Dealing with uncertainty in strategy and valuation

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Uncertainty about economy and changing markets
Impact on strategy, valuation and flexibility for banks, insurance companies and pension funds

Our modern society becomes more complex and changes faster and faster: what the world will look like in a relatively short time from now is increasingly uncertain. This is valid a fortiori for the financial world, which is a reflection and sometimes even a blow-up of the 'physical world'. Now that the uncertainty about the economy has grown, the media are full of articles on banks, insurance companies and pension funds that are believed to have entered the danger zone. In this way much of the focus is on the threats of uncertainty for financial organizations. However, the increasing uncertainty also offers chances for financial companies. To be able to grasp these chances financial companies should consider dealing differently with uncertainty in their strategy processes and valuation models.

Strategy processes: change, uncertainty and flexibility

In the conventional (linear) way of strategy formation the process starts with the company, its environment and future (strategic analysis). The next step is to choose and describe a strategic solution (strategy formulation) and finally all of this is processed to a set of activities (strategy-implementation), which is then carried-out.

This (linear) process working towards a 'solution' works well when:

- The complexity that is involved is relatively low,
- The predictability of markets and developments is relatively high,
- Uncertainty should be avoided,
- Clear commitments should be prepared,
- Strategy formation is a 'top-down' elite process,
- And a product-oriented view is used.

The other way round, this traditional way of strategizing does not fit well in situations that have the following characteristics:

- A high degree of complexity,
- Rapid changes,
- A high degree of uncertainty,
- A strong need for flexibility,
- A more democratic organization philosophy, and
- A service-oriented view.

Clearly, in current market circumstances a more flexible, agile approach towards strategy formation should be considered. Traditional planning techniques must then be complemented with strategic experiments, investigating and developing multiple strategic alternatives at the same time.

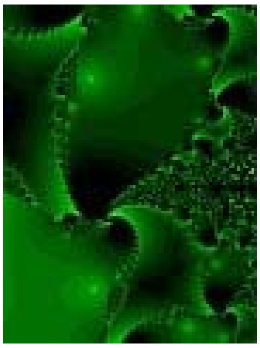
A strategy should no longer be seen as 'ultimate solution', but rather as an intended direction that often contains options to enable and steer future acting or non-acting. A strategic spectrum or a strategic bandwidth should be created and cultivated.

In this flexible philosophy commitments can and even should be postponed. This approach fits well to current complex and uncertain market conditions because of these postponement options.

If on top of this the strategy process is also enriched with the input of knowledge workers and small-scale experiments, the implementability of the strategy also becomes better. Because of this experiments and knowledge workers involvement there will be less resistance towards the intended ideas, and experiments can be stopped, used for other experiments, or rolled-out fast and big when the conditions are favorable.

Valuation Models: change, uncertainty and flexibility

As already mentioned, the current economy is complex and circumstances change quickly. The future is therefore relatively uncertain and companies need a high degree of flexibility. Also the way a company deals with valuation can help in achieving this agility.



Traditional valuation methodologies (DCF, NPV) and their recent variations (EVA) calculate future cash flows backwards towards the decision moment and are an improvement over ROI, which surprisingly is still used sometimes. However they do not deal with intermediate changes after the decision is made.

Also they don't deal with the level of risk/uncertainty of the investment and because of this they over- or underestimate future cash flows.

On top of this these methods don't consider intangible benefits. Because of this, no justice is done to such valuable things as knowledge, innovation and customer relations for financial organizations.

Finally these traditional valuation methods offer no facilities for dealing with scenarios or a spectrum of possibilities. Because of this they offer no or very limited help in dealing with uncertainty.

Therefore in the current uncertain and fast changing times we need other valuations tools to compensate for the weaknesses of the traditional tools. In recent literature one can find many articles and contributions on intellectual capital, human capital, innovation capital, and many more. We have successfully combined all of these capital categories into a single tool called Universal Valuation Framework©. This Framework has proven to be very useful to determine and communicate the Universal Value of any project, project portfolio, investment or strategic scenario. The UVF deals with all the weaknesses of the traditional methods.
It helps to provide the ability to react faster to change and to complex situations. Also it reduces the need for decision makers to use their 'gut feeling' extensively when making important decisions and when communicating the value of the cooperation and its strategy towards shareholders and stakeholders.

Conclusion: sustainable competitive advantage

Agile strategies, modern valuation frameworks and an organization that's tuned to deal with uncertainty can help to make uncertainty not only a source of problems for financial companies, but also a source of competitive advantage.

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