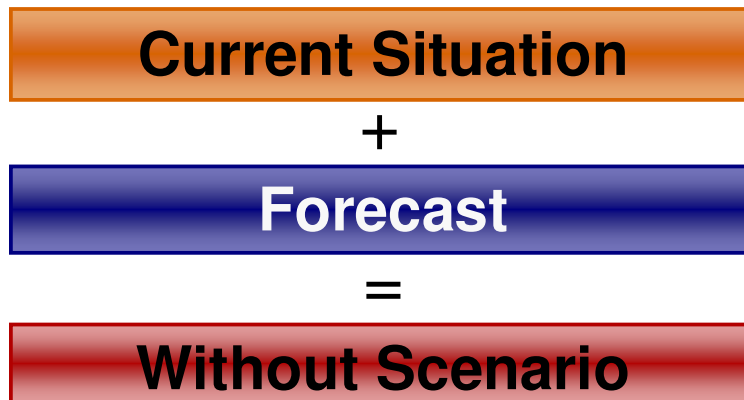
with the cash flows of the business with the project and what will happen with the cash flows of the business without the project. Using the with/without principle allows us to develop an easy way to forecast the incremental cash flows of the project. These incremental cash flows represent the cash flows directly attributable to the project's existence.

One of the most important aspects of this principle is that it illustrates that a financial analysis of a concept or idea is NOT based on a before and after analysis. Like the statement included in all prospectus' in the funds management industry, past performance is no indication of future performance, a company's situation before it existed is no indication of what would happen if it didn't exist.

A good example of this is the simple manufacturing plant expansion. A company has a mutually exclusive investment decision to make. It can invest in a completely new machine to produce widgets or it can upgrade the existing machine. The company expects that a new marketing campaign will significantly boost sales. If the company upgrades the existing machine, it will need to run the machine 24 hours per day and employ 2 new staff to meet production demands (current running time is 18hrs/day). Due to the increased capacity of a new machine, it would be able to maintain the current running time of 18 hours a day and not employ new staff.

If you were to analyse this situation on a before and after basis, the upgrade option may look more appealing than it should as the benefit of the increased production capacity is not considered. Many executives would say that the new machine won't reduce the current number of staff employed (headcount before = headcount after), and as it costs more, then the upgrade option looks like the better one. However, the new machine actually saves the company from employing two new people. These people weren't in the company before, but they certainly will need to be there **without** the new machine.

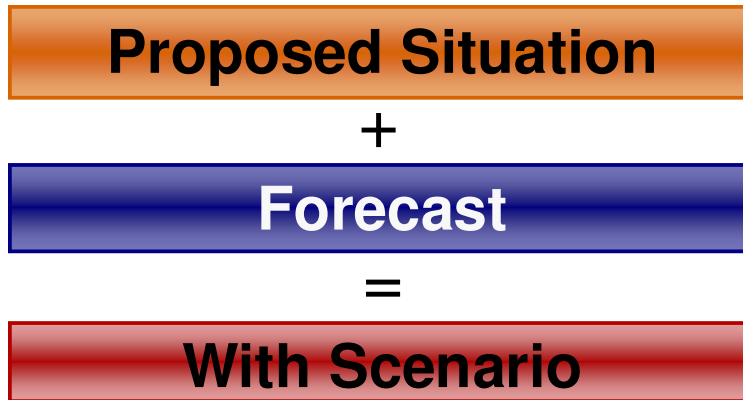
The Without Scenario



The simplest way to calculate the incremental cash flows is to forecast life without the project, forecast life with the project and then subtract the without from the with. This leaves you with the cash flows that are directly attributable to the project.

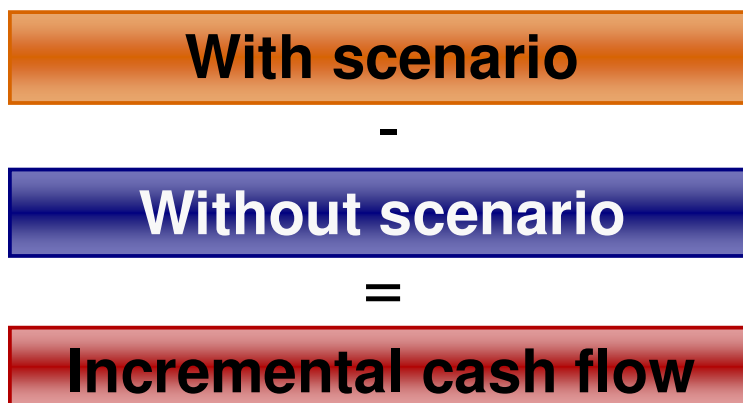
To forecast the without scenario, obtain what the current status is in terms of cost and benefit drivers impacted by the project and forecast them out over the life of the project.

