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The influence of strategy formation capability on firm's value creation: An empirical review

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Abstract

Value creation analysis is a critical element yet often disregarded by the financial management as one of the important elements in an organization, including Malaysian Government Linked Companies (GLCs). The creation of use value is essential for sustaining the firm. Without this component, firms would have no added value and there would be no reason for firms to exist. These use values are recognized when someone perceives the resources or products of a firm as valuable and people might perceive values differently. GLCs hold a main profit-making objective, in which the Malaysian Government possesses a direct controlling stake and serves as the backbone of the Malaysian economy. By possessing the value creation element, GLCs are expected to create sustainability, have a competitive advantage and produce a better business performance in order to enhance the interest of shareholders, creditors, employees, suppliers, customers, governments and communities. Prior studies have shown that value creation can be created through strategy formation. Strategy formation is the core of strategic management and is related to the effectiveness of the firm's strategy, which leads to better performance. An effective strategy formation capability is valuable because it enables the firm to create strategies that increase its effectiveness or efficiency and when it matches the firm's environment that eventually leads to a competitive advantage. This paper tried to ascertain the influence of strategy formation capability on value creation, which then improves a firm's reputation, product differentiation and process innovation in GLCs. The strategy formation capability tends to provide an empirical review that enables the top management and policy makers to review the strategy formation capability in order to create the firm's value, achieve sustainable growth and improve GLCs competitiveness in the global market.

Keywords: Government linked companies, competitive advantage, strategy formation capability, value creation

1. INTRODUCTION

In Malaysia, the role of GLCs is crucial in supporting the development of the overall national economic growth through their economic performance and social contributions. The significant impact of GLCs on the Malaysian economy gives GLCs a huge responsibility in ensuring the continued contribution to serve the community. GLCs are described as organizations that hold the main profit-making objective, in which the Malaysian Government holds a direct controlling stake. Controlling stake refers to the Government's power to assign board members, senior management and decide on major decisions of GLCs either directly or through its Government-Linked Investment Companies (GLICs). A company is classified as a GLC if the government owns an effective controlling interest, which is more than 50 percent. Vision 2020 highlighted the role of GLCs as growing and shaping the economy (PCG, 2005) through a major role in every commercial concern ranging from transportation, energy, telecommunications, construction, oil and gas and financial services (Lau & Tong, 2008).

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Regardless of the significant impact GLCs have on the Malaysian economy, some GLCs have performed poorly and in a lack-lustre fashion from as early as 1990 (PCG, 2007). MINDA (2009) and, Amirul and Daud (2012) posit that the factors possibly responsible for the lack of success of GLCs could be the lack of value creation and their ability to create firm's value through the talents, skills and capabilities inherent in the organization itself. Singh and Ang (1999) found that the effectiveness of GLCs' top management leadership plus well formulated and implemented strategies are critical for the success in every organization. Their study recognized the strategic importance of some GLCs while focusing on common aspects of strategies, such as achieving consistent profitability, matching industry benchmarks, regionalization, diversification, collaboration, and support for government policies. These strategies were shown to have an impact on a firm's performance.

Past studies have provided evidence on factors that contribute to value creation (Ernst & Young, 2013; Kraaijenbrink, 2011; Sulaiman *et al.*, 2006). According to Fuller (2001), firm value creation is a process that starts with the operation of the business model, prioritizing sections for more detailed investigations and discovering opportunities for development until the necessary changes are implemented to establish their measurements and revision. These changes predict market change and should be long-term in nature in order to sustain competitive advantage. Studies by Norman and Ramirez (1993) and, Kaplan and Norton (2004) indicate that value creation could be initiated through strategies that provide ideas to create value for its shareholders, customers and communities. Thus, strategy formation capability would help GLCs to create intellectual frameworks, conceptual models and governing ideas that create value for customers and subsequently contribute towards a better performance.

Therefore, the primary objective of this paper is to ascertain, based on empirical literature, the strategy formation capability and its effect on the firm's value creation. Subsequently, this paper would discuss how strategy formation capability and value creation contribute positively to the performance of Malaysian Government Linked Companies (GLCs). This paper is organized as follows: in the next section, we will explain the concept of strategy formation capability and value creation. This is followed by discussion on the argument between strategy formation capability and value creation and how to relate it to GLCs. Finally, this paper addresses the conclusions, implications and considerations of the effect of strategy formation capability on value creation in GLCs.

