THE INFLUENCE OF COMPETITIVE STRATEGY ON CAPITAL INVESTMENT DECISIONS

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ABSTRACT

Various authors have scrutinised the sole utilisation of quantifiable (financial) appraisal criteria in capital investment appraisal. They argue that the appraisal of capital investment proposals must concentrate on the capital investment process as a whole and not only on the selection phase. These authors suggest that capital investment opportunities and proposals must be sought within the parameters set by strategy.

Therefore, the purpose of this study was to explore and to describe how decision-makers in the platinum industry experience the influence of competitive strategy on the capital investment process. Semi-structured interviews were held with strategic capital investment decision-makers within a major role player in the platinum industry. Respondents were selected according to the snowball sampling method.

An analysis of the results indicates that competitive strategy does influence the capital investment process. This influence is particularly observable with regard to the initiation of capital investment ideas, the capital budget allocation and the strategic appraisal criteria utilised by decision-makers to screen capital investment proposals.

The strategic capital investment process constitutes much more than just the selection of capital investment proposals. Therefore, the findings of this study signify the importance of considering the influence of competitive strategy on the capital investment process.

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THE INFLUENCE OF COMPETITIVE STRATEGY ON CAPITAL INVESTMENT DECISIONS

PHASE I

PART 1

A GENERAL INTRODUCTION TO THE RESEARCH STUDY

CHAPTER 1

A GENERAL INTRODUCTION

1.1 INTRODUCTION

Financial management, especially the capital investment process, caught the interest of the researcher during his fourth year of study. Various financial appraisal techniques that decision-makers utilise in the capital investment process were introduced during the course of this subject. However, these financial appraisal techniques only give an indication as to whether to invest or not. Projects are approved and rejected solely according to these financial appraisal techniques.

This raised the question: Will an approved project make any contribution to the competitiveness of the company if it does not fit into the competitive strategy? Many projects may be acceptable if screened according to financial appraisal methods but their strategic suitability could be questionable. An example could be when a company invests in a project to expand the market share but the product is already in the maturity phase of its product life cycle. Such a project will contribute little to the competitiveness of the company in that particular product life cycle.

Bearing in mind the high value of these investment projects, it is crucial to ensure that the best possible investment is made in order to enhance competitiveness. Therefore, making financial estimations about the future (which could change overnight) and then investing millions of rands in such projects does not seem sufficient. Various authors of financial literature agree with this notion.

Furthermore, financial literature fails to address strategic issues. Literature and research found on this topic was also not that recent. Various authors have touched on the objectives of this study. They agree to some influence with regard to the variables, but no recent in-depth discussions of research could be obtained. This gave rise to the idea to investigate how competitive strategy influences the capital investment process. What strategic criteria are utilised to screen investment proposals?

1.2 MOTIVATION FOR THE RESEARCH

1.2.1 The importance of strategy in the capital investment process

Johnson (1999:xi) states that "capital investment decisions involve the largest tangible investments of any firm". In turn, effective and strategic capital investments can ensure greater competitiveness. Seitz and Ellison (c1999:42) add to this and argue that a competitive advantage may prevent competitive forces from eliminating economic profits and positive net present values (NPVs).

Thus, omitting strategic appraisal methods from the capital investment process will result in inferior decision-making and will not be beneficial to the company and its stakeholders.

The need to investigate the interface between capital budgeting and strategy is necessary, because "[t]omorrow's business success depends on investment decisions made today" (Hall, 2000:355). Capital investment decisions influence the very survival and prosperity of an enterprise.

1.2.2 The importance of capital investment

Capital investments are important to the economy for two reasons.
"In the short run, the business cycle is affected by the amount of demand for new capital investments" (Seitz & Ellison, c1999:23). Thus, ineffective and inefficient investments may result in cash flow problems for the company, which may cause a decline in work opportunities.

In the long run, the competitiveness of a nation's economy may deteriorate if companies do "not make adequate investments" (Seitz & Ellison, c1999:23). This will influence the industry, which in turn affects the economy of a country, as Porter (1992:65) indicates in his study. He explains that if the capital investment process fails, it may seriously weaken global competitiveness and ultimately threaten the long-term growth of an economy.

1.2.3 Area of research

Initially, strategic capital investment decision-makers within Anglo Platinum were chosen as the population. However, due to the fact that this enterprise is currently undergoing a major restructuring, together with the fact that decision-makers have a busy schedule, it was decided to do the research within another enterprise.

Therefore, another major player in the platinum mining industry was chosen.

Because these enterprises are cautious to provide information which could damage their competitive advantage, it was agreed not to disclose the identity of the enterprise nor that of the respondents.

Investments made by the enterprise at which the interviews were conducted are long-term. These investments make an enormous contribution to the gross domestic product of South Africa. Capital expenditure by this enterprise amounts to R1 230,1 million over the investment period. Even though the expenditure is of extreme amounts, the inflow expected from this investment and its contribution to the enterprise, economy and society is of much more value.

Decision-makers involved in this expansion process were interviewed. This enabled the researcher to define the impact of competitive strategy on the capital investment process within the platinum industry. Furthermore, it may result in the formulation of hypotheses for further investigation.

Such a study may improve the capital budgeting process, which in turn can increase competitive advantage. An increase in the competitiveness of companies may “yield improved long-term productivity growth” and create a greater prosperity for the entire economy (Porter, 1992:82). Increased economic growth leads to more and improved employment opportunities.

1.3 PROBLEM STATEMENT AND PRACTICAL RELEVANCE

Numerous financial appraisal techniques have been introduced over time to assist decision-makers in this crucial task of capital budgeting. Berry (1984:61) explains that, according to the computational decision-making approach, an investment proposal with the highest NPV is accepted once it clears a predetermined cost of capital criteria and an appropriate time horizon.

Given the above, Park and Herath (2000:1) claim that the capital budgeting theory is too rigid, because it evaluates projects as a whole. They argue that the NPV approach does not allow for the decision-maker to react to emerging opportunities. Projects cannot be rejected merely as a result of a negative NPV. The opportunity to invest, which may originate from such an investment project, must be considered.

Furthermore, Maccarrone (1996:55), Mukherjee and Henderson (1983:86) and Pinches (1982:16) criticise the sole application of quantifiable (financial) criteria in the appraisal of capital investment projects. Maccarrone (1996:55) finds that “managers are becoming aware” that these financial appraisal tools are “useless, unless they are put in the wider context of strategic planning”.

The capital budgeting theory therefore is deficient because it fails to provide for:

- how and where to search for opportunities, and
- how to screen ideas and proposals according to strategic hurdle rates.

Enhancing the capital budgeting process will allow decision-makers to filtrate out projects not worthy of further investigation (Butler, Davies, Pike & Sharp, 1993:53) at an early stage, saving capital and valuable time.

1.4 AIMS OF THE RESEARCH

The purpose of this case study is to explore and to describe how decision-makers actively involved in the strategic capital investment process experience the influence of competitive strategy in the capital investment process.

The objectives of this study are to establish how decision-makers experience the following phenomena, namely:

- how competitive strategy triggers/initiates capital investment ideas,
- how competitive strategy influences capital budgeting allocation, and
- what strategic criteria decision-makers implement to screen capital investment ideas and proposals.

1.5 MAPPING OF THE RESEARCH DOCUMENT

The research document comprises two phases, namely a literature study phase and an empirical research phase.

1.5.1 Phase I: Parts 1 and 2

Phase I consists of two parts, namely a general introduction and a literature study. The objectives were utilised to provide a framework for the layout of the literature study. It was done in this way to cover and to define the independent and dependent variables.

In Part 1, chapter 1, the general introduction to the research study introduces the reader to the research study.

The literature study focuses on the objectives as well as concepts which will be examined during the empirical study.

Part 2 therefore consists of four chapters. In chapter 2 the strategic capital investment process with the various applicable steps is discussed.

Chapter 3 discusses the first objective of this study, namely how strategy initiates capital investment ideas. In this chapter, the influence of strategy and its formulation on capital investment ideas are discussed. This chapter points out how capital investment ideas are sought within the parameters of competitive strategy.

Chapter 4 discusses how strategy influences the capital budget allocation process. The influence of competitive strategy on each of the elements of the capital budgeting allocation process is examined.

This is followed by chapter 5, with a discussion on strategic criteria utilised to screen capital investment ideas. Three sets of strategic criteria are discussed.

1.5.2 Phase II

Phase II deals with the empirical study conducted. Chapter 6 discusses the research methodology utilised during the empirical study. Chapter 7 presents an analysis of information obtained during the case study. Chapter 8 summarises the findings of the empirical study, draws conclusions and suggests recommendations.

PART 2
CHAPTER 2

THE STRATEGIC CAPITAL INVESTMENT PROCESS

2.1 INTRODUCTION

Capital investment is defined “as an outlay that is expected to result in benefits in the future” (Seitz & Ellison, c1999:13). Butler et al. (1993:49) argue that such an outlay of assets may include tangible and intangible assets. In most circumstances such an outlay comprises different choices related to distinctive uncertainties which will ultimately influence the goal (profit maximising) of the enterprise.

Capital investment decision-making does not consist solely of the evaluation and/or selection of a suggested investment project. Such a view only constitutes one of the various steps within the capital investment process. Capital investment ideas must first be identified. Thereafter, they can be developed, screened, implemented and controlled.

For this reason, various authors suggest capital investment process models to facilitate this important process. In this chapter the decision-making process and, more specifically, the strategic capital investment process, with each of its applicable steps, will be discussed.

2.2 CAPITAL INVESTMENT - A DECISION-MAKING PROCESS

Decision-making involves the selection of a proposed course of actions (Butler et al., 1993:6). The outlay of assets calls for a thorough process where all relevant factors such as strategic fit and evaluation criteria can be discussed and planned for. For this reason, it is necessary to regard capital investment decision-making as a process with certain steps where decisions are taken with regard to alternatives available.

Lumby and Jones (2001:3) contribute to this by stipulating three conditions that must be met before a decision can be taken. They are as follows:

- Alternatives must exist.
- There must be an objective to meet.
- There must be a base (criteria) according to which the alternatives can be compared.

Still, questions with regard to where to invest, how much to invest and also when to invest arise. These questions relate not only to quantitative (financial) decision-making but also to strategic decision-making. Actions taken during such a decision-making process could either enhance or jeopardise the competitive position of the enterprise.

However, Maccarrone (1996:55), Mukherjee and Henderson (1983:86) and Pinches (1982:16) are of the opinion that the exclusive application of quantifiable criteria is not sufficient in the capital investment process. They suggest that it is essential to introduce strategic criteria to this process as well. Decision-makers have to concentrate on the entire capital investment decision-making process as a whole and not solely on the selection phase (Pinches, 1982:16).

Hence, it is necessary to investigate how strategy will influence this crucial process. The strategic capital investment process can give guidance to the decision-maker in making such decisions.

Such decision-making is especially applicable to projects with budgets of thousands of millions of rands and with a time span of five years or longer. Bearing this in mind as well as the enormous abiding effect of its outcome, it is essential for decision-makers to make capital budgeting decisions that ensure and enhance the competitiveness of the organisation. Inferior decisions "will affect the very survival and future prosperity" (Butler et al., 1993:49).

Capital investment decisions, ideas and projects, referred to in this study, are "long-term related, risky ... take place within social organizational contexts and impact upon the strategic and operating position of the organization" (Northcott, c1998:2).

Decision-making is further complicated as capital investments can be categorised into four broad categories or types of investments (Gitman, c2003:357), namely:

- expansion investment projects,
- replacement investment projects,
- renewal investment projects, and
- investment projects for other purposes such as advertising, research and development and management consulting.

The capital investment process, however, encompasses various steps or phases. The strategic capital investment process will be discussed below.

2.3 THE STRATEGIC CAPITAL INVESTMENT PROCESS

In order to facilitate the capital investment process various authors and academics have introduced different decision-making models which can be utilised by decision-makers.

Mintzberg, Raisinghani and Théorèt (1976:252) suggested a four-stage decision process to assist decision-makers. This model then was later applied to capital budgeting by Pinches (1982:9). In addition to this, Seitz and Ellison (c1999:14) and Maccarrone (1996:43) have suggested more recent models. Nevertheless, all of the steps contained in these models can be divided into four broad categories as suggested by Pinches (1982:9), Butler et al. (1993:52) and Hall (2000:355), namely identification phase, selection phase, implementation phase and control phase.

However, the steps of the capital investment process as suggested by Seitz and Ellison (c1999:14) (see below) will be used as a framework for this chapter. Although the framework suggested by Seitz and Ellison contains more steps, all of these steps can still be categorised within the four phases explored by the above authors. Nevertheless, their model is more comprehensive.

<u>Steps within the strategic capital investment process</u>

Step 1 - establish goals

Step 2 - develop strategy

Step 3 - search for investment opportunities

Step 4 - evaluate investment opportunities

Step 5 - select investments

Step 6 - implement and monitor

Step 7 - conduct post-audit

Seitz and Ellison (c1999:14) contend that this process is well organised and the steps are in a specific sequence. However, Butler et al. (1993:51) provide evidence, obtained from an investigation of seventeen investment decisions, that in reality this process may be somewhat less ordered and rational than supposed. Nevertheless, the steps are very much integrated.

Each step will be discussed individually below.

2.3.1 Establish goals

The first step in this crucial process is to establish the goals of the enterprise. "Some firms also use terms like 'mission' or 'objective' instead of 'goals'" (Porter, 1998:xxiv). Enterprises may establish different goals but it is essential to comply with this step first. Succeeding steps will be moulded around the goal of the enterprise.