The with scenario



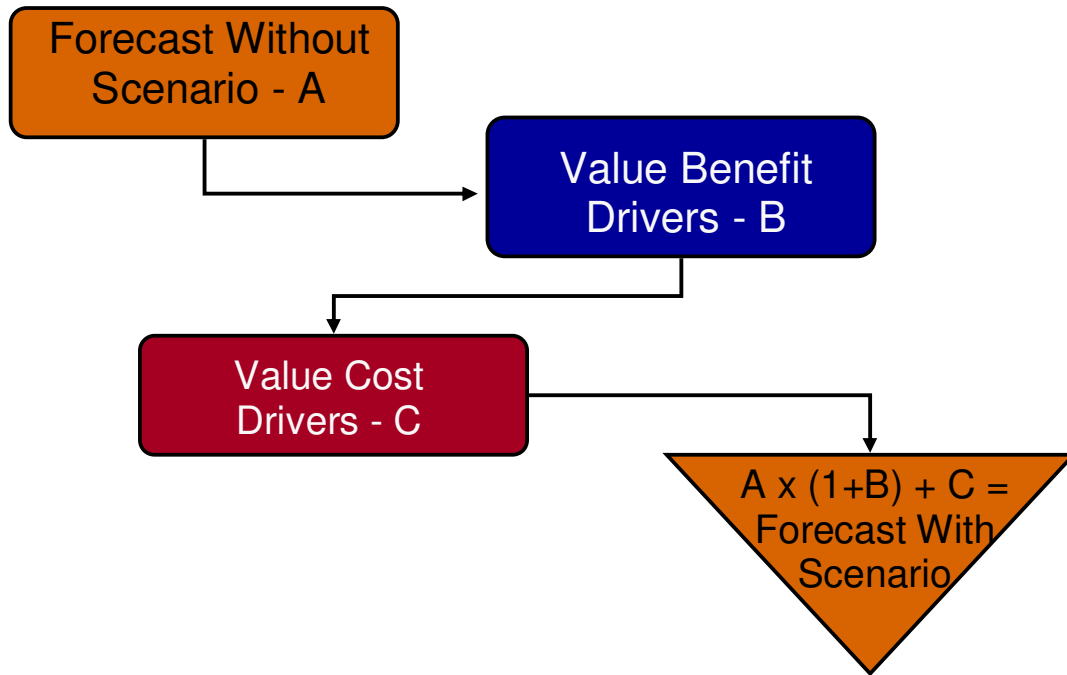
The with scenario is calculated by looking at the proposed situation, forecasting what it will cost to get to it (i.e. the project costs) and the forecasting what the benefit and cost drivers will be once you are there.

Incremental cash flow



Once the two scenarios have been forecasted, subtracting the without from the with leaves us with the incremental cash flow.

Incremental cash flows process – a value driver approach



Case Study – Australian Major Appliance Manufacturer

Electroflux have requested a full business case for the bagless vacuum cleaner project. The additional information is below:

Current forecast for Vacuum cleaner sales in \$000s and operating profit margins are:

Year 1	Year 2	Year 3	Year 4	Year 5
2,000	1,950	1,740	1,500	1,250
10%	7%	5%	3%	1%

Growth rates created by the bagless vacuum cleaner in both sales and margins are:

Year 1	Year 2	Year 3	Year 4	Year 5
10%	15%	20%	25%	30%
20%	100%	200%	400%	1400%

Capital costs for the project are \$10m. This is for plant and equipment with a useful life of 5 years and scrap value of \$500k. Projects operating costs are \$5.5m. 20% of sales is represented as debtors and 25% of costs are held as creditors. Calculate the incremental cash flow.

Letter	Without	Formula	Year 0	Year 1	Year 2	Year 3
A	Sales					
B	OPM					
C	Profit	$A \times B$				
D	Tax	$C \times \text{tax rate}$				
E	NPAT	$C - D$				
	Benefit Drivers					
F	Improvement in Sales					
G	Improvement in OPM					
	Cost Drivers					
H	Project Opex					
I	Project Capex					
J	Changes in Working Capital	$A \times \text{Debtors \%} - (A \times (1-B) + H) \times \text{Creditors \%}$				
K	Residual Value					

	With Scenario					
L	Sales	$A \times (1 + F)$				
M	OPM	$B \times (1 + G)$				
N	Profit	$L \times M + H + I \times$ Depn				
O	Tax	$N \times \text{Tax rate}$				
P	NPAT	$N - O$				
Q	With Scenario Cash Flow	$P - I \times \text{Depn} + I$ $+ J + K$				
R	Incremental Cash Flow	$Q - E$				
S	Net Present Value	$R / (1 + \text{discount rate})^n$				