2. STRATEGY FORMATION CAPABILITY

According to Husted *et al.* (2012), the concept of strategy was initially developed in a military environment and was later applied to the business and other sectors. From the business perspective, strategy is broadly defined as the overall plan for deploying resources to establish a favourable position (Grant, 1999). This definition includes two broad components, namely plan and position. As corporate market behaviour has become more complex, definition of strategy had focused almost exclusively on planning and positioning in order to create competitive advantage. Intangible resources and capabilities play a central role in designing and executing effective strategies, which subsequently generate benefits through corporate reputation, employee motivation, and customer loyalty and each of these elements are based on a dynamic relationship (Husted *et al*, 2012).

Strategy formation has been at the centre of strategic management for more than three decades (Mintzberg, 1973) and is related to the effectiveness of the strategy formed by the firms (Slater *et al.*, 2006). Barney (1991) stated that a strategy that increases effectiveness or efficiency is valuable, rare, and difficult to imitate and would give the firm a competitive advantage compared to other firms. According to Petterson and Oun (2012), strategy formation is a process whereby a realized strategy is formed and it covers both strategy formulation and action. They added that strategy formation consists of an overall process that leads to strategic behaviour in practice.

Teece *et al.* (1997) posit that strategy formation capability would have a dynamic capability when matched to the firm's environment and lead to competitive advantage. The strategy formation capability comprises mission/goal clarity, situation analysis, comprehensiveness of alternative evaluation, and a strategy formation process (Mintzberg *et al.*, 1998). Mission includes organizational purpose, scope of market activities, and competitive distinctiveness. Situation analysis is concerned with the scope of the firm's environmental scanning and organizational analysis. Another element is the comprehensiveness of alternatives that have been generated and valuated. Finally, the strategy formation process ranges from informal and emergent to formal and deliberate (Slater *et al.*, 2006).

Slater *et al.* (2006) had studied the strategy formation process with business performance and suggested that an effective strategy formation capability is valuable because it enables the firm to create strategies that increase its effectiveness or efficiency. This capability is rare when it allows the firm to create a strategy that is not pursued by a large number of firms. Tell (2012) posits that growing firms have to adopt a more comprehensive, more dynamic and less simplistic strategy that requires a certain extent of planning and formalization. Meanwhile, Leitner (2014) found no clear support for the association between strategy formation and performance in Small and Medium-size Enterprises (SMEs). He added that small business managers who are concerned about strategy making should be alert and focus on exploiting their advantages that stem from their capability to be strategically aware and adaptive. Both strategy formation modes are important and complement each other when practicing strategy in small firms.

A study on the role of strategy formation in entrepreneurial firms by Covin *et al.* (2006) argued that the emergent strategy formation mode in entrepreneurial firms is more convincing compared to conservative firms, which are better in planning strategies. According to Mintzberg *et al.*, (2009), "strategy formation is not just about values and vision, competence and capabilities, but also about crisis and commitment, organizational learning and punctuated equilibrium, industrial organization and social revolution." Therefore with strategy formation capability, it is expected that GLCs would not only be able to form an effective strategy intended to gain competitive advantage and create value but also be obligated to other stakeholders.

3. VALUE CREATION

Basically, value refers to the worth of some product or service to the consumer (Husted *et al*. (2012). Porter (1985) defined value as what customers are willing to pay, and the superior value that offers equivalent benefits compared to other competitors at lower prices or provides unique benefits that more than offsets a higher price. A firm creates value by combining its resources innovatively to increase the productivity of those resources (Moran & Ghoshal, 1999; Schumpeter, 1934). Understanding value invites holism rather than particularization, as value creation can simultaneously refer to content and process (Lepak *et al.*, 2007), and thus, requires understanding of evaluating value as well as the processes involved in creating it. According to Miller and Floricel (2004), value creation can be developed through new products and services and firms with high profitability and growth levels are deemed to adopt capabilities and practices to create value rather than to adopt best practices.

Value creation has been one of the major objectives in every business organizations aimed at maximizing customer's satisfaction and shareholders wealth (Normann & Ramirez, 1993; Langfield-Smith *et al.*, 2006). According to Ernst & Young (2013), value can be created by transforming inputs and capital amongst the relevant business activities and interactions to either produce outputs and outcomes over a short, medium or long-term period, and either to create or destroy value for the organization, its stakeholders, society and the environment. Normann and Ramirez (1993) stated that the combination of suppliers, business partners and customers would co-produce value for their organization and society. They added that interactions between strategy, resources and processes, business propositions, and stakeholders are the main elements in value network.

Kraaijenbrink and Spender (2011) indicated that every firm has its own practice for creating value such as from efficiency or smart anticipation, effective integration or alignment of activities, or from creative judgments of resource attributes. Different modes of value creation imply different value creation activities in a firm and these activities are likely to have an effect on the boundaries and internal structure of a firm (Kraaijenbrink & Spender, 2011).

