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## A White Paper

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### **BUSINESS STRATEGY**

#### **HOW DO BUSINESS STRATEGIES HELP YOU GAIN A COMPETITIVE ADVANTAGE**

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Understanding your business strategy and aligning that business strategy with your executive total rewards program is a key element when it comes to gaining competitive advantage for the organization and its shareholders. Each company's unique business strategy should result in a unique total executive rewards strategy.

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### **DON'T BE A LEMMING**

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Many consultants use market's "best practices" to determine their recommendations to the compensation committee. That is a huge mistake, because if you design your rewards program to look like the average—or even the "best practices"—of the competition then, all things being equal, your company will be rewarded by approaching the mean, and your company will begin to look and operate like the crowd of lemmings headed for the cliff.

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### **LOOKING IN YOUR REAR VIEW MIRROR?**

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Many clients come to us with executive reward strategies that reflect past successes or failures, instead of having executive reward strategies that focus on future challenges. A reward strategy focused on incremental improvements over prior years tends to develop and encourage a lack of market sensitivity on the part of the executive management team.

Business strategy is complex, but decoding an organization's strategy for purposes of designing an executive reward strategy is the responsibility of the management team, the Board of Directors, and the outside consultant.

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## BREAKING THE CODE

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There are three levels of business strategy: general business strategy, value chain strategy, and specific business strategy. The key to designing an effective executive compensation program lies at each of these levels.

### GENERAL BUSINESS STRATEGY

The general business strategy is typically the longest form of directive, after vision, mission, and values, when it comes to developing an executive total rewards strategy.

A renowned Harvard Business School professor categorizes general business strategy into either cost-based, differentiated, or focused. Each of these three general business strategies has significant implications for the design of executive reward strategies, and each calls for different skills and requirements for success. Let's look at these three business strategies:

#### *COST-BASED STRATEGY*

All executives understand the benefit of having a cost advantage when it comes to selling their products or services in the marketplace. But despite the fact that a cost-based strategy is easy to understand conceptually, it's one of the most difficult strategies to implement operationally.

One of the keys to developing a good cost-based strategy is to look long and hard to determine where within the company organizational capabilities such as cost control exist, and to ensure that the very best executives who manage that capability or function are developed and retained within the organization. This means that when you are reviewing the mix between short-term compensation and long-term compensation; lean toward long-term for the folks in the positions that control the organization's cost capabilities.

In order to run a cost-based strategy an organization might also remove a significant number of managerial layers. Organizations that go this route should pay senior executives substantially above the market average to ensure that they are able to run the company on a centralized basis, without the benefit of multiple layers of expensive middle management.

#### *DIFFERENTIATED STRATEGY*

Organizations with differentiated strategies focus on the ability to separate themselves and stand out from their competitors with a unique product or service that is valuable to potential buyers. Differentiation allows the firm to command a premium price, to sell more of its product at a given price, or to gain equivalent benefits such as a greater buyer loyalty during cyclical or seasonal downturns.

The first step in determining how to compensate the executives under a differentiated strategy is to figure out where within the firm the organizational capabilities to execute the strategy exist.

Rewarding these executives is more a function of determining how to measure their ability to provide customers with what they want and how they need it. To that end, some of the performance-based rewards plans should be based on such things as market share, new customer accounts, retention of old customer accounts, and customer satisfaction.

### *FOCUSED-BASED STRATEGY*

Focus-based strategies use either cost advantage or differentiation within a small market segment. In other words, a focus-based strategy focuses on a particular buyer group, segment of the product line, or geographic market. This particular choice of generic strategy is different because it requires the selection of a unique set of competitive scope within an industry. If a firm achieves sustainable cost leadership or differentiation in its segment, and the segment is structurally attractive, then the organization will most certainly be an industry leader.

### **THE IMPORTANCE OF GETTING IT RIGHT**

Every business has some sort of business strategy. The key is to understand how that strategy operates through to the ground level of tactical execution. If you want to really understand how important the linkage is between business strategy and reward strategy, look at any industry in which there is a major evolution. A change in the industry structure or a change in a critical element of competitive advantage can result in an important change in both short- and long-term incentive goals. If the goals don't change with the times, executives will find themselves being rewarded on a "look back" basis.

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### **THE VALUE CHANGE STRATEGY**

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The second level of business strategy is value chain strategy. It is a fairly simple concept. Basically, it suggests that there are various points along the value chain in an organization where extra resources can be applied in order to gain a competitive advantage in the marketplace.

Unfortunately, most companies aren't in the position to throw resources at all points along the value chain. Most organizations need to pick and choose where they are going to spend their critical resources. Here are two of many examples. Some companies have the very best purchasing and sourcing divisions, allowing them to either reduce costs or come up with a product that is more useful to their customers. Others—pharmaceutical companies are a good example here—spend the on research, development, engineering, or technology portions of their value chain in order to stay competitive.

The value chain strategy plays into the heart of executive reward strategy in very straightforward ways. Certain job families are clearly associated with creating and maintaining competitive advantage. As a result, the executives heading up those job families should be highly compensated, and the performance factors inside their executive reward performance program should be specifically and directly related to their success in managing those key strategic functions.

As simple as this concept is, companies find it hard to put into practice. Organizations don't like to differentiate between executives. Instead they apply an across-the-board percentile and maintain that executive team cohesion is more important than calling attention to those executives who head up value chain functions that drive the success of the company. Short-term, mid-term, and long-term incentives, as well as benefits and perquisites, are also often designed in the same uniform manner. Is there a price to pay for this one-size-fits-all, membership mentality? You bet. Because it positions all executives in a similar competitive percentile, the focus is on generic executive performance factors like earnings per share, operating profit, EBIT, etc. the sharp focus on what the organization needs to do to perform better than the competition in any particular market is lost. If the organization is lucky, the penalty will be mediocre performance. At worst it's dinosaur time—in other words, extinction.

One simple question can help organizations understand how to apply value chain principles to the design of a competitive executive reward program. "Where along the value chain would you characterize your organization's competitive advantage?"

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### SPECIFIC BUSINESS STRATEGIES

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The third pillar of business strategy is specific business strategies. These might include growing through a merger, growing market share, optimizing margins, expanding operations geographically, expanding distribution, decreasing production capacity, growing from within, increasing cash flow, building better customer relationships, using joint ventures, managing costs for reengineering, or becoming more global. Each of these specific strategies results in the need for organizational capabilities that is unique to the specific time, maturity, or phase of business strategy execution.

These types of strategies usually run in the six-month to three-year timeframe. Some may be the management fad of the day prescribing simple, generic solutions to complex, individualized business situations. Others, however, are valid and have been developed as a result of an appropriate amount of analysis at both the general business strategy level and the value chain business strategy level.

Specific business strategies are the types of strategies at which executives and designers should be targeting substantial short-term compensation. There is no need for the strategies and the resulting rewards to be annual. Milestone incentives can be used where incentives are tied to and paid when goals are accomplished, regardless of the time of year.