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THE IMPORTANCE OF STRATEGIC ANALYSIS IN INVESTMENT APPRAISAL

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ABSTRACT

The investment of a company allows the creation of shareholder value, so an adequate analysis of all factors that may interfere with its viability is relevant. For the evaluation of a given project, financial criteria and non-financial criteria should be used. Here we highlight the importance of the strategic aspects for the investment decision and highlight the importance of the synergies and the consistency with the strategic objectives of the company. We also present the main strategic risks and how to minimize them.

INTRODUCTION

A company can choose, strategically, one of three situations: to buy competences, capacities and resources; outsourcing (allows flexibility and speed); develop those skills internally (allows for secrecy, exclusivity and surprise). If the company chooses the latter way, it will have to implement investment projects that allow it to reach such objectives.

The strategy defined for a project should lead the company to the objectives outlined. In strategic terms, a project must result from the play of the threats and opportunities of the environment and the company's strengths and weaknesses (Goll and Sambharya, 1998). This analysis makes it possible to clarify issues, identify preferred and likely courses of action, and to carry out a general and rapid analysis of the potential, i.e. to help us better understand the project. It also seeks to help the actors to know what they are getting involved in and why. Therefore, an analysis of external conditions and internal conditions should be carried out to analyse the feasibility of the project, particularly in the medium and long term (Pettinger, 2003).

This paper is organized as follows. Then, we present a discussion of the topic. The following section is about the strategic risk factors. Then, we can analyse the main procedures for minimizing strategic risks. In the following section we propose to understand how companies have perceived the importance of this topic and how they act when they make investment decisions. At the end we present the conclusion.

FRAMEWORK

In this dimension, the approach to be taken should encompass the evaluation of three aspects that allow an integrated vision of the project in the company: strategy, synergy and risk.

As for the strategy, since the projects are a way to implement the company strategy, its objectives must be directly related to the strategic objectives of the company (Kenny, 2003). Several authors point out that investments must be consistent with and consistent with the company's overall corporate and functional objectives in both the short and long term (Shenhar et al., 2001; Tayles and Drury, 2001).

Since a project must be consistent with the company's strategy, only those that are critical to the company's development should be adopted (WheelWright and Clark, 1992). Lefley (1996) points out that the evaluation of projects must be made in the light of the strategic business culture, and strategic alignment of projects is essential (Turner et al., 2000). White and Fortune (2002) point out the need to integrate the project into the company and to verify the project's consequences for the company's business performance. Thus, a project may be appropriate for one company and not for another (Lopes and Flavell, 1998).

Keegan and Turner (2000) and Walls (1995) argue that projects should combine synergies with the business of the company. Along the same lines, Lopes and Flavell (1998) emphasize the high importance of the project's compatibility with the existing activities in the company and the benefits of their combination. Thus, in a project, the activities should be focused on the business needs and the creation of competitive advantage for the company (Shenhar et al., 2001).

As for the project's risk level, Lopes and Flavell (1998) show that there should be concern about the project's specific risk level and the company's capacity to support it. From this perspective, it is important to ascertain the impact of the project on the overall risk of the company, as it may be preferable to carry out a number of small-scale projects with a low risk, instead of a large project with a high risk- the company.

STRATEGIC RISK FACTORS

Anderson and Merna (2003) report that an inappropriate or poor management of the project at the initial design stage creates unnecessary risks (deviations from the strategic objectives initially proposed), with inevitable consequences of poor performance. The alternative should be based on understanding and respect for project management and on the ability of project managers to assume their responsibilities.

Lopes and Flavell (1998) highlight the main strategic risk factors. First, the lack of an integrated vision of the business can lead to problems such as the underutilization of its resources and its better capabilities, as well as the duplication of some tasks, reflecting the company's performance. In effect, the company runs a serious risk of business fragmentation. On the other hand, the problems of non-synergies between the project and the other activities in the company may lead to incompatibility and inconsistency between business units. Another type of risk for the company is the concentration of risk, due to the fact of implementing a large project, when compared to the size of the company.