Based on extensive chief executive officer (CEO) interviews and polling, Accenture (2011) had organized five key imperatives for planning, managing, and scaling a sustainable value creation strategy. According to Kasali (2010), value creation is a fundamental change in a way on how organizations execute their value creation process and objectives, interface and relationship with customers and stakeholders, and resource allocation process. It can be created by increasing the benefits and use of products through improved quality, function, imaging, branding or by lowering costs through production, efficiency and other means. These actions would need the formulation of well planned strategies in order to create value for the firm (Kasali, 2010).

Value creation is generally described as an idea embarked by the organization in order to enhance the wealth of stakeholders. Therefore, it is necessary to understand the importance of having value creation in the context of Malaysian GLCs. Hence, based on the discussion above, value creation can be created in many ways and this paper tends to focus on how strategy formation capability can influence value creation in GLCs, which would then improve firm performance as well as maximize shareholder wealth and eventually lead to business excellence.

4. GENERATING VALUE CREATION VIA STRATEGY FORMATION CAPABILITY

Many scholars have argued that the central purpose of firms is to create value (Parsons, 1951; Pies, Beckmann, and Hielscher, 2010; Kraaijenbrink, 2011). The creation of value is crucial to start a business and functions as the heart of the organisation's strategy. Starting to formulate the value of the company is a good way to make business opportunities feasible and realistic (Sanchez *et al*., 2007). Fuller (2001) stated that value creation analysis is critical but often disregarded by the financial management as one of the important elements in an organization due to lack of understanding the practical application of value creation. Nowadays, people are more aware of the importance of creating a firm's value. The creation of 'use value' is essential for the firm's sustainability. Without this component, firms would have no added value and there would be no reason for firms to exist. These 'use values' implies that the resources and products of a firm are not valuable in themselves, but only if someone perceives them as valuable (Kraaijenbrink, 2011).

Husted *et al.* (2012), studied on the topic of social strategy, posited that strategy generates economic value through strategic social positioning and social planning. The presence of powerful stakeholders and corporate values increase the use of social planning, while the industry's competitive environment and the firm's resources drive strategic social positioning. Strategy creates economic value for the firm via improved firm reputation (Fombrun & Shanley, 1990), product differentiation (Reinhardt, 1999) or process innovation. Firms generate economic value when customers pay a premium for the firm's products and services. These can be achieved from strategy planning initiated through its new products or services that incorporate a social attribute or through the development of entirely new markets (Orsato, 2006).

Norman and Ramirez (1993) had examined the effect of strategy on creating value and discovered that strategy is the art of creating value and it provides intellectual frameworks, conceptual models and governing ideas that allow companies to create value for customers and subsequently contribute to higher profits. Kaplan and Norton (2004) stated that a strategy describes how an organization can create value for its shareholders, customers and communities. Rohrbeck and Schwarz (2013) stated that the strategy formation process could be regarded as a constructive process, where the combination of numerous factors interpret the perceived signals and create meaning while the potential value creation of strategic foresight would be to integrate key stakeholders in the process of strategy formation. Other stakeholders, such as employees in the functional and business units, and even external stakeholders, can and should also be integrated in the strategic foresight, and into the strategy formation.

However, Leitner (2014) found no direct association between strategy formation and performance in SMEs. Taking into account the indicated industry dynamics, the study showed that emergent strategy formation in the market development domain is associated with higher employment and sales growth in stable industries. This result confirmed to some extent the work of Covin and Slevin (1989) and, Slevin and Covin (1997), who found that emergent strategy-making mode was more often successful in benign environments. Thus, emerging opportunities in markets, especially in dynamic industries, seldom helped companies to boost development and growth, and it also found that these companies had lower sales growth rates. Thus, small business managers who are concerned with strategy making should be cautious when adopting a highly rational process. A study on strategy formation capability by Slater *et al.* (2006) had indicated that the strategy formation process had a greater effect on performance among low cost defenders, followed by prospectors, and then by differentiated defenders. This shows that strategy formation capability influences business performance and leads to competitive advantage.

Meanwhile, there was an online survey by McKinsey (2010) on corporate strategies formation, which received responses from executives around the world, representing the full range of industries, regions, tenures, and functional specialties. Out of 2,313 executives, 1,944 respondents were from multi-business companies and could describe their companies' initiatives for developing a corporate strategy. A group of 151 respondents stated that their companies' had developed very effectively and that their profit margins were higher than those of competitors. Furthermore, 97 percent of these respondents viewed their companies' processes for developing corporate strategy as consistent and said that their company spent more time developing strategies, reviewing strategies more frequently, and were much better at eliminating barriers to implementation. This survey concluded that a multi-business company could develop better strategies with clear choices about its portfolio and allocation of its resources. Besides, the survey also showed the firms capability in formatting an effective strategy that could generate better business profits compared to its competitors and this situation could lead to the achievement of competitive advantage as well as creating value for the firm.