Gitman (c2003:15) and Seitz and Ellison (c1999:13) report that wealth creation is generally the overall goal set by enterprises to achieve. By formulating a goal the enterprise communicates how it wants to compete and what its economic and non-economic objectives are (Porter, 1998:xxiv). The goal or mission is where the firm is striving to be.

Goetsch and Davis (1997:82) state that goals are rather a "what" than a "how" exercise. They claim that these goals must be measurable, focused and indicate what the enterprise wants to accomplish. It must be remembered that: "If it can be measured, it can be managed."

2.3.2 Develop strategy

"Objectives are the 'ends' and strategy is the 'means' of achieving them" (Thompson & Strickland, 2001:10). Strategy creates a path and sets direction to actions taken within a company by different role players.

Porter (1998:3) argues that the essence of formulating a strategy is to relate an enterprise with its industry. The reason for this is that there are five forces driving competition within an industry. If the enterprise does not analyse the environment (industry) for the existence and the influence of these forces on itself, it may draw ineffective and inefficient conclusions with regard to capital investments.

Therefore, Porter (1998:xxvi) suggests that companies must analyse their environment with regard to the following forces before formulating a strategy, namely:

- Internal factors (variables)
  - strengths and weaknesses
  - personal values of key role players

- External factors (variables)
  - industry opportunities and threats
  - broader societal expectations

Porter (1998:4) explains that a thorough analysis will enable the enterprise to position itself to utilise these forces in its favour and to best defend itself against such competitive forces. It must be emphasised that it is the strategy decided upon that will influence capital investment decisions rather than the industry analysis. The reason is that external variables within an industry may be constant, relative to other enterprises within the same industry. Still, internal variables *vis-à-vis* external variables and consequently strategies implemented by various enterprises within the same industry may differ.

Given the above, Liberatore, Monahan and Stout (1992:35) suggest that capital projects may serve as a vehicle to achieve business strategies. From this, it may be inferred that decision-makers will search for capital projects (large or relatively small) which will contribute to implementing strategy in order to achieve the set objectives. Therefore, strategy will indicate and determine where to invest in order to achieve the objectives of the enterprise.

This tends to lead to the next step, namely the search for investment opportunities.

2.3.3 Search for investment opportunities

King (1975:78) once argued that investment ideas do not begin life in a filing cabinet ready for evaluation. This implies that investment ideas, and moreover the best ideas, must be searched for to support the strategy in order to achieve objectives. Furthermore, decision-makers are obliged to search for opportunities that will best support the strategy. However, it is important to bear in mind the integrated uniqueness of the capital investment process.

This step consists of two factors, namely:

- where to search for investment ideas, and
- who will search for such ideas.

As can be seen from the above, during the analysis of the industry and the formulation of the competitive strategy, capital investment opportunities will emerge as objectives and strategies will become evident.

Seitz and Ellison (c1999:14) emphasise that strategy “provides a framework within which capital investment opportunities are sought”. In the above step it was emphasised that an industry analysis, internal and external, must be conducted before a strategy can be formulated. It was then further emphasised that such an analysis will indicate to the enterprise which strategy to follow in order to best defend itself or to take advantage of these internal and external factors. Therefore, it was concluded that it was the strategy decided upon which directly influences and assists the company “where” to search for investment ideas. This point will be discussed in more detail in chapter 3. However, this process requires decision-makers (actors) who must search for investment ideas.

With regard to who will search for investment ideas, Matundu (1997:89) found in his study that more than 93 per cent of capital investment ideas are generated by top management. If it is borne in mind that strategy is formulated and implemented by top management, it can be inferred that these decision-makers will search for investment ideas within the parameters set by strategy as reported by Seitz and Ellison above.

In addition, Butler et al. (1993:53) and Seitz and Ellison (c1999:16) argue that top management must cultivate a culture which will encourage managers to search for and identify investment ideas. In contrast with this, the reward system of role players involved in the capital investment process deters innovation. After studying eight large international enterprises Maccarrone (1996:45) found that control, performance measurement and reward systems influence the decisions taken by managers. He refers to these variables as contingent variables and, more specifically, firm parameters.

Additionally, Porter (1992:81) states that incentives to decision-makers are based on current profits. This will focus the attention of decision-makers on short-term investments. However, he suggests that this incentive compensation must rather be linked to the competitive position of the enterprise. This refers to long-term prosperity of the enterprise.

One further important issue relating to the role players involved are their motivation for the project which can be political or personally motivated. Butler et al. (1993:13) warn against decision-makers and their political self motivations. These could influence investment ideas taken by the decision-makers. This could act then as a third variable and could indirectly change the course of ideas generated.

Nevertheless, if the company can direct such internal factors to its best advantage, this can only enhance the capital investment process and as a consequence also the company's competitive position.

After numerous ideas or opportunities emerge from this step, they have to be evaluated, which will consequently lead to the next step in the capital investment process.

2.3.4 Evaluate investment opportunities

Alternative investment ideas identified in the previous step need to be evaluated.

At this stage only the alternative investment ideas are known. Further information about the various investment ideas with regard to cash flow estimations to and from the enterprise, the amount of risk as well as knowledge regarding the compliance with competitive strategy is unknown.

Lumby and Jones (2001:3) argue that if alternative ideas do not exist, there is no need to choose. This may be the case with regard to certain investment opportunities where only one investment possibility exists without any alternatives. However, this will seldom be the case.

Alternative investment ideas can only be thoroughly evaluated after they have been defined into investment proposals. In order to evaluate investment proposals, decision-makers need to gather information in terms of quantitative and qualitative aspects, according to Butler et al. (1993:55) and Seitz and Ellison (c1999:17).

These investment proposals are then evaluated according to financial and non-financial criteria. Matundu (1997:75) established that of 92 per cent of the respondents in his population, 47 per cent “always” incorporated quantifiable as well as non-quantifiable criteria into the capital investment decision, 49 per cent did “sometimes” and 4 per cent “never” incorporated these criteria. The main reason for not doing so was that the enterprises considered themselves as too small.

However, caution must be exercised with regard to estimations about cash flows to and from the enterprise. Seitz and Ellison (c1999:17) report that such estimations are systematically biased. Nonetheless, this does not mean that cash flow analysis must be left out of the capital investment process at all. This simply emphasises the importance of evaluating investment proposals according to quantitative as well as qualitative (strategic) criteria.

Therefore, the evaluation and selection steps are experienced by some authors of financial literature as an integrated phase. Ideas are evaluated according to information gathered with regard to cash flows, strategic fit etc., as well as the assessment of risk. This information (on investment proposals) is then screened according to quantitative and qualitative (strategic) criteria and proposals are then accepted or rejected accordingly.

2.3.5 <u>Select investments</u>

Seitz and Ellison (c1999:18) report that committees are very much involved in the selection of investments. These investment proposals are subjected, by these committee members, to both strategic as well as financial (quantitative) criteria. However, bear in mind that Butler et al. (1993:54) and Seitz and Ellison (c1999:17) warn that it is not feasible nor desirable to screen each and every investment idea according to a long and complicated discounted cash flow analysis (financial criteria). The application of strategic criteria can indicate at an early phase that the ideas are not consistent with the competitive strategy and therefore not up for selection.

Luehrman (1998:89) and Park and Herath (2000:2) are moreover critical of discounted cash flow analysis, because of the shortcomings of this financial tool. Luehrman (1998:89) is of the opinion that the discounted cash flow approach “assumes that we will follow a predetermined plan, regardless of how events unfold”. Such an approach does not allow the decision-maker to react to new circumstances which may evolve during the time span of the investment project.

The real option theory allows the decision-maker to do just that. It allows the decision-maker to invest a little up front and to wait and see how the market forces influence the investment decision thereafter.

The decision-maker can furthermore establish, through this approach, how these market forces are affected by the investment decision. During the discussion of competitive analysis (chapter 3) it will become apparent that market forces can be affected by investments. This means that decision-makers may decide to invest now or later and to terminate further investments or to make additional investments as the future becomes more certain. This could in turn initiate additional investment ideas.

Thus, real option theory (or an analysis) broadens the horizons of selecting capital investments. Here, capital investments can be screened according to quantitative (financial) and qualitative (strategic) criteria. In addition, this approach enables an enterprise to keep its “options open” (Park & Herath, 2000:1). According to this approach, investment proposals are not rejected or selected solely according to quantitative criteria. Investments are undertaken with the view to see how strategic options may evolve.

The qualitative (non-financial) factors referred to above are viewed by Matundu (1997:43 & 81) as criteria. Butler, Davies, Pike and Sharp (1991:402) and Hall (2000:365) also refer to qualitative or non-financial factors which, if read in context with these authors’ findings, are utilised as strategic criteria. These are criteria which determine the competitive position of the enterprise. Thus, it can be concluded that non-financial and qualitative factors (criteria) are viewed, and therefore also utilised, by many as strategic criteria. This study will therefore refer to financial and strategic criteria.

2.3.6 <u>Implement and monitor</u>

The implementation and monitoring step begins after the investment proposal has been approved. It is crucial to monitor the implementation and performance of the investment project. Valuable financial and strategic information can be obtained in this way.

Butler et al. (1993:58) discovered, in their research, that pre-decision control exists. Such control can be exercised from the first step of the capital investment process. Examples of this type of control are:

- the selection and training of subordinates to experience goals and risks in the same way senior management do,

- the establishment of authorisation levels and procedures to be followed during the capital investment process, and
- the influencing of investment proposals, submitted by decision-makers, through the setting of certain goals, criteria, cash limits and the identification of strategic areas for growth.

Butler et al. (1993:59) note that post-decision control consists of the successful implementation of the project and the assurance that projected results are met. Post-decision control relates more to the post-audit process, whereas pre-decision control relates more to the capital investment process up to the implementation step. This, however, once more highlights the integrated nature of the capital investment process.

This step may assist in identifying additional capital investment ideas and improve the learning curve, which could save costs. The learning curve of role players is very valuable within capital budgeting. It can only be utilised to the advantage of the enterprise during future capital investment procedures.

2.3.7 Conduct post-audit

The essence of this step is that the performance of investment projects in comparison with the forecasted performance is assessed. Seitz and Ellison (c1999:19) are of the opinion that this will encourage managers (decision-makers) to put forward investment proposals of quality and to be accurate in making estimates. Post-auditing will prevent decision-makers from putting political or personal motivations above the objectives of the enterprise.

Post-auditing must not result in a destructive exercise, but rather a constructive one. However, it must further encourage decision-makers to make realistic estimates which will improve competitiveness in seeking to reach the goals of the enterprise.

Furthermore, post-audits must assess the aggregated value of the project and not merely the project itself in isolation. Such an audit will highlight the strategic value of the project. This step, if conducted thoroughly, may improve the capital investment process as a whole, according to Northcott (c1998:21).

2.4 CONCLUSION

From the discussion above it can be inferred that strategy and capital budgeting are integrated. Investment ideas which are not within the framework of the competitive strategy might not enhance the competitiveness of the company. In order to be competitive it is necessary for the company to direct key operating policies and actions in such a way that they will give the company a competitive advantage. Thompson and Strickland (2001:276) suggest that an enterprise must "[i]nvest in creating a sustainable competitive advantage".

This means that an enterprise must first set goals, objectives and strategies on how to achieve the set goals. Once this is completed, investment ideas can be searched within the framework of the competitive strategy. Nevertheless, the integrated characteristics of the process cause investment ideas to emerge from the start.

The influence of strategy on the capital investment process, and more specifically the initiation of investment ideas, will now be discussed.

CHAPTER 3

THE INFLUENCE OF STRATEGY ON THE CAPITAL INVESTMENT PROCESS

3.1 INTRODUCTION

The influence of strategy on the capital investment process will be discussed in this chapter. The discussion will focus primarily on the influence of competitive strategy on the identification phase of the capital investment process.

Strategy is defined as “large-scale, future-oriented plans for interacting with the competitive environment to achieve company objectives” (Pearce & Robinson, 2003:4). This means that it is necessary to analyse the environment (industry) in order to formulate the strategy. It further implies that strategy is a continuing process and industry analyses and strategy formulation are highly integrated processes.

Therefore, it is necessary to discuss the strategic planning process in order to establish how competitive strategy influences and initiates capital investment decisions.

However, it is first necessary to view the relationship between industry and strategy.

3.2 INDUSTRY, STRATEGY AND THE CAPITAL INVESTMENT DECISION

Michael E Porter is viewed by many as an authority on competitive strategy and international competitiveness. The work consulted and quoted in this section and throughout this study “grows out of my [Porter’s - AJ] research and teaching in industrial organization economics and in competitive strategy” (Porter, 1998:xvii). His research studies with regard to industry analysis and competitive strategy were conducted on hundreds of industries internationally. Porter (1998:xviii) stresses that competitive analysis is not only important in formulating competitive strategy, but also to corporate finance.

Porter (1998:3) investigated and found evidence that the environment (the industry structure) in which an enterprise competes has an enormous influence on the way business is conducted as well as the strategies available to the enterprise. Competition within the industry is determined by five basic competitive forces, which will be analysed later. Porter (1998:5) determined that these forces influence the degree of inflow of investments.

In addition, Matundu (1997:84) studied the correlation between strategic aspects utilised by different types (industries) and sizes of enterprises in the capital investment process. He determined that the enterprise’s size stratification analysis reveals that the larger the enterprise’s investment, the more this enterprise considers strategic factors in capital investment decision-making. The size of the capital investment is one of the determinants of the size of the enterprise (Matundu, 1997:70).

Matundu (1997:81) reports that more than 80 per cent of the respondents, in this particular stratum, considered strategic factors in the capital investment process. Furthermore, 95 per cent of enterprises with capital investments of more than R500 000 considered strategic aspects in this decision-making process. This study suggests that the larger the capital investment of the enterprise, the more consideration is given to strategic factors.