STRATEGIC RISK MINIMIZATION

As a way to address the risk of business fragmentation an integrated business vision must be created. The company must previously and clearly define concrete objectives and priorities and its strategy should be reviewed throughout the project review (Lopes and Flavell, 1998).

Concerning the risk of incompatibility, consistency should be sought between all the units involved and the choice of projects should be made taking into account the existence of at least some synergies in order to benefit from the knowledge and experience already gained (Lopes and Flavell, 1998).

In order to minimize ambiguities and conflicts during the implementation of a project, Ling and Lau (2002) highlight the importance of dividing a large and complex project into several small projects, for which the best specialists can be subcontracted to each of the areas develop. For Lopes and Flavell (1998) the company must be able to analyse its risk-bearing capabilities in order to control the inherent uncertainties. It is necessary to know the type of risks that the company is willing to support and, at the same time, to know clearly what types of projects the company is able to implement – it should only be done where the company is good.

It may also be important to diversify the source of risk. If the company diversifies risk across multiple areas (geographical, political, technical, etc.), it dilutes the concentration of risk and the likelihood of something going wrong.

ASSESSMENT OF STRATEGIC ASPECTS

For Lopes and Flavell (1998) the evaluation of strategic factors should be done as soon as possible and precede any other type of evaluation. The goal is not to waste resources in more advanced phases without major (initial) strategic decisions being resolved. Since these decisions are taken early in the life cycle of the project, it is important that, over time, revisions are made to the initial decisions, to adapt to the changing circumstances of the project. The assessment of strategic factors should be conducted by senior experts with a strong strategic vision and extensive experience in risk issues. On the other hand, all units of the company must be present in this analysis to ensure coordination and consistency of the project with the various areas of the company. It is therefore important that all departments are consulted in order to obtain prior feedback from the various experts in order to analyse all the details.

WheelWright and Clark (1992) add that it is not right or appropriate to assign only one department to single responsibility for starting all projects because it is generally not in a position to analyse the strategic importance of all projects.

STRATEGIC THINKING OF COMPANIES

The analysis of the strategic aspects in projects is relevant to perceive its limits, as well as the synergies of the project with the development of the business of the company that supports it.

In a field work for Portuguese companies, Moutinho and Lopes (2011a) found evidence that the strategic aspects of the projects are the most relevant factors in investment appraisal. These aspects seem even more relevant than the financial ones.

As in Kenny (2003), Cooke-Davies (2002) and Lopes and Flavell (1998), in a more detailed study, Moutinho e Lopes (2011b) show that the *contribution of the project to the company's strategic goals* is the most relevant characteristic in project valuation. The companies also carefully analyse the *impact on the company's global risk* and the *impact on future projects*. Alkaraan and Northcott (2006) also show that strategic issues are very important, being that the most relevant strategic criteria are those that are perceived as being related to financial results.

Regarding the importance attributed to the goals in the decision to proceed with the project, Moutinho e Lopes (2011b) show that the *development of company's current business*, the *exploring opportunities/strengths*, the *meeting the market's needs* and the *profit maximization* are the most important goals in the investment appraisal. These authors also point out that the most important strategic risk factors are the *use of new resources* and the *strategic complexity of the project*.

Moutinho and Lopes (2011b) also present a set of procedures used by Portuguese companies to minimize potential strategic risks. The main procedures identified are a *clear a priori definition of goals*, analysing *the capability to implement the project*, the *definition of priorities* and the *choice of projects with synergies*.

CONCLUSION

The strategic analysis in investment appraisal is fundamental as a way of understanding if the existing synergies with the company leverage the project.
In this paper it is analysed the relevance of the strategic aspects for the investment decision and it is clear that these issues are crucial in the decisions, which is explained by the risks associated with an inadequate analysis and with the procedures to minimize them.
In spite of the evidence found for the Portuguese companies, which praises the strategic factors, for future study it is suggested the analysis of the importance of these factors in companies from other countries.

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