Thus, it is evident that strategy formation capability could generate firm value creation. With this capability, GLCs are expected to design and execute a strategy that would increase effectiveness or efficiency, while being valuable, rare, and difficult to imitate in order to achieve competitive advantage and firms can create value for their customers by improving their market positioning, segmentation and targeting. Nevertheless, how could strategy formation capability improve the firm's value creation in Malaysian GLCs? Further discussion on this matter is found in the next section.

5. STRATEGY FORMATION CAPABILITY AND VALUE CREATION IN MALAYSIAN GLCS

Back in 2004, the Malaysian Government had introduced the GLC Blue Book, which was intended to assist in the GLCs value creation initiative by underlining the important drivers and performance indicators throughout the company and business units. These performance indicators and targets in the GLC Blue Book need to be linked to the strategy and focus on all aspects of value creation within each GLC (Helmi *et al*, 2009). Lau and Tong (2008) indicated that in order for GLCs to contribute towards the country's economic development, GLCs need to position their role in creating firm value and it is not a barrier to have several goals in the GLCs' drive to create firm value. Besides, the launch of the GLC Transformation programme comprises a subset of broader national development strategies that include the principles of growth with equity, improving total factor productivity, the development of human capital, and the development of the Bumiputera community (PCG, 2007). Under this programme, each GLC has to develop value creation based on its own capabilities. Given this scenario, it is evident that value creation in GLCs is still inadequate and in order to ensure greater success, it is very important for GLCs to create their value within the organization and to create a custom strategy with its capabilities, which would then contribute towards value creation.

For example, Khazanah creates value through strategic investment. Khazanah's main objective is to play a more active role in promoting economic growth and make strategic investments on behalf of the Government. Their vision is to be the leading strategic investment house and their role as an active and strategic investor involves driving and creating greater shareholder and strategic value for the nation. Along with a vision, Khazanah's long-term plan is to create sustainable value for a globally competitive Malaysia (Khazanah, 2012). This indicates that the importance of having value creation in GLCs and the need of a clearly defined strategy formation for executing their short and long-term plans to achieve the goals.

There are several ways that GLCs could create value by formulating and executing a strategy, for example via product differentiation, focus strategy, marketing strategy and lowering costs through production and efficiency (Kasali, 2010; Orsato, 2006; Reinhardt, 1999). The differentiation strategy focuses on providing products that are perceived by customers to be unique. This is possible by offering superior quality, customer service and brand image. The sources of this advantage could be brand loyalty, product design, after-sales services and retail facilities differentiation (Cinquini & Tenucci, 2010). Meanwhile focus strategy implies competing in a specific market segment through either cost leadership or differentiation (Cinquini & Tenucci, 2010).

However, before the execution of any strategic choice, GLCs need to consider the relevance and risk of each strategy by formulating a well-planned strategy formation before implementing the strategy. With strategy formation capability, each strategy would go through a process that leads to strategic behaviour and competitive advantage (Petterson & Oun 2012; Teece *et al*., 1997), which covers both strategy formulation and action. The strategy formation capability allows each strategy to go through a process of identifying the mission and goals, situational analysis, comprehensiveness of alternative evaluation, and strategy formation process (Slater *et al.*, 2006). This process helps GLCs in positioning, planning, analysing and evaluating their organizational purpose, scope of market activities, and competitive distinctiveness before the execution of a strategy.

Therefore, with the strategy formation capability, GLCs are able to create economic and shareholder value through improved performance and reputation. Besides that, GLCs are expected to engage in managing other valid stakeholder interests, in particular those of employees, customers, suppliers and the Government itself, as regulators and policy makers.

6. CONCLUSION

This paper has reviewed the extant literature related to strategy formation capability and value creation, and has argued that most of what is known about the relationship between strategy formation capability and value creation. Building on this, the research found that strategy formation capability is an important element among the firm's critical success factors within and outside the organization for the short term and long-term period. The success of strategy formation is reflected in the top management's capability to improve performance and value creation, which then helps the company to achieve competitive advantage. Besides this, empirical review helps the GLCs' top management to plan and review their strategies in order to be effective managers and be liable when managing public funds in order to achieve sustainable growth and improve Malaysia's competitiveness in the global market. As for researchers, there is a need for further empirical research on diffusion, implementation and usefulness of possessing the capability to form the company's strategies. Extensive research is needed to identify other elements involved in value creation and allow firms to pursue competitive advantage in a global market. Nevertheless, additional stakeholders, capabilities, values, and market conditions also need to be studied.

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