However, the enterprise’s type (industry) stratification analysis does not reveal any particular consideration of strategic factors in this process (Matundu, 1997:85). Still, more than 87 per cent of the respondents in his study considered strategic aspects in the industry stratification (Matundu, 1997:78). Note that this does not nullify the investigation of Porter, because the study of Matundu refers to the correlation between the type of industry and the utilisation of strategic aspects in the capital investment decision-making process. The findings of Matundu merely indicate that there is no distinct difference in consideration of strategic aspects between industries. The larger the investment decision, the more consideration is given to the investment decision by all the industries.

Porter (1998:5) defines an industry as a group of enterprises “producing products that are close substitutes for each other”. The industry can then be divided into different strategic groups. Porter (1998:129) defines these strategic groups as enterprises within a specific industry which follow the same or similar strategies.

Porter (1998:29) and Seitz and Ellison (c1999:42) explain that the industry must be analysed before the firm’s posture relative to each of these forces can be analysed. After such an analysis a competitive strategy can be formulated, which “takes a defensive or offensive action in order to create a defendable position against the five competitive forces” (Porter, 1998:29).

From the suggestions stated by Porter (1998:126) it is noticeable that enterprises in the same industry may have different strategies. The reason for this is that an enterprise is “ultimately a unique construction reflecting its particular circumstances” (Porter, 1998:34). Enterprises differ in internal strengths and weaknesses with regard to their industry and *vis-à-vis* each other.

Thus, although the five competitive forces do indirectly influence the capital investment process, it remains the strategy derived and implemented by the enterprise (after such an analysis) which ultimately influences the capital investment process. This notion is confirmed by Seitz and Ellison (c1999:14), who stipulate that investment ideas must be sought within parameters set by strategy. Pearce and Robinson (2003:4) add to this by arguing that strategy provides a framework for managerial decisions.

None of the above studies reveal what type of strategic factors must be considered nor do they define the parameters set by strategy. For this reason, competitive strategy and the process of how it is derived (as studied and suggested by Porter) will be discussed to point out how the strategy decided upon influences capital investment decisions.

3.3 THE STRATEGIC PLANNING PROCESS

An effective and strategic business plan will set the parameters of the enterprise's financial plans, according to Lumby and Jones (2001:27). In order to compile a strategic business plan, Lumby and Jones (2001:28) suggest answering the following questions (in the specified order):

- Where are we now?
- Where do we want to be?
- How are we going to get there?

As mentioned above, Porter (1998:29) and Seitz and Ellison (c1999:42) differ from Lumby and Jones (2001:28) by arguing that the enterprise must conduct an industry analysis before conducting a SWOT analysis.

The researcher agrees with the suggestion made by Porter (1998). The reason for this is that an enterprise can only do a complete and comprehensive SWOT analysis after variables (opportunities and threats) active within the industry are known. The enterprise has to compare inner strengths and weaknesses *vis-à-vis* the industry concerned.

However, the two phases may be viewed as an integral part of each other, because knowledge about the industry is part of the SWOT analysis. Opportunities and threats relate to the industry. An analysis of opportunities and threats is therefore indeed an analysis of the industry.

Because it is not the focus of this study to scrutinise the strategic planning process, the order laid down by Lumby and Jones (2001:28) will be accepted, followed and discussed below.

The strategic planning process comprises the following:

- A SWOT analysis
- A competitive analysis
- How to implement the chosen strategy

3.3.1 SWOT analysis

The best way to answer the question: Where are we now? is to conduct a SWOT analysis of the enterprise relative to the industry (Lumby & Jones, 2001:28).

This encompasses a critical search for internal strengths and weaknesses relative to the opportunities and threats the industry yields. This is a search for a good fit between its internal situation and its external situation (Goetsch & Davis, 1997:76).

3.3.1.1 Internal variables (strengths and weaknesses)

Internal variables consist of strengths and weaknesses. Goetsch and Davis (1997:76) define an organisational strength as “any characteristic or capability that gives the organization a competitive advantage”. They further define an organisational weakness as “any characteristic or capability that is lacking to the extent that it puts the organization at a competitive disadvantage”.

These internal variables must be analysed by the enterprise. Lumby and Jones (2001:28) refer to the analysis of strengths and weaknesses as a critical “inward look”.

This is done by critically examining the internal strengths and weaknesses of the enterprise. Specific strength and weakness characteristics, which deliver or take away a distinctive competitive advantage to the enterprise, must be searched for and analysed. These strengths and weaknesses must be analysed relative to the opportunities and threats the industry bears (Porter, 1998:149).

Porter (1998:29) concludes that strengths and weaknesses can then be offensively or defensively utilised in the formulation of a competitive strategy against the five forces within the industry.

3.3.1.2 Offensive or defensive use of strengths and weaknesses

The internal variables of an enterprise can consist of concepts like “its existing product range, its fixed assets base, human resources and its managerial capabilities” (Lumby & Jones, 2001:28). It is necessary to establish which of the above-mentioned internal variables the enterprise may excel in, because this will give the enterprise a competitive advantage relative to its competitors.

The concepts mentioned above by Lumby and Jones (2001:28) must be examined in order to establish what factors within these concepts contribute an advantage and/or disadvantage to the enterprise. It may be a strong point such as low-cost production machinery relative to cost-expensive production machinery of competitors. This will give the enterprise an offensive advantage over its competitors. However, the opposite also holds true. In this way such a disadvantage will weaken the strategic position of the enterprise in the industry which will require a different strategic approach.

Porter (1998:149) argues that strengths or weaknesses will be those factors that will either enhance or weaken the:

- entry opportunities of competitors into the industry,
- the bargaining power of the enterprise *vis-à-vis* buyers and suppliers,
- the "insulation" which defends the enterprise from rivalry from competitors, and
- the ability to head off substitute products.

He further mentions that resources and skills of human resources could either enhance or weaken the competitive position of the enterprise. It is of great importance to bear in mind that strategies decided upon can only be implemented by human resources. For this reason, strengths and weaknesses associated with human resources are of the utmost importance.

Because the analysis of external variables is part of the industry analysis, it will be discussed under the applicable heading.

3.3.2 Competitive analysis (industry analysis)

Competitive analysis entails the analysis of the industry for opportunities and/or threats generated by the particular industry. Goetsch and Davis (1997:77) assert that opportunities identified within the industry will enable the enterprise to gain a competitive advantage and threats within the same industry may cause a competitive disadvantage.

Lumby and Jones (2001:28) describe the analysis of the industry as an "outward look" to the operating environment of the enterprise. Porter (1991:4) also stresses the importance of such an analysis in order to establish how the enterprise must position itself within the industry and, more specifically, the strategic group. This is an action of setting strategic objectives to the enterprise (Lumby & Jones, 2001:31).

Additionally, Porter (1998:3) asserts that the collective strength of competitive forces determines the long-term return on invested capital. This further highlights the importance of industry analysis.

Therefore, to establish where the enterprise wants to be, Lumby and Jones (2001:30) suggest conducting a competitive analysis as put forward by Porter (1998:6). The five competitive forces are:

- bargaining power of a buyer,
- bargaining power of a supplier,
- barriers to entry,
- threats of substitution, and
- competitor rivalry.

Lumby and Jones (2001:30) also refer to these forces as profit or value drivers. According to them, the enterprise must take these drivers or forces into account. They argue that the question as to where the enterprise wants to be must be answered in terms of the following:

- What business areas should the enterprise expand into?
- Which business areas should the enterprise withdraw from?
- How can a business area's level of profitability be improved?

The five competitive forces, as suggested by Lumby and Jones (2001:30) and developed by Porter (1998:6), will now be discussed.

Bargaining power of buyers

This force relates to the power of a buyer to force down prices. This is done by playing off suppliers against each other. They demand higher quality products or services for less money. The result is that the profitability of the enterprise and the industry is sacrificed.

This force can coerce an enterprise to defend itself in such a way that it implements a competitive strategy in order to weaken the power of the buyer.

Altering or capitalising buyer power and initiating capital investment ideas

Porter (1998:25) suggests different strategies for how this can be done best. The enterprise (seller) can lower its fixed costs, increase the switching costs of the buyer, differentiate its product, select buyers to which the product is very important to the quality of the buyer's product, etc.

The enterprise can best alter this force by selecting buyers that pose the least threats to the enterprise (Porter, 1998:26). As soon as the buyer exerts too much power, it will threaten the profitability of the enterprise and eventually that of the industry.

The enterprise could also decide to follow a forward integration grand strategy. This will expand the market share of the enterprise, ensuring distribution of its products. Thus, bargaining powers can initiate a vertical integration opportunity where a buyer company can be established or purchased.

Bargaining power of a supplier

This force relates to the power of the company to keep down its cost of sales. If the supplier has powerful bargaining powers, it will decrease the profitability of the enterprise and consequently the industry.

There are a few conditions that strengthen the bargaining power of suppliers, e.g. supplier monopoly and differentiated input products. It is up to the company to find a strategy for how the enterprise would best defend itself against such a force. This will enhance its competitive advantage.

Porter (1998:27) notes that this threat mirrors those factors which make the buyer powerful.

Altering or capitalising supplier power and initiating capital investment ideas

The power of this force can best be dealt with by selecting suppliers that can exert the least power and accordingly weaken the power of suppliers to increase the price of products.

The enterprise can also conquer this threat by ensuring that resources are supplied at a favourable price. This could be attained by implementing a grand strategy of backwards integration.

Such a strategic approach will initiate an opportunity to the enterprise to diversify, which creates a capital investment opportunity.

Barriers to entry

New entrants bring different threats to the industry and the enterprise. This signifies new capacity, which in turn decreases the market share of the enterprise. It could in turn affect the economies of scale negatively which were utilised by the enterprise to reduce costs. This will cause profits to decline. Therefore, it is necessary to create barriers of entry in order to prevent new entrants from entering the industry.

Altering or capitalising the threat of entry and initiating capital investment ideas

Porter (1998:7-13) lists six major sources of barriers to entry. They are:

- economies of scale,
- product differentiation,
- capital requirements,
- cost disadvantage independent of scale,
- access to distribution channels, and
- government policy.

The enterprise may face and/or create such barriers. In order to implement or to overcome such barriers the enterprise must undertake certain capital investment projects. These capital investment projects will be chosen bearing in mind the strategy implemented.

If the enterprise wants to take on the industry in terms of cost leadership, machinery could be employed for mass production. This will result in increasing entry barriers such as economies of scale.

Threats of substitution

Substitute products exert pressure on enterprises within an industry. This is done by offering an alternative product to the buyer. If the prices of products are too high, buyers will then consider using a substitute product. This places a ceiling on the price of the product that the enterprise can charge. This in turn limits the profitability of the enterprise and also the industry.

Enterprises are continually competing with other industries in delivering substitute products. Therefore it is important for the enterprise to identify which products can be classified as substitute products. Thereafter, the enterprise can plan a strategy for how it is going to best defend itself against this force.

<u>Altering or capitalising the power of substitute products and initiating capital investment ideas</u>

Porter (1998:38) suggests that the enterprise may consider differentiating its product. This entails an outlay of assets in order to implement this strategy and to alter this particular force. Such a strategy will cause a stronger customer loyalty which weakens the power of substitute products as customers become less price sensitive.

Competitor rivalry

Pearce and Robinson (2003:75) state that rivalry between competitors takes the form of jockeying for position. They explain that competitors may use tactics such as price competition, product introduction and advertising campaigns.

Porter (1998:17) puts forward the following reasons for competition:

- Competitors within the industry feel the pressure from forces like economies of scale, or
- the identification of a new opportunity.

He also claims that such a rivalry or jockeying for position has an effect on other enterprises within the same industry, because they are mutually dependent on each other.

In contrast with this, enterprises may also compete together. Porter (1998:24) reports that enterprises may stand together to fight off threats from substitute products. They can do so by advertising heavily as an industry in order to improve the collective position of the industry. However, enterprises within an industry compete mostly with each other.

Altering or capitalising the power of competitor rivalry and initiating capital investment ideas

Porter (1998:21) suggests a few ways of shifting the rivalry. This can be done through various strategic moves such as product differentiation, cost leadership and focus.

Product differentiation can be achieved through added value in the form of after-service technical advice. This will make the buyer dependent on the product and advice of the enterprise's engineers, for example. Such a strategy will increase the switching costs of the buyer, which will shut out rivalry from competitors.

With regard to a low-cost leadership strategy, if the enterprise enjoys low fixed production costs, it will forewarn competitors not to engage in price wars. Porter (1998:39) further reports that a focus strategy can also mean that the enterprise has a low-cost position with regard to its focus group. This type of strategy will fend off competitors by strengthening the overall competitive position of the enterprise within the industry.

However, to successfully implement these strategies the enterprise needs to make some form of capital investment in order to accomplish the objectives as well as jockey for position.

3.3.2.1 Corporate and competitive strategy

Porter (1991:15) points out that a diversified enterprise has two levels of strategic decision-making. The two levels consist of a business unit strategy and a corporate strategy. He also refers to business unit strategy as competitive strategy and hence the reason for using this concept throughout this study.

Pearce and Robinson (2003:6) agree with the notion of the different levels of strategic decision-making in a diversified company, but add a third level of decision-making where the functional strategy is formulated. They explain that within such an enterprise there are three fully operative levels, meaning corporate, competitive and functional. However, within a single business enterprise they only report two levels of strategy formulation. Here the corporate and business levels of strategic decision-making are combined into one level and the remaining level consists of the functional level.

First, it is necessary to define what a diversified company is. Pearce and Robinson (2003:170) define diversification as a distinctive departure from the existing operations of the enterprise. This entails the acquisition or the internal generation of a separate enterprise. They assert that it will be favourable if the "new" enterprise has synergistic abilities, counterbalancing the strengths and weaknesses of the two or more enterprises.

As mentioned above by Pearce and Robinson (2003:6) and Porter (1991:15), the first level of strategic decision-making consists of corporate strategy.

According to these authors, the corporate strategy of a diversified company concerns two different aspects. The two aspects are:

- the type of business the enterprise should be in, and
- how the corporate office should manage the group (portfolio) of business units.

Pearce and Robinson (2003:6) report that corporate level decision-making may also comprise the setting of objectives as well as the formulation of strategies "that span the activities and functional areas of business units". This means that corporate strategy is concerned about managing the various business units in such a way as to create synergy.

They further stipulate that corporate strategy is executed at the corporate level of decision-making by corporate executives. Pearce and Robinson (2003:255) explain that corporate strategy defines an enterprise's "general posture in the broad economy". For this reason it is concluded that a corporate strategy is the setting of broad objectives and the formulation of broad strategies. Pearce and Robinson (2003:6) state that corporate strategy selects a product-market arena within which the business unit must compete.

The second level of decision-making consists of the setting of concrete objectives and strategies. Pearce and Robinson (2003:6) explain that business unit managers and corporate executives are involved at this decision-making level. They must translate the broad objectives and corporate strategies into the competitive strategy.

"Competitive strategy concerns how to create competitive advantage in each of the business units in which the company competes" (Porter, 1998:15). Furthermore, Pearce and Robinson (2003:6) indicate that competitive strategies "strive to identify and secure the most prominent market segment within such a product-market arena". Thus, competitive strategies determine how the enterprise (business unit) must compete within such a segment in order to establish a competitive advantage.

In financial terms competitive advantage is “the difference between revenues and cost of sales” (Lumby & Jones, 2001:30). In order to maximise competitive advantage, enterprises must implement a competitive strategy. With regard to competitive advantage, Porter (1992:65) views capital investment as the most critical determinant of competitive advantage.

This means that the enterprise can position itself within the industry through a competitive strategy in such a way as to take best advantage of the competitive forces active in the industry. This is done by positioning the enterprise by either defending the firm against these competitive forces, influencing the balance of the forces or anticipating shifts in these forces (Porter, 1998:30).

In addition, competitive strategy is about “developing a broad formula for how a business is going to compete” (Porter, 1998:xxiv). Porter reports that competitive strategy is concerned about how the enterprise is going to achieve the set goals. This implies that competitive strategy describes or suggests “ways” (policies or tactics) of how business is going to be conducted.

The third strategic level of decision-making comprises functional strategy formulation. Functional strategy is formulated by functional managers. This level of strategy strives to implement the enterprise’s strategic plans. Functional strategies are more specific and short-term objectives and strategies are established to achieve competitive and corporate strategies.

Nevertheless, because functional strategies are short-term and capital investments discussed in this study are long-term, functional strategies will be ignored.

From the discussion above it becomes apparent that strategies at these different hierarchical levels do have an influence on each other. This especially holds true with regard to corporate strategy and competitive strategy. Thompson and Strickland (2001:51) explain this by reporting that corporate strategy is concerned with ways to strengthen the long-term competitive position of the business it comprises. Porter (1991:18) further emphasises that a “[s]uccessful corporate strategy must grow out of and reinforce competitive strategy”. From this it can be deductively inferred that there is a mutual correlation between these two hierarchical levels of strategy.

Given the above, Porter (1998:15) states that “almost no consensus exists about what corporate strategy is, much less about how a company should formulate it”. Because it is so difficult to define corporate strategy and the influence of competitive strategy on it and because “diversified companies do not compete; only their business units do” (Porter, 1991:18), it can be inferred that competitive strategy has a more significant influence on capital investment decisions taken within a business unit of a diversified company. For this reason the influence of competitive strategy on capital investment decisions will be examined, and not that of corporate strategy.

Therefore, competitive strategies will be discussed in the next section.

3.3.2.2 Strategic approaches

In order to formulate a competitive strategy there are various approaches to follow. Porter (1998:35), however, suggests three generic strategic approaches. He suggests implementing only one. These generic strategies will enable the enterprise to best defend itself against the five competitive forces.

This means that one of these approaches can serve as a competitive strategy, provided the strategy was derived from a thorough SWOT analysis. If the most tailor-made strategy is picked, it will ensure a competitive advantage with which competitors will be outperformed (Porter, 1998:34).

Porter (1998:35) puts forward three strategic approaches to attain a competitive strategy. The three strategic approaches are as follows:

- Overall cost leadership
- Differentiation
- Focus

The three strategic approaches will be discussed below.

Overall cost leadership

The enterprise which follows this type of strategy strives to reduce costs and maximise efficiency. Pearce and Robinson (2003:160) report that this type of enterprise tries to maximise economies of scale, implement cost cutting technologies, reduce overheads and administrative costs, etc.

According to them, this strategy depends on unique capabilities in order to achieve and sustain low-cost leadership. Examples of these unique capabilities may take the form of:

- secured suppliers,
- owning a dominant market share position,
- a high degree of capitalisation, and
- scarce raw materials.

In order to reduce costs and maximise efficiency the enterprise uses certain policies or tactics. The actions of the enterprise are directed at defending the enterprise against the five competitive forces active in the industry.

A low-cost strategy defends the enterprise against competitor rivalry. A competitive advantage is sustained through the fact that more profit is available to the enterprise after competitor rivalry has cut down profits.

With regard to power of buyers and suppliers, a buyer can only drive down the price of a product to the level of the most cost-efficient competitor. Overall low-cost leadership enables the enterprise to cope more effectively with increasing input costs. Additionally, if the input costs do not increase, it will give the enterprise an offensive position because of a profit margin higher than that of the next competitor. This will enable the enterprise to cut down on prices, giving it a competitive advantage relative to the next competitor. This will also weaken the possibility of buyers turning to substitute products.

Differentiation

Through differentiation of the product the enterprise can also achieve a competitive advantage. This is done by differentiating the product of the enterprise from that of the industry. It is about creating a unique product which is received and experienced in just such a unique way by the buyer. This in turn will create brand loyalty among customers, making them less price sensitive, which weakens the threat of competitor rivalry and substitute products.

Such a unique product causes entry barriers, because the competitor must try to overcome or to duplicate the uniqueness of the product. This implies that fewer manufacturers of the product are available, which strengthens the position of the enterprise selling the product to buyers.

Fewer manufacturers of the product also strengthen the purchase power of the enterprise.

Focus

The third approach is to concentrate on a specific buyer segment of the product. With this approach the enterprise focuses on serving only a particular buyer. All actions of the enterprise are aimed at serving the buyer effectively and/or efficiently. The enterprise also concentrates on meeting a particular need of the buyer. Through such a strategy the enterprise can also achieve a competitive advantage within the specific industry.

The fact that the enterprise focuses on the need of a specific buyer enables it to differentiate its product and to cut down costs through economies of scale and its learning curve with regard to the research and marketing department and production departments.

This strategy would have the same impact on the five competitive forces as discussed under the headings of overall cost leadership and differentiation strategies.

3.3.3 How strategy initiates capital investment ideas and proposals

The "outward look" to the industry which determines where the enterprise wants to be or where it wants to position itself within the industry was discussed in the above section. Now, the enterprise must decide how to get where it wants to go (Lumby & Jones, 2001:31).

Inner strengths and weaknesses are now known relative to the five competitive forces active in the industry and strategic objectives have been set. These objectives are the ends to which Porter (1998:xxiv) refers. The enterprise is now capable of selecting a competitive strategy from the three generic approaches. The competitive strategy decided upon will determine how the enterprise will achieve the strategic objectives through overall cost leadership, differentiation or focus strategies.

After the enterprise knows which competitive strategy it is going to implement, the question is: How will overall low cost leadership be achieved? Low-cost production machinery could be needed or economies of scale have to be established through an increase in production which will increase profits from operations. From this it is evident how competitive strategy initiates the need for an investment in fixed assets that also needs financing. If another strategy were selected, a different kind or type of investment would be initiated.

Inner strengths, weakness and strategic objectives will determine the strategy that will direct all actions of the enterprise in order to achieve the set objectives. This in turn influences the investment-specific variables.

In addition to this, Lumby and Jones (2001:31) argue that the five competitive forces within the industry determine the net cash flow of an enterprise in terms of the rate of sales growth and the level of profit margins. This means that cash flow from operations, investment activities and financing activities are thus influenced by these competitive industrial forces. “It is at this stage that the company formulates its investment strategy in terms of the capital expenditure decision” (Lumby & Jones, 2001:32).

Competitive advantage is not only achieved by increasing revenues and minimising cost of sales, but also by minimising the cost of finance. Investment decisions as well as decisions how to finance the investment all form part of the capital investment process. These decisions are therefore all influenced by the choice of competitive strategy.

Furthermore, the need for investment will be determined by the strategy the enterprise chooses.

3.4 CONCLUSION

Internal and external variables in the enterprise and the industry, respectively, largely determine what type of competitive strategy an enterprise will choose to follow. These variables give a good indication as to where the enterprise is and where it is going to position itself in the industry. If the enterprise knows what its objectives are (SWOT analysis) and how it is going to go about achieving them (strategy), opportunities and need for investments in order to achieve the set objectives will become evident.

Capital investment decision-making "is linked inextricably with the long-term strategic direction" of the enterprise, which "cannot be seen as a discrete, independent activity" (Northcott, c1998:139). This statement concurs with that by Liberatore et al. (1992:35) that capital investment can be viewed as a vehicle to implement and achieve business (competitive) strategies.

Strategy is a long-term plan and business is not conducted within a fixed environment. These strategic internal variables (e.g. the quality of the product) and external variables (e.g. competitor rivalry), which drive the competitive strategy, change continuously. Competitive strategy may therefore adapt in order to better position the enterprise. To best defend itself or to grasp an opportunity is a strategic decision which consequently initiates capital investment opportunities. This will consequently influence the capital investment process accordingly.

The type of investment will be determined by the strategy which the company will choose to follow *vis-à-vis* its internal and external variables. Therefore it is concluded that it is ultimately the competitive strategy that will determine how this "positioning" or the objectives will be achieved.

The influence of competitive strategy on capital investment decisions was discussed and pointed out in this chapter. Therefore, it is also necessary to examine the correlation between competitive strategy and capital budgeting allocation as capital must be allocated to different departments in order to finance these investment proposals.

CHAPTER 4

THE INFLUENCE OF STRATEGY ON CAPITAL BUDGET ALLOCATION

4.1 INTRODUCTION

The influence of strategy on the capital budget allocation process will be discussed in this chapter.

Diversified companies consist of different business units. These business units could in turn consist of different business units and/or departments. These business units and/or departments can operate dependently on or independently from each other. The ideas initiated by competitive strategy must be implemented and controlled by the appropriate business units and/or departments. The organisational structure therefore is also an important internal variable to bear in mind when allocating budgets to different business units and departments. This will be discussed briefly in this chapter.

From what was discussed in the previous chapter it is inferred that these departments and investment proposals (projects) are aligned in order to meet the corporate and business unit objectives. Therefore, the allocation of capital investment budgets is a crucial process in order to ensure efficiency and effectiveness. The influence of competitive strategy on the key components of the budget allocation process, pointed out by Wooldridge, Garvin, Student members and Miller (2001:86), will now be discussed.

Business units and/or departments of business units will be referred to as departments from now on.

4.2 THE INFLUENCE OF COMPETITIVE STRATEGY ON KEY ELEMENTS OF BUDGET ALLOCATION

Wooldridge et al. (2001:87) examined the influence of accounting and budgeting information on distinct elements of the capital allocation process. They refer to condition assessment, planning, financing and acquisition as "basic elements of the capital allocation process" (Wooldridge et al., 2001:88).

In their findings these writers reported various imperfections which impede the ability of decision-makers to "effectively execute the capital allocation process" (Wooldridge et al., 2001:93). *Inter alia* they found that:

- financial data is not adequate to compare the sources and uses of capital for alternative capital investments, and
- budgeting methods foster a short-term thinking and skew planning toward external resources.

Although their study was conducted on capital allocation in the public sector, it can be very much applicable to the private sector. This notion is confirmed by Butler et al. (1993:27) who contend that "[t]he difference between the public and private sectors has become increasingly blurred". Mott (1997:1) shares this view.

With regard to the authors' reference to the influence of financial and budgeting methods on the capital allocating process, one must bear in mind that various authors (Maccarrone, 1996:55, Mukherjee & Henderson, 1983:86 and Pinches, 1982:16) have scrutinised the sole use of financial methods. Budgeting committees also need to establish the influence of competitive strategy on each of the applicable capital budget allocation elements in order to allocate limited capital effectively.

The influence of competitive strategy on the capital budget allocation process and, more specifically, the four elements (condition assessment, planning, financing and acquisition) will be discussed below.

4.2.1 Condition assessment

Condition assessment embraces the assembling of information related to the identification of investment needs and the current state of assets. The identification and prioritisation of project needs are one of the key challenges faced by decision-makers to sustain and acquire infrastructures within local government (Wooldridge et al., 2001:88).

In chapter 3 it was concluded that competitive strategy identifies and initiates investment ideas and projects within the enterprise. The enterprise will have to implement these investment projects in order to achieve the set corporate objectives. Northcott (c1998:18) argues that this is mostly the task and responsibility of a project manager from a particular department on which the capital investment will have an impact. In order to enable such a department to implement these ideas and projects, capital is needed and has to be allocated.

However, the availability of capital is mostly limited. This means that not all investment ideas will be implemented and that decision-makers have to prioritise between project needs. For this reason, Gitman (c2003:359) emphasises that enterprises generally operate under capital rationing. He defines capital rationing as when an enterprise has only a fixed amount of capital and numerous capital projects compete for these available funds.

Seitz and Ellison (c1999:192) concur and add that investments may compete for two reasons, namely:

- they are mutually exclusive, or

- capital rationing.

Gitman (c2003:358) defines mutually exclusive investment projects as “projects that compete with one another”. The acceptance of one will eliminate the consideration of the other alternatives. Additionally, Seitz and Ellison (c1999:192) state that money or capital is not the reason for not accepting both investment projects with regard to mutually exclusive investment projects.

The opposite of this type of investment project is an independent project. Independent investment projects are defined by Gitman (c2003:358) as “projects that are independent of one another”. If one is accepted, it will not influence the acceptance of the other, nor the cash flow.

However, these two definitions refer to the degree of influence which the acceptance of one investment project may have on the acceptance of other alternatives. Although these investment projects may all be identified or initiated within the parameters set by strategy, capital rationing restricts them all from being selected.

Notwithstanding this, the successful implementation of some investment projects may have an influence on the successful implementation of others. This implies that within a capital investment portfolio, investment projects may be either dependent or independent on the outcome of others.

Furthermore, if departments are mutually dependent on one another, the scenario will force decision-makers to be extra cautious with the allocation of budgets. The reason is that if one investment project (either independent or mutually exclusive) is at an earlier stage of the value chain or process line, it could affect the outcome of subsequent investment projects and consequently the successful implementation of strategy. This signifies the importance of a thorough condition assessment when this is an actual scenario.

Although condition assessment will be conducted during internal and external analysis, the enterprises must also conduct a thorough condition assessment after investment ideas have been identified about the current state of assets. This notion is shared by Wooldridge et al. (2001:88). They are of the opinion that a complete assessment may indicate “facility distress or inadequate operations and maintenance”. Information related to the various capital investment alternatives identified must be obtained.

This will assist decision-makers to prioritise between projects in order to select the best available investment portfolio, *vis-à-vis* competitive strategy, in order to achieve the set corporate and business unit objectives. Walls (1995:255) warns, however, that it is “impossible to achieve the best level with respect to each objective”. Trade-offs have to be made. The reason is that objectives may be conflicting in nature. Another reason may be that the current knowledge and experience within the enterprise to implement the particular investment project are inadequate.

A condition assessment could further indicate whether an investment project could be implemented successfully or not. This implies a thorough internal analysis with regard to the availability of human resource knowledge and experience and assets to complement and assist the implementation and operation of the new investment projects.

Competitive strategy will therefore influence and facilitate the condition assessment element of the capital budget allocation process. The reason is that investment needs can be identified as well as prioritised with the aid of competitive strategy.

4.2.2 Planning

Capital budgeting is an integral part of financial management. Additionally, Lumby and Jones (2001:31) argue that the planning objective of financial management is to maximise shareholders' wealth through an increase in share value. Their notions correspond with the discussion in chapter 3, where it was concluded that all actions within an enterprise are directed at achieving set objectives.

In order to achieve this objective, they further argue that decision-makers first have to identify the competitive strategy. This again refers to an internal and external environmental analysis before such a strategy can be identified and formulated. During this strategic planning process, investment ideas will materialise.

Additionally, Wooldridge et al. (2001:89) state that a condition assessment of assets cannot be "a useable solution unless they are considered within an appropriate context". They are of the opinion that past deficiencies and projected shortfalls can be recognised by integrating historical and anticipated accounting and budgeting data. This integrated information can then be used to plan for future capital needs.

However, the congregated information mentioned above by Lumby and Jones (information with regard to the internal and external competitive environments) and Wooldridge et al. (historical and anticipated accounting and budgeting data) must be used when decision-makers plan for capital investments and, consequently, capital budget allocation. The enterprise must utilise this information during the strategic planning phase of future capital investment needs. Wooldridge et al. (2001:89) argue that at strategic level, decision-makers must plan whether the enterprise is going to expand, sustain or reduce its current operations.

Thus, competitive strategy and quantitative information will influence the planning element of capital budget allocation. For example, a low-cost leadership strategy could indicate to decision-makers what and how to plan for the implementation of an expansion investment project, through which economies of scale could be obtained.

Competitive strategy will therefore aid the planning element in providing information about competitive forces and the competitive positioning of the enterprise relative to these competitive forces.

4.2.3 Financing

Investment projects need financing. Financing of projects is a crucial part of capital budget allocation. Lumby and Jones (2001:32) are of the opinion that if the financing strategy is neglected at the expense of the investment strategy, it can damage the competitive position of the enterprise. Both strategies are important.

If the cost of capital of the enterprise is higher than that of competitors, this internal weakness will lower the profit margin of the enterprise. This will weaken the position of the enterprise to compete with other competitors within the industry. Lumby and Jones (2001:32) contend that such a disadvantage may even result in the enterprise being excluded from certain investment opportunities, because the cost of capital criteria will advise them not to invest in such a capital investment project.

As discussed above, the need assessment will identify investment needs. Furthermore, planning must be done in order to implement investment projects to fulfil these investment needs. However, planning must also be done with regard to financing. The importance of effective and efficient financing is crucial to competitive advantage and also achieving corporate objectives. This implies that the capital investment influences the type of financing.

In contrast to this, when “the attractiveness of a capital investment is independent of how that particular investment is financed” (Seitz & Ellison, c1999:664), it is referred to as the separation principle. Seitz and Ellison (c1999:20) state that this “principle is correct under perfect market conditions, in which wealth is unaffected by the ways in which the firm finances its activities”.

However, there are exceptions to this principle. “In the imperfection-loaded world of normal activity” (Seitz & Ellison, c1999:20), financing choices relative to the capital investment project do matter and they do create wealth. Seitz and Ellison (c1999:679) argue that when the investment “affects the optimal debt ratio and/or the components of cost of capital” the “financing implications of the investment must be considered in the capital budgeting process”. These authors (c1999:23) conclude that “it is impossible to completely divorce investment and financing decisions”.

Therefore, it can be inferred that financing must be considered within the capital investment process. Furthermore, it can be deductively inferred that if competitive strategy influences the capital investment decision, it also influences the financing element of capital budget allocation.

4.2.4 <u>Acquisition</u>

The acquisition of assets is an integral part of the capital investment process. This is especially applicable to the implementation phase. In order to build a plant, production line, etc. assets must be obtained. Wooldridge et al. (2001:89) emphasise that an enterprise must formulate procurement strategies.

These procurement strategies will have to be aligned with the capital investment process and also the competitive strategy. Therefore, it is necessary to view the influence of competitive strategy on the acquisition element.

As already discussed in chapter 3, competitive strategies embody a thorough knowledge of internal and external variables. It was mentioned that supplier power plays an enormous role in obtaining and sustaining a competitive advantage. In addition, these particular forces can further increase cost of sales. Thus, if an enterprise is faced with such a competitive force it will be advisable to plan accordingly in order to minimise its effect. Porter (1998:4) emphasises the importance of strategy as a defence against the competitive forces or to “influence them in its favor”.

Consequently, the acquisition or procurement of assets must be thoroughly planned and budgeted for to achieve a competitive advantage. A low-cost leadership strategy, for example, will influence the procurement strategy in such a way as to minimise procurement costs.

It is therefore important to keep in mind, while analysing the environment and implementation of strategies, that enterprises are obliged to implement the provisions of the Black Economic Empowerment Act. Theobald and Singh (2004:78) assert that “[a]ffirmative procurement remains a potent way of promoting broad-based empowerment and economic development”. They found in their survey that black empowerment companies could earn up to “R 515 billion in revenue” from procurement in South Africa (Theobald & Singh, 2004:78). This certainly indicates an opportunity for the taking to black empowerment suppliers. Opportunities attract competitors.

This external variable, seen by some as a threat, can be utilised as an opportunity and in time converted into a competitive advantage, if managed and implemented correctly. This objective can be achieved by:

- ensuring that various black economic empowerment suppliers are available, who are well acquainted with the standards and requirements of the enterprise,
- increasing the switching cost of the supplier, or
- choosing to follow a strategy of backward integration.

Porter (1991:7) views the choice of an enterprise's suppliers as a crucial strategic decision. These options will have a direct influence on the budget allocation of the enterprise.

Neglecting the acquisition variable may result in an increased future procurement cost. This may result from black economic empowerment enterprises, which have become more dominant suppliers and as a consequence increased their product prices in the industry. Such a procurement strategy will impede the successful implementation of a low-cost leadership strategy.

From the above discussion it is evident that competitive strategy will also influence the acquisition element of capital budget allocation.

4.3 CONCLUSION

The influence of competitive strategy was discussed relative to each element of capital budget allocation in this chapter. Evidence was provided that these elements constitute an integral part of competitive strategy and its planning.

Secondly, it appears as if the elements may also have an influence on competitive strategy. For example, a competitive advantage will not be obtainable if assessment, planning, financing and acquisition are incorrect. Thus, it can be concluded that there is a mutual correlation between competitive strategy and the elements of capital budget allocation. For this reason the two variables cannot be separated from each other.

Hence, capital has to be allocated to the different departments effectively in order to ensure the most appropriate investment portfolio possible. This will then enhance the optimal achievement of corporate objectives within the parameters set by competitive strategy.

Competitive strategy and its influence on the capital investment process were discussed throughout this chapter. However, it is also necessary to view what types of strategic criteria are utilised to screen capital investments and consequently capital budget allocation.

CHAPTER 5

STRATEGIC CRITERIA IMPLEMENTED TO SCREEN CAPITAL INVESTMENT IDEAS AND PROJECTS

5.1 INTRODUCTION

The influence of competitive strategy on capital investment appraisal criteria will be discussed in this chapter.

When an enterprise applies criteria to which an investment project must adhere, it tries to determine whether the outcome of the strategy or investment project will be successful. Therefore, it is necessary to examine what strategic criteria will be utilised to screen investment projects within an enterprise. Strategic criteria implemented within enterprises will be discussed below.

5.2 CRITERIA RELATED TO STRATEGIES AND CAPITAL INVESTMENTS

"Evaluation criteria are intended to enable managers to conclude whether or not a particular sequence of actions will lead to a particular future state which will produce some target measure of performance" (Stacey, 2003:53).

During discussions in previous chapters it became evident that competitive strategy should determine the type of capital investments. These capital investments constitute the successful implementation of strategy. Although strategy is a long-term plan for how the enterprise will compete, investment projects are constantly needed to complement and facilitate this plan in order to execute it.

In order for strategies and consequently capital investments to be successful, they have to meet certain sets of criteria. The capital investment which fits best within the competitive strategy of the enterprise must be selected. Within the screening process of capital investment proposals, financial and strategic criteria will be utilised to either select certain projects or to reject them.

The link between strategy and the capital investment decision was examined by Northcott (c1998:140). He concludes that the investment decision cannot be properly implemented if it is practised apart from strategic decision-makers.

In addition, Liberatore et al. (1992:35) state that capital investments are viewed as part of action plans to achieve competitive strategies. They further report that enterprises evaluate capital investment projects against certain criteria which are linked to the strategy of the enterprise. Criteria like satisfaction, flexibility and throughput are found to be directly linked to "the overall mission and goal" of enterprises (Liberatore et al., 1992:40).

Seitz and Ellison (c1999:15) concur with the above-mentioned authors and contend that "[e]ach strategic decision is in itself a general capital budgeting decision".

Furthermore, Butler et al. (1991:402) found evidence to support this notion that the "implementation of competitive strategy is filtering through to investment decisions". They inferred this statement from three case studies where product quality, strategic fit and improving competitive position were experienced as the most important factors in the investment decision-making process.

Hall (2000:365) provided evidence in his study that non-financial criteria play a large role in the selection process of capital investment proposals. His research study indicated that 33,8 per cent of the respondents' capital investments were rejected by non-financial (strategic) criteria.

In addition, Fremgen (Lumby, 1991:491) determined through his survey in the United States of America that 97 per cent of respondents approved capital investments on non-financial grounds for which financial techniques advised rejection. This confirms that capital investment proposals can be and are being approved on strategic criteria, even if financial criteria indicate otherwise.

Furthermore, it can be concluded that criteria related to strategies and long-term plans will also apply to capital investments. This view will form the foundation of subsequent discussions and arguments.

These sets of strategic capital appraisal criteria will now be discussed.

5.3 STRATEGIC CRITERIA UTILISED IN THE CAPITAL INVESTMENT PROCESS

The above studies and their authors fail to define the different sets or categories of strategic criteria utilised by enterprises in the capital investment process. They only refer to certain strategic criteria in general, for example strategic fit, product quality and improving competitive positioning.

Although these strategic criteria can be categorised under the headings discussed below, this is only the tip of the iceberg. Therefore, it is necessary to examine what sets or categories of strategic criteria are applicable and can be utilised in the capital investment process. For this reason, the work done and the strategic criteria suggested by Stacey (2003:54) will be examined and discussed.

Stacey (2003:1) examined how decision-makers think about strategy, the enterprise and change. He also focused on what kinds of questions are posed with regard to the strategy, enterprise and change. Organisational theories were explored, including descriptions and prescriptions to decision-makers.

Various actions or options are available to achieve the set corporate and business unit objectives. A strategic plan must be chosen, formulated and implemented. “Prescription is for this choice to be made following a rational sequence of logical steps, using rational evaluative criteria” (Stacey, 2003:51). Stacey aimed at pointing out the key elements of the theory of strategic choice.

The literature put forward by Stacey is based on his experience and teaching as a professor of Management at the Business School at the University of Hertfordshire. Furthermore, Stacey consults management groups within enterprises and is also a member of the Institute of Group Analysis.

Thus, drawn from experience, Stacey (2003:54) suggests three sets of criteria which must be met in order for a long-term strategic plan and thus also capital investment projects to be successful. These sets of criteria are acceptability, feasibility and suitability.

These criteria assist decision-makers to conclude if a particular sequence of actions (capital investments) will lead them to success (Stacey, 2003:53). Each one of these criteria will be briefly analysed in the following sections.

5.3.1 <u>Acceptability</u>

The acceptability criterion determines that, in order for a strategy to be successful, it must be acceptable to the most powerful groups of the enterprise’s stakeholder categories (Stacey, 2003:54).

Gitman (c2003:17) defines stakeholders as any group of persons who have a direct economic link to the enterprise. These groups may consist of employees, customers, suppliers, creditors, owners and others with a direct economic link.

Acceptability must be tested "*before* investing significant time, effort and money in evaluating them [investments that are likely to be attractive - AJ]" (Moran, c2000:4).

In addition, "[t]here are at least three senses ... in which strategies have to be acceptable" in order to be successful (Stacey, 2003:54). They are as follows:

- Performance, with regard to financial terms, must be acceptable to owners and creditors.
- The consequences of the strategy must be acceptable to powerful internal stakeholders.
- The consequences of the strategy must therefore also be acceptable to external stakeholders.

Each of these senses will be discussed *vis-à-vis* capital investment ideas and projects.

5.3.1.1 Acceptable financial performance

Stacey (2003:54) argues that the long-term plans must be financially acceptable to the applicable stakeholders. He is of the opinion that the financial consequences of capital investment projects must therefore meet expectations with regard to cash flows, capital expenditures and other costs, sales volumes, price levels, profit levels, borrowing and other funding requirements.

The acceptability criterion implies that the capital investment project must be financially acceptable to the various stakeholders. The investment project has to meet the set financial criteria.

Hall (2000:360) found in his study that the most important financial evaluation methods utilised by South African enterprises are the return on investment method (33,8 per cent usage) followed by the internal rate of return method (32,3 per cent usage). Still, it must be kept in mind that the acceptability of investment projects will be based on estimations about an uncertain future.

Furthermore, Northcott (c1998:17) states that the financial criteria will differ from investment project to investment project. He says that financial criteria applied by enterprises can be influenced by the type of financial analysis undertaken as well as the type of capital investment (for example expansion or replacement projects). Northcott further mentions that the more risk involved, the more stringent the financial acceptance criteria will be.

Seitz and Ellison (c1999:51) warn that a too strong emphasis on the enterprise to perform in the short term may inhibit the implementation of strategy. This could impede the competitive advantage, because potentially successful investment projects can be rejected prematurely due to the fact that they did not meet short-term financial criteria. These authors explain that investments of major strategic value take time to pay off. Nevertheless, short-term financial criteria may be applied, without neglecting long-term results and advantages.

For this reason, the acceptable financial performance criterion must be established within the context of the above variables and their influence on them.

5.3.1.2 Acceptable strategic consequences for powerful internal stakeholders

This criterion affects the internal stakeholders of the enterprise. Northcott (c1998:3) agrees with this notion that the investment decision will affect the people in the enterprise.

Moran (c2000:15) suggests considering the impact of the capital investment on employees. This is crucial especially for the successful implementation of the investment project. For example, if the capital investment project could lead to job losses, employees will be reluctant to give optimal co-operation.

However, internal stakeholders' commitment is needed not only during the implementation phase of the capital investment process, but also during the other phases. This holds true from the initiating phase of capital investment ideas right down to the auditing of the outcome.

For these reasons Stacey (2003:56) emphasises that decision-makers "must analyse the impact of their plans on the expectations, relative power positions, and cultural beliefs of key individuals and groups within the organisation".

It is therefore necessary to also establish the impact of the capital investment decision on the acceptability criterion of powerful internal stakeholders. If it is unacceptable to internal stakeholders, it is necessary to rethink and redefine the contemplated investment project. Defining an investment project is turning ideas "into operational formulation of spending requirements, implementation practicalities and quantifiable future benefits" (Northcott, c1998:13).

5.3.1.3 Acceptable strategic consequences for powerful external stakeholders

Stacey (2003:57) states that powerful external role players can determine the successful implementation of strategy and therefore also capital investment projects.

An example of the power of such a group is the pressure which a community group can exercise with regard to air or noise pollution, which a certain investment project may cause. Such a group may take court action which could delay the implementation of such an investment project. This could consequently lead to a competitive disadvantage.

The commitment and involvement of external stakeholders is crucial. Therefore, if the investment project does not live up to the expectations of external stakeholders, and there is substance to their notion, the existence of the investment project must be reconsidered.

5.3.2 Feasibility

Although the capital investment project may be acceptable to all the relevant role players, it may still fail because it is not feasible. This criterion stipulates that there must be "no insurmountable obstacle" influencing the enterprise not to successfully implement a capital investment project and consequently a competitive strategy (Stacey, 2003:58).

Stacey (1996:159) mentions a few obstacles that could affect the feasibility of the successful implementation of strategies. The obstacles are:

- inadequate resources,
- resources of insufficient quality,
- inappropriate technology,
- timing in relation to other events, and
- competitor strength.

More recent work conducted by Stacey (2003:58-59) adds the following obstacles, namely:

- financial resources,
- product life cycle,
- experience curves, and
- the product portfolio.

These obstacles are applicable and crucial to the successful implementation not only of strategy, but also of capital investment projects. The absence and/or presence of these obstacles will seriously influence the successful implementation of capital investment projects.

Stacey (2003:58) provides an example to prove this statement. He argues that an enterprise would certainly not invest substantial amounts in its product that is in a mature stage. It would have made large investments much earlier during the product life cycle, during the growth stage.

It is therefore necessary to first establish the possible influence of these obstacles on the successful implementation of a capital investment project. Thereafter, role players must ensure that the above obstacles will have no or minimal influence on the investment project.

Thus, if the capital investment project cannot be feasibly implemented, other alternatives have to be considered.

5.3.3 Suitability

Suitability or strategic fit is also a criterion which the successful implementation of strategy must meet. This signifies that "a proposed sequence of actions is consistently related to the objectives of the organisation on the one hand and matches the organisation's capability in relation to its environment on the other" (Stacey, 2003:60). Seitz and Ellison (c1999:51) concur and add that strategic investments must be evaluated in the context of their impact on other investments now and in the future.

This implies that capital investments must be selected because of their particular nature to utilise internal strengths to best defend the enterprise against external competitive forces in such a way as to achieve set objectives. Furthermore, it implies that if the investment decision does not comply with the specifically chosen strategy, it will not be advisable to select the particular investment project.

The above statement can be confirmed by the study of Butler et al. (1993:68) who found that the forty-four managers rated the strategic fit of a capital investment of greatest importance. They conclude that unless a capital investment fits into the strategy of the enterprise, managers are unwilling to support such a proposal. (Strategic fit was experienced by the respondents as of more importance than financial appraisal techniques like internal rate of return and payback period.)

Strategic fit of a particular investment project is of utmost importance to the enterprise and its competitive advantage. Butler et al. (1993:54) further argue that it is not necessary to screen all initial capital investment ideas, because these investment ideas may not fit the strategy of the enterprise. Northcott (c1998:139) adds that the capital investment decisions must take the enterprise's environment into consideration. These statements confirm the importance of this criterion and the appropriateness of applying it during the screening of capital investment ideas.

The criteria applicable to strategy and capital investments were discussed above. However, these criteria only give an indication as to whether an investment project is accepted or not. No other alternatives apart from the rejection or acceptance of investment projects are available.

This points out a shortcoming in the capital budgeting theory. For this reason, the real option theory has gained wider acceptance by decision-makers. This theory may fill this shortcoming and will be discussed below.

5.4 THE REAL OPTION THEORY

The real option theory points out the shortcomings in the capital budgeting process where investment projects are subjected to decision-making tools, for example net present value and payback period. These tools are utilised together with the acceptability criterion. Park and Herath (2000:2) argue that the net present value decision-making tool boils down "all the possibilities for the future into a single scenario". Park and Herath and various other authors (see chapter 2) criticise the sole use of financial criteria.

In contrast, the real option theory (or an analysis) "simply says that companies benefit by keeping their options open" (Park & Herath, 2000:1). This implies "that any corporate decision to invest or divest real assets is simply an option" (Park & Herath, 2000:2). Decision-makers may react to an opportunity now, but withhold specialised choices to much later.

This theory enables capital investment decision-makers to invest a little up front. Thereafter they are allowed to experience how the future unfolds with regard to risks and uncertainties. As the future unfolds and more clarity and certainty realise, they may make further investments or terminate the project if unacceptable and unfeasible. This approach allows decision-makers to utilise other options not known at the beginning of the investment process.

Park and Herath (2000:2) report that the real option theory "is a new way of thinking about corporate investment decisions" and is "gaining wider acceptance in financial markets". They argue that this especially holds true since Scholes and Merton won the 1997 Nobel Prize for Economics for work done on the option-pricing theory.

5.5 CONCLUSION

From the above discussion it is evident that the utilisation of strategic criteria is crucial to the successful and effective implementation of capital investment projects. An investment project may be financially acceptable but is not strategically fit. If capital investment ideas are not sought within the criteria set by competitive strategy, such an investment idea will not contribute to the achievement of corporate objectives.

This further means that capital investment projects must adhere to all three sets of criteria, namely acceptability, feasibility and strategic fit.

However, it is important to bear in mind the real option theory. This approach can only enhance the abilities and options of capital investment decision-makers.

All the literature necessary to understand concepts as well as the relationship between competitive strategy and capital investment decisions, ideas and projects was outlined above. The next phase of the study will consist of the empirical study.

EMPIRICAL CASE STUDY

PHASE II

CHAPTER 6

RESEARCH METHODOLOGY

6.1 INTRODUCTION

In Phase I, a literature study was conducted in which concepts with regard to strategic capital investments were discussed and explained. The influence of competitive strategy on the capital investment process was discussed. Specific attention was given to how competitive strategy initiates capital investment ideas and consequently investment projects. Literature presented in Phase I serves as a foundation on which the research study was designed and executed.

In Phase II, attention is given to the research methodology utilised in this qualitative research study. In this chapter, specific attention is given to the following, namely:

- the research design,
- the population and sampling,
- data collection methods,
- data analysis, and
- validity and reliability.

6.2 THE RESEARCH DESIGN

This study is explorative and descriptive in nature.

6.3 THE PHENOMENOLOGICAL METHODOLOGY

The aim of the phenomenological approach was to understand how people involved in a particular phenomenon experience that specific situation. This experience and the consequent actions of decision-makers actively involved in the strategic capital investment process were explored and described and not the (phenomenon) strategic capital investment process per se.

Welman and Kruger (1999:21) suggest that a case study research method intends to point out the “uniqueness and the idiosyncrasy of a particular case in all its complexity”. Hence, a case study research methodology was used to tap individuals’ experience within a complex single bounded system, like the strategic capital investment process in order to point out its uniqueness and idiosyncrasy.

Furthermore, Welman and Kruger (1999:192) point out that the concern with a case study is to search inductively for recurring patterns. Therefore, interviews with various respondents were held to examine the recurrence of such patterns and corresponding findings.

6.4 THE POPULATION AND SAMPLING METHOD

The case study focused on the experience of decision-makers actively involved in the capital investment process of a major platinum producer. The enterprise is a major player and implements capital investment projects worth billions of rands.

The enterprise is not at this stage a diversified company, although it intends to become one in the near future. This does not affect the level of its strategy, as such an enterprise’s corporate and competitive strategy will function on the same level (see section 3.3.2.1 and Pearce & Robinson, 2003:6). Units of analysis were selected from this enterprise.

Eight units of analysis were selected by means of snowball sampling. Snowball sampling occurs when a few individuals are approached from a relevant population. They are then interviewed and asked to identify new members from the relevant population, as suggested by Welman and Kruger (1999:63). In this way the sample grows in size.

These units of analysis consisted of people actively involved in the capital investment process of the enterprise from which the sample was drawn. Capital investment decisions, proposals and projects are initiated, screened and developed by these respondents. They are representative of different departments as well as levels within the capital investment decision-making process of the enterprise. These units of analysis hold senior management positions within the enterprise.

The sample consisted of accountants, financial managers, mining engineers, chemical and metallurgic engineers and technical experts. The average experience of respondents within the field of strategic capital investment decision-making was 13.25 years. Some of the respondents also had experience in the capital investment decision-making process with other enterprises. Each role player contributed specific and related expertise to the strategic capital investment decision-making process.

Respondents were selected from the finance, engineering, technical, administrative and project manager functions. This was done “in order to be confident that the full range of views has been explored” (Gaskell, 2000:41). Gaskell suggests that different members of the social milieu must be interviewed. Each member interviewed was asked to recommend an additional respondent who could add value to the related topic, preferably from a different stratum.

However, respondents from the different functions were minimised, as information came to a point of data saturation. Furthermore, respondents were minimised as a precaution, because Gaskell (2000:43) warns that the size of the corpus must be considered. A sample size that is too large could hamper the analysis.

6.5 DATA COLLECTION METHODS

6.5.1 Interviews

Various types of interviews are available to collect data from respondents. A structured interview does not allow very much room for respondents to express their own views or opinions in a way that they would have preferred (May, 2001:125).

The opposite of this type of interview is unstructured interviews where no schedule is prepared due to the fact that the area entered is unfamiliar (Welman & Kruger, 1999:196). May (2001:123) warns that this type of interview does not allow for much comparability.

Consequently, semi-structured qualitative interviewing was utilised as an instrument to gather data. This type of interview allowed the respondent to answer the questions “more on their own terms ... but still provide a greater structure for comparability” (May, 2001:123). Respondents were interviewed individually.

This method is especially useful as it is difficult to recruit busy elite respondents, and a far richer detail about personal experience, decisions and actions can be elicited with this method (Gaskell, 2000:48).

6.5.2 The interview guide

Welman and Kruger (1999:167) refer to the appropriate measuring instrument utilised during semi-structured interviews as an interview guide. The essence is to collect information with regard to the aims and objectives of the study, as suggested by Gaskell (2000:40).

Gaskell (2000:40) further warns against “an extensive series of specific questions”. He suggests rather using questions in the form of paragraph headings. Welman and Kruger (1999:167) add that the interview guide consists of “a list of topics and aspects of these topics”.

For this reason the objectives of the study and questions related to them were posed to respondents. The researcher used probes (e.g. “Why is this variable important to your company?”) and clarification (e.g. “Do I understand you correctly that ...”) during the interview as suggested by Welman and Kruger (1999:167) and May (2001:123) in order to record this qualitative information.

However, the interviewer needed to put more probes and questions to the respondents in order to verify certain information and to establish the influence of competitive strategy on the dependent variable, the capital investment process. This was done as a result of the vast nature of the different levels of the independent variable (for example, the different types of competitive strategies, the five competitive forces and various internal variables that all form part of the competitive strategy). Additionally, the interviewer experienced that different variables were important to different respondents and hence the reason for posing more probes and questions.

The two variables were operationally defined (as described in the literature study) at the beginning of each interview. This was done in order to introduce the respondent to the field of study as well as to ensure the measuring and construct validity.

The interview guide did not solely consist of open-ended questions but also of paragraph headings. It was developed to guide the study and was not followed slavishly.

Additionally, the interview guide was structured to move from the specific to the general and vice versa, as suggested by Gaskell (2000:53).

6.6 DATA ANALYSIS

Gaskell (2000:41) argues that the real purpose of qualitative research is to explore the different opinions and representations of the specific issue or research topic. He is of the opinion that it is not about counting opinions, but rather experiencing the different views of the related topic.

Data gathered from respondents was categorised under three headings, which are also the objectives of this study. In order to do this the researcher sought recurring and interrelating patterns between respondents and categories.

Thus, data obtained from this case study was analysed according to coding. Where "questions and answers about categories and about their relations" are put together, this type of analysis is referred to as coding (Straus, 1988:20-21).

6.7 VALIDITY AND RELIABILITY

Seidman (1998:17) defines validity and reliability as measures of trustworthiness. In order to ensure that the interview and its findings were trustworthy, the following concepts were considered:

- Credibility – The results were made available to an informant to validate accuracy.
- Consistency/dependability - The interview was taped.
- Neutrality – The findings cannot be provided to an external person due to the confidential nature of information obtained during the collection of data.

Furthermore, "ecological validity is much more important than any other types of validity" (Welman & Kruger, 1999:126) with regard to qualitative research. The researcher refers to the degree of generalisation that can be made in chapter 8.

Triangulation with regard to observation and study of records is not always feasible as daily schedules of these elite persons do not allow it and strategic decisions are seldom traceable in records (Mintzberg et al., 1976:248).

6.8 IMPEDIMENTS EXPERIENCED DURING THE EMPIRICAL STUDY

Two aspects affected the empirical study. They are confidentiality of the information obtained and the input from strategic decision-makers within the enterprise.

Competitive strategy, actions, strengths, weaknesses, opportunities and threats are confidential and could seriously sabotage the competitive position of the enterprise if read by competitors. Additionally, respondents were not authorised to comment on information related to operations which could jeopardise their competitive advantage.

Still, it is necessary to explore and to define their experience in this regard. For this reason, respondents were not required to comment on operations related information, but rather on how they, with their related experience in this particular field, experience the influence of competitive strategy on the capital investment process. During the interview, they were free to utilise or build their answers on any competitive strategy utilised in the past and which they applied to the capital investment process.

For this reason the researcher agreed to keep the name of the enterprise as well as the employees anonymous.

Although the respondents were very much representative and acquainted with the strategic capital investment process, the research study could only have benefited if some of the strategic formulators of the enterprise could also have been interviewed. The reason is that these decision-makers formulate the strategy within which the respondents have to initiate these capital investment decisions. However, for various reasons, such as busy schedules of these elite decision-makers and distance to travel, this option was hampered.

Nevertheless, this does not pose a serious threat to the population validity of this research study, as respondents were still representative of the population. Another reason is that decisions taken by the respondents are monitored to ensure that they are within the parameters set by the competitive strategy.

6.9 CONCLUSION

The objective of this study was to explore and to define how capital investment decision-makers experience the influence of competitive strategy on the capital investment process.

Eight units of analysis were selected from a leading platinum producer according to the snowball sampling method.

Semi-structured interviews were held and data obtained was analysed according to coding. The next chapter contains an analysis of the results.

CHAPTER 7

ANALYSIS OF RESULTS

7.1 INTRODUCTION

In this chapter how strategic capital investment decision-makers experience the influence of competitive strategy on the capital investment process will be analysed.

Data gathered from respondents was categorised as follows:

- Corresponding views with regard to how decision-makers experience competitive strategy as influencing/initiating the capital investment idea
- Corresponding views with regard to how decision-makers experience competitive strategy as influencing the capital budgeting allocation process
- What strategic evaluation criteria these decision-makers utilise to screen capital investment ideas and proposals

Data obtained through the individual interviews will now be analysed.

7.2 ANALYSIS OF INFORMATION OBTAINED FROM RESPONDENTS

7.2.1 How do decision-makers experience competitive strategy as influencing/initiating the capital investment idea?

In analysing the experience of the eight respondents, 87,5 per cent were of the opinion that the competitive strategy of the enterprise influences and initiates capital investment ideas. Capital investment decisions are sought within the parameters set by the strategy.

Capital investment projects which relate to environmental factors were also implemented by the enterprise. Nevertheless, the majority of the capital investments currently in process were initiated by the competitive strategy of the enterprise. With regard to environmental investment projects it is doubtful if these types of investments fell outside the parameters set by the competitive strategy and strategic objectives. It was not clear as what initiated this type of capital investment, but it may be inferred that it was driven by legislation.

These decision-makers did not experience competitive strategy as a rigid long-term plan but rather one within which several variables may change from time to time. Variables (drivers) within the competitive strategy which influence the competitive strategy are internal as well as external. When these variables change, the influence of strategy will differ with regard to the capital investment process.

Some 87,5 per cent of the respondents were of the notion that an internal analysis is conducted first, followed by an external analysis. Thereafter a competitive strategy is formulated which directs them where and when to invest.

Important internal strategic variables (drivers) put forward by the respondents that drive the competitive strategy and consequently the capital investment decision were:

- the quality (purity and the amount of platinum per ton) of the ore,
- the depth of the ore,
- profit margin, and
- human resources.

Important external strategic variables (drivers) put forward which drive the competitive strategy and consequently the capital investment decision were:

- the price of platinum,
- the exchange rate, and
- demand for the product.

It was the view of the respondents that if they do not have the product, if there is no demand for this product and if the enterprise cannot produce it at a profit, they are out of business.

One respondent reported that the driver to invest or not was determined by whether this investment would make money or not. Another respondent added that capital investment ideas could also be initiated by unforeseen circumstances (such as an underground explosion). Two further respondents felt that capital investment ideas could also be initiated by opportunities which may come up during the implementation of a particular capital investment. This “opportunity” capital investment would, however, still be within the parameters set by the strategy or contribute towards it. This corresponds with the real option theory (see section 5.4).

As a result of the competitive strategy, different types of capital investments were implemented by the enterprise, the most common of which were:

- expansion,
- replacement, and
- renewal.

Seventy-five (75) per cent of the respondents experienced that competitive strategy also influenced the types of capital investment decisions which were implemented by the enterprise. Although some of the current capital investment projects were replacement or expansion (or both) in nature, these projects were viewed to be still aligned with the competitive strategy.

Respondents were then asked if different competitive strategies (low-cost leadership, differentiation and focus) initiate different types of capital investments. All the respondents answered this question in the affirmative. However, one respondent added that it depended on how the strategy was formulated.

7.2.2 **How do decision-makers experience competitive strategy as influencing the capital budgeting allocation process?**

With regard to this question, 87,5 per cent of the respondents said that competitive strategy influences the way capital is allocated to various capital investment projects. One respondent's answer was vague with regard to this question. However, the respondent replied that with regard to capital investments which were implemented to improve efficiency, the project champion who shouted the loudest would receive the capital.

The influence of competitive strategy on the capital budget allocation can best be described by the replies of seven of the eight respondents. They experienced that projects with a higher strategic value received priority over those of lesser strategic value when capital was allocated. This points out that capital investment projects which are of more importance to the competitive strategy and consequently the existence of the enterprise will receive priority during the allocation of capital budgets.

Two of these seven respondents added that return on investment could also influence the allocation of investment capital. However, one of them felt that this had rather been the case in the past and that this decision was now driven by strategy.

In order to further investigate the influence of competitive strategy on the capital budget allocation process, specific questions which relate to the four elements of capital budget allocation process were put to the respondents.

If competitive strategy does influence these four elements, this can then be more descriptive of how it influences the capital budget allocation process. For this reason, the views of respondents were observed as to whether they experienced competitive strategy as influencing the different capital budget allocation elements.

7.2.2.1 Does competitive strategy influence condition assessment?

Questions were posed to four respondents to determine if they experienced competitive strategy as influencing where and how information is gathered with regard to the capital budgeting allocation. All four of them were of the opinion that competitive strategy would influence this variable.

Another question was put to two other respondents to determine if they experienced that information gathered during the strategic planning process would be utilised when capital budgets were allocated. It was both their experience that this information would be utilised in order to allocate capital to investments.

If, however, responses from the respondents are considered holistically, competitive strategy will influence the way information is gathered within the capital budget allocation process. Furthermore, the strategic value (and information) as well as the return on investments appear to be very important factors when budgets are allocated to different investments.

Another respondent answered that capital would be allocated to the core business of the enterprise. That particular respondent was of the notion that currently capital allocation was driven by volume, but this driver would later change to efficiency.

7.2.2.2 <u>Does competitive strategy influence the planning element of capital budget allocation?</u>

One respondent was of the view that information obtained during the strategic planning process would be utilised when planning for capital investment projects.

Five of the other respondents said that information obtained during the strategic planning process would be utilised when planning was done with regard to the allocation of capital budgets. The information referred to in the question (which is obtained during the strategic planning process and which will consequently influence the planning element) relates to:

- current state of assets,
- shortfalls,
- strategic fit of the project, and
- financial fit.

Two respondents felt that competitive strategy would not influence the planning element.

7.2.2.3 <u>Does competitive strategy influence the financing element of capital budget allocation?</u>

Seventy-five (75) per cent of the respondents said that competitive strategy influenced the financing element. One respondent did not experience competitive strategy as influencing the way capital investment projects were financed. Another respondent replied that in some circumstances a higher cost of capital may be allowed according to which capital investments were screened.

Furthermore, 87,5 per cent of these respondents stated that the type of capital investment determined the type of financing.

Respondents were then asked whether, if competitive strategy influences the type of capital investment and if the type of investment influences the type of financing, competitive strategy would then influence the type of financing. Seven of the eight respondents felt that competitive strategy would also influence the type of financing. The remaining respondent replied that different investment projects were financed differently.

7.2.2.4 Does competitive strategy influence the acquisition element of capital budget allocation?

Some 75 per cent of the respondents agreed that competitive strategy influenced the acquisition element of the project. One respondent said competitive strategy exercised an indirect influence on acquisition.

7.2.3 What strategic evaluation criteria do these decision-makers utilise to screen capital investment ideas and proposals?

All the respondents applied financial as well as strategic appraisal criteria when capital investments were screened. With regard to strategic criteria the respondents were asked if they concurred with the strategic criteria put forward by Stacey (2003:54) namely:

- acceptability,
- feasibility, and
- suitability (or strategic fit).

Seven of the eight respondents would also utilise these three sets of criteria. One respondent, however, was of the opinion that feasibility is part of acceptability and would therefore only utilise acceptability and strategic fit as strategic criteria.

All the respondents replied that strategic criteria would differ within the scenarios of different competitive strategies. The three sets will remain the same; it is only criteria within these three sets that will differ.

The respondents added other sets of strategic criteria which were utilised in the appraisal of capital investment proposals. These criteria, if not considered, have strategic implications on their business. For example, if environmental criteria were not applied, it may cost the enterprise its mining licence. The criteria which were utilised in addition by decision-makers are summarised as follows:

- Safety
- Quality
- Flexibility
- Sustainability
- Social responsibility
- Socio-economic issues
- Exchange rate
- Price of platinum
- Legislation
- Environmental impact

Of these strategic criteria, legislation, safety, environmental issues, the price of platinum and the exchange rate were of utmost importance to these decision-makers.

Strategic evaluation criteria were considered by 50 per cent of the respondents to be the most important criteria when evaluating or screening capital investment proposals. The other 50 per cent viewed financial criteria to be more important. However, of those four respondents who preferred financial appraisal criteria, two were of the opinion that although financial criteria were more important to them, the capital investment still had to fit within the competitive strategy.

Furthermore, the majority of the respondents would not approve a capital investment proposal if it did not clear financial appraisal criteria. However, it is interesting to note that if the capital investment project did fit into the competitive strategy and the capital investment would contribute to achieving strategic objectives, most of the respondents would then be willing to approve it.

7.3 CONCLUSION

The results obtained from the respondents reveal that competitive strategy influences the capital investment process. More specifically, competitive strategy initiates capital investment ideas. These capital investment opportunities are sought within the parameters set by competitive strategy.

Furthermore, results indicate that competitive strategy also influences the capital budget allocation process. This influence was illustrated by the influence of competitive strategy on the four elements of the capital budget allocation process.

Lastly, it was also established that strategic capital investment appraisal criteria have an important function within the strategic capital investment process. The sole use of financial investment appraisal criteria is not sufficient to screen (appraise) capital investment proposals. They must be utilised in conjunction with strategic appraisal criteria.

The conclusion with regard to the findings of results will be drawn in the next chapter.

CHAPTER 8

CONCLUSIONS AND RECOMMENDATIONS

8.1 INTRODUCTION

In this chapter conclusions will be drawn with regard to the analysis of the results obtained. Thereafter, the ecological validity will be discussed and recommendations for further research will be suggested.

8.2 CONCLUSIONS

The respondents interviewed can be regarded as representative of the population as discussed in chapter 6. Their experience and opinions were analysed in chapter 7.

Apart from the competitive strategies referred to in the interviews, the researcher experienced that most of the respondents also referred to various other types of strategies. These strategies are implemented and also considered to have an influence on the capital investment process. Strategies referred to are, for example, expansion strategies, development strategies and safety and procurement strategies.

However, this may not pose a serious threat to the applicability of the research study. These functional strategies are actions which must be implemented to contribute to the competitive strategy (Stacey, 2003:53). These actions are still within the framework of the competitive strategy. Furthermore, these investment decisions are also scrutinised by strategic decision-makers to be within the parameters set by the competitive strategy.

With regard to the first objective, namely how competitive strategy influences capital investment decisions, it would appear that there is a positive correlation between the two variables. It was found in the empirical study that competitive strategy influences/initiates the type of capital investment which the enterprise implements. Seventy-five (75) per cent of the respondents believed that competitive strategy ultimately determines whether the enterprise will implement either an expansion, renewal or replacement project.

In addition to this objective, all the respondents were of the notion that different types of strategies will also determine different types of capital investments. Most of the respondents (87,5per cent) believed that competitive strategy does set the parameters within which capital investment is sought and this corresponds with the statement of Seitz and Ellison (c1999:14). Thus, competitive strategy influences the capital investment decision and gives direction as to where to invest, when the investment must take place and also what type of capital investment will be made.

Various strategic variables (drivers within the strategy) were also obtained during the interview. Although competitive strategy may remain the same, these strategic variables within the competitive strategic plan will change from time to time and consequently influence the capital investment decision accordingly.

The second objective, namely to determine how competitive strategy influences the capital budget allocation, was met from the information obtained. It was discovered that projects with a higher strategic value will receive priority when capital is allocated. Furthermore, competitive strategy does influence the condition assessment, planning, financing and acquisition elements of the capital budget allocation. This implies that competitive strategy directs where information must be gathered, how the capital budget allocation must be planned for, how an investment will be financed and also where and from whom assets have to be acquired.

Various strategic criteria are utilised by capital investment decision-makers when evaluating capital investment projects. Most of the decision-makers in this study concurred with Stacey (2003:53) that acceptability, feasibility and strategic fit are important sets of criteria and they indicated that they would also utilise these three sets of criteria. Various other strategic criteria were of great importance to these decision-makers. Those of most importance to them were legislation, safety, environmental issues, the price of platinum and the exchange rate. These criteria, together with those posed by Stacey (2003:53), would be utilised by them when they screened capital investment proposals.

In response to the aim of this study, namely how decision-makers experience competitive strategy as influencing the capital investment process, it would appear that competitive strategy initiates investment ideas and gives guidance on how capital must be allocated within this process. This further confirms the work done by Butler et al. (1991:402) that the "implementation of competitive strategy is filtering through to investment decisions". Competitive strategy will furthermore influence the strategic criteria which are utilised to screen these investment proposals.

This study provides evidence with regard to the importance of considering competitive strategy and strategic criteria within the capital investment process and not only financial appraisal criteria. Results reveal that the appraisal of capital investment proposals is much more than only the evaluation and selecting phases. It is also about how this investment fits into the enterprise's strategy.

8.3 ECOLOGICAL VALIDITY (GENERALISATION)

Strategies and capital investment decisions vary from enterprise to enterprise and also from industry to industry. The manner in and degree to which a specific strategy influences/initiates a specific capital investment idea cannot be generalised to other industries due to the uniqueness of internal and external variables related to an enterprise.

However, the findings of this study provide evidence with regard to the influence of competitive strategy on the capital investment process within the platinum industry. This corresponds with the findings and suggestions of various authors (Butler et al., 1991:402, Hall, 2000:365, Matundu, 1997:84 and Seitz & Ellison, c1999:14) that strategy does influence the capital investment process. Their studies and knowledge referred to various different types and sizes of industries.

Therefore, it can be generalised that competitive strategy will influence the capital investment process in all enterprises and in all industries, although not in exactly the same way as in this particular case study.

Furthermore, this allows for a further generalisation that changing internal and external variables within the competitive strategy will influence different capital investment ideas/decisions differently within the same enterprise, industry and also other industries.

8.4 RECOMMENDATION FOR FURTHER RESEARCH

During this study it was found that important strategic internal and external variables (drivers) within the competitive strategy influence the capital investment process. An opportunity of research in this field could be to establish the degree or level of influence of these variables within the competitive strategy.

This could supply enterprises with valuable knowledge of which strategic internal and external variables pose a threat to them or which ones they can benefit from in order to give them a competitive advantage.

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ANNEXURE A

THE RESEARCHER

To Whom It May Concern:

APPLICATION TO CONDUCT A RESEARCH STUDY REGARDING THE INFLUENCE OF COMPETITIVE STRATEGY ON CAPITAL INVESTMENT DECISIONS

INTRODUCTION

1. I am currently busy with a research study as part of the degree: Masters Technologiae in Business Administration at UNISA.

2. The purpose of this case study is to explore and describe how decision-makers, actively involved in the strategic capital investment process experience the influence of competitive strategy on the capital investment process.

3. The objectives of this study are to establish how decision-makers experience the following phenomena, namely:
   - how competitive strategy initiates capital investment ideas,
   - how competitive strategy influences capital budgeting allocation and
   - what strategic criteria the decision-makers implement to screen capital investment ideas and proposals?

   With this study the researcher would like to prove the correlation between competitive strategy and capital investment

AREA OF RESEARCH

4. Your company was selected to participate in this study because it is one of the leading companies in the platinum industry. Investments by your company

amounts to millions of rand according to your web page. Capital investments of such a nature are limited, as well as the decision-makers involved in this process. Therefore, the experience of executives and experts employed by your company are essential to successfully conduct this research study.

CONFIDENTIALITY AND REQUESTED INFORMATION

5. It is known that competitive strategy, actions, strengths, weaknesses, opportunities and threats, experienced by the enterprise, are confidential and could seriously sabotage the competitive position of the enterprise if read by competitors. **No information about confidential strategic plans, future tactical planning and other confidential aspects such as financial or strategic figures are required.** The questions are formulated in such a way in order to establish if theory and practise correspond. Questions are in the general and do not require confidential responds. The interview guide is attached here to for your perusal.

6. Although the above mentioned business intelligence cannot be obtained, it is still necessary to effectively explore and to define the experience of decision-makers actively involved in the capital investment process. For this reason, it will not be expected from respondents to disclose any confidential business intelligence. Respondents will be allowed to base their answers on how they (with their experience in this particular field) experience the influence of a particular competitive strategy on a capital investment decision/project within a real life scenario.

7. During the interview, they will be free to utilise or build their answers on any current competitive strategy or strategy utilised in the past and which they applied to the capital investment process. This study is not an exercise to gather confidential information.

ANNEXURE A

MOTIVATION TO CONDUCT THE RESEARCH STUDY

8. It is necessary to define this process in order to establish if **the theory of strategy and capital investments correspond with that of the real world.** This will enable the researcher to formalize hypotheses with regard to the influence of competitive strategy on the capital investment process. This will initiate future research in order to test the newly formulated hypotheses.

9. Furthermore, this study can benefit your company, as it can be utilised as a strategic capital investment manual.

10. The research study may improve strategic capital investment planning.

DATA COLLECTION METHOD

11. Individual interviews will be conducted at a time that is most convenient to the respondents. Six to eight respondents will be interviewed in order to explore a full range of views.

12. The type of sampling utilised during this study is snowball sampling. A respondent will be interviewed, where after he/she will be asked to refer the interviewer to a next person involved within this process with the relevant experience. Respondents may be from different operating units or departments.

13. Once approval for the research study is obtained, a time, date and venue for the interviews will be arranged with respondents as soon as possible.

14. I trust that this application will meet your kind and favourable consideration.

Regards,

A. J. VAN BRAKEL

ANNEXURE B

THE INTERVIEW GUIDE

The interview guide, containing three principle questions, is hereby presented and explained. These are the questions that will be asked, as well as possible probes for clarification to be asked in order to record this qualitative interview. *(Probes for clarification will depend on the answer from the respondent.)*

However, it is necessary to first operationally define certain concepts that will be utilised during the interview. This will serve as an introduction.

According to strategic, organizational and financial literature I shall refer to your enterprise (employer) as the parent company with a corporate strategy or competitive (business unit) strategy. All the different mines are viewed as business units of your enterprise with a functional strategy. Michael E. Porter also referred to a business strategy as a competitive strategy.

This study was built on the framework that every action (including capital investments) within the company is directed and executed within parameters set by the competitive strategy. This is derived from Seitz and Ellison (1999) as well as Porter (1998) who believe that a company can best defend itself against competitive forces, active in the industry, by implementing one of the following competitive strategies available, namely: low cost leadership, differentiation and focus. Any one of these competitive strategies is the independent variable of this study.

In the interview I will also refer to capital investment ideas, proposals, decisions and projects (the dependent variables). References to capital investments apply to any capital investment that is "long-term related, risky ... take place within social organizational contexts and impact upon the strategic and operating position of the organization". The motive for an investment can either be for expansion, replacement, renewal or for other purposes such as a long-term commitment of funds in expectation of future returns, for example; pollution control.

Particulars of respondent

1. NAME ______________________________

2. OCCUPATION _________________________

3. EXPERIENCE IN THE FIELD OF CAPITAL INVESTMENT DECISION-MAKING ______________________________________

1. <u>THE QUESTION :</u>

How do you experience competitive strategy to trigger/initiate capital investment ideas?

POSSIBLE PROBES TO BE ASKED WITH REGARD TO QUESTION 1:

- Is it your experience that competitive strategy influences the type of capital investment decision?

- Will different competitive strategies initiate different types of capital investment decisions?

2. <u>THE QUESTION :</u>

How do you experience competitive strategy to influence the capital budget allocation process?

ANNEXURE B

BACKGROUND TO THE QUESTION:

Wooldridge et al (2001) referred to four basic elements of capital budget allocation. In his study he investigated the influence of financial and budgeting data on these elements of capital budget allocation. However, various other authors scrutinized the sole use of financial/quantitative investment appraisal criteria in the screening of capital investment ideas/proposals. Therefore, this study aims to examine the influence of competitive strategy on these four variables, namely: condition assessment, planning, financing and acquiring.

POSSIBLE PROBES TO BE ASKED WITH REGARD TO QUESTION 2:

- How do you experience competitive strategy to influence condition assessment? (Capital rationing is present.)

- How will competitive strategy influence capital investment projects, of which the successful implementation is dependent on each other within the same production or process line?

- How will competitive strategy influence the planning element of capital budget allocation?

- How does competitive strategy influence the allocation of limited capital?

- How does competitive strategy influence the financing element of capital budget allocation?

- Does competitive strategy influence the cost of capital used as criteria in the appraisal of capital investment decisions?

- Does the type of investment determine the type of financing?

- Given the foregoing, if competitive strategy influences the investment decision, do you agree that competitive strategy determines the type of financing?

- Wooldridge et al (2001) viewed the acquisition of assets as part of the capital budget allocation process. In order to build a plant, assets must be obtained. How does competitive strategy influence the acquisition element of capital budget allocation?

3. <u>THE QUESTION :</u>

How does competitive strategy influence capital investment appraisal criteria?

BACKGROUND TO THE QUESTION:

Stacey (2003) argued that in order for strategy to be successful, it must meet three sets of criteria. Furthermore, Seitz and Ellison (1999) argued that each strategic decision is in itself a capital budgeting decision. For this reason it is assumed that criteria relevant to strategy are also relevant to capital investment decisions and proposals. The three sets of criteria are:

- **Acceptability**
  - acceptable financial performance to owners & creditors

  - Acceptable strategic consequences for powerful internal stakeholders
  - Acceptable strategic consequences for powerful external stakeholders

- Feasibility

- Suitability (Strategic fit)

POSSIBLE PROBES TO BE ASKED WITH REGARD TO QUESTION 3:

- Do you agree with Stacey, that acceptability, suitability and feasibility are strategic criteria that are also very much applicable to the successful implementation of capital investment projects?

- How does the specific competitive strategy determine strategic capital investment appraisal criteria?

- What strategic criteria will be utilised by you to screen capital investment decisions and proposals?

- Will there be different strategic criteria applicable to capital investments within the scenarios of different competitive strategies or will strategic criteria remain the same within the three sets mentioned above?

- Do you consider both quantitative as well as strategic criteria in the appraisal of capital investment proposals?

- Which one of these two criteria weighs the most to you as decision-maker?

ANNEXURE B

- Will you approve a capital investment proposal even if it has not passed quantitative capital investment appraisal criteria